



European Economic and Social Committee

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Investment services

Brussels, 18 June 2003

OPINION

of the European Economic and Social Committee

on the

Proposal for a Directive of the European Parliament and of the Council on investment services and regulated markets, and amending Council Directives 85/611/EEC and 93/6/EEC and European Parliament and Council Directive 2000/12/EC

COM(2002) 625 final - 2002/0269 (COD)

On 16 December 2002, the Council decided to consult the European Economic and Social Committee, under Article 262 of the Treaty establishing the European Community, on the

Proposal for a Directive of the European Parliament and of the Council on investment services and regulated markets, and amending Council Directives 85/611/EEC and 93/6/EEC and European Parliament and Council Directive 2000/12/EC

COM(2002) 625 final - 2002/0269 (COD).

The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 4 June 2003. The rapporteur was **Ms Böving**.

At its 400th plenary session on 18 and 19 June 2003 (meeting of 18 June), the European Economic and Social Committee adopted the following opinion, with 60 votes in favour, and one abstention:

1. **Gist of the Commission paper**

1.1 The Investment Services Directive (ISD), adopted in 1993, sought to establish the conditions in which authorised investment firms and banks could provide specified services in other Member States.

1.2 The existing directive no longer provides an effective framework for undertaking investment business on a cross-border basis in the EU.

- The ISD does not provide sufficient harmonisation to allow effective mutual recognition of investment firm licences.
- The ISD contains outdated investor protection disciplines.
- The ISD does not span the full range of investor-oriented services.
- The ISD does not address the regulatory and competitive issues that arise when exchanges start competing with each other and with new order-execution platforms.
- The ISD provides for an optional approach to the regulation of market structure.
- There is no uniform basis for cross-border cooperation.
- The existing provisions under the ISD are inflexible and outdated.

1.3 The aims of the new directive are: (i) the protection of investors and market integrity by establishing harmonised requirements governing the activities of authorised intermediaries and (ii) the promotion of fair, transparent, efficient and integrated financial markets. The directive seeks to create a regulatory framework in which obligations are tailored to the specific risk-profile of different market participants. The revised ISD is designed to facilitate the integration of secondary markets in financial instruments by harmonising rules for dealing with or on behalf of clients or for own account and promoting the transparent functioning of organised trading systems. Key elements of this include:

- rules harmonising the content and format of disclosure of relevant information by issuers;
- safeguarding market integrity, preventing market abuse;
- allowing collective investment schemes to exploit single market freedoms;
- promoting efficient and competitive clearing and settlement of cross-border trades.

2. Details of the proposal

2.1 An efficient, transparent and integrated financial trading infrastructure

2.1.1 Where integrated broker-dealers are involved, clients need to be particularly confident that the action taken is in their best interests. For that reason, the draft provides for special investor protection in the area of internalisation.

2.1.2 The aim is to define the rules of the game so that order-execution is undertaken in a way which serves investor interests and the overall efficiency of the financial system.

2.1.3 Risks to investor protection and market efficiency must be eliminated. That requires the introduction of a package of measures to ensure that the dispersal of trading across multiple marketplaces and through diverse trading channels does not fragment liquidity and prevent market participants from identifying mutually advantageous potential trades. At the heart of this package is an effective transparency regime which seeks to ensure that appropriate information regarding the terms of recent trades and current opportunities to trade at all marketplaces, trading facilities and other trade-execution points is made available to market participants on an EU wide-basis.

2.1.4 There should be as little restriction on competition and innovation as possible. Differences in regulatory treatment should not undermine the ability of institutions/exchanges operating subject to a particular regulatory regime.

2.1.5 The directive seeks to establish a coherent and risk-sensitive framework for regulating the main types of order-execution arrangement, including:

- regulatory interventions to contend with the specific investor protection and market efficiency risks; and
- competitive and regulatory interactions that arise when different trading platforms and methods exist alongside each other but are subject to different permutations of the market and investor-facing regulation.

2.1.6 To do that, a comprehensive set of rules is needed, requiring transparency of trading information. These transparency obligations aim to allow the effective, real-time, cross-border interaction of trading interests. However, the degree of transparency required will vary.

2.1.7 The directive seeks to ensure that off-exchange execution of client orders takes place only where it can be demonstrated to be in the best interests of the client. Investment firms will be forced to undertake a regular assessment of which execution venues offer the most favourable terms for transactions.

2.1.8 The status and authorisation regime for regulated markets are preserved. The proposal seeks to establish a common set of high-level principles for the authorisation, regulation and supervision of regulated markets so as to:

- identify the competent authority and applicable law;
- introduce requirements relating to the operator of the market;
- establish comprehensive pre- and post-trade transparency obligations.

2.1.9 The proposal establishes principles under which a “regulated market” can admit instruments to trading on its systems, while allowing the detailed implementing measures that are to give effect to these principles to be developed at level 2. Each regulated market must implement admission requirements, which have received prior public approval and which aim to ensure the free negotiability and effective settlement of instruments. These include:

- the introduction of a new core ISD service relating to the operation of an MTF: this will allow entities operating such systems to be authorised as an investment firm subject to a customised regulatory regime;
- organisational requirements for MTF;
- pre- and post-trade transparency obligations in respect of equity transactions concluded on MTFs;
- waiver from agency obligations for transactions concluded on MTFs.

2.1.10 The proposal envisages a systematic obligation incumbent on investment firms when they execute transactions outside the rules and systems of a regulated market or MTF. It is proposed to:

- introduce a new self-standing provision on conflict of interests;
- reinforce “best execution” obligations;
- establish client order-handling rules;
- introduce post-trade transparency obligations, under which investment firms concluding trades in equity instruments are required to disclose publicly, as close to real-time as possible, the price and volume of completed trades;
- introduce pre-trade transparency obligations for investment firms in the form of a client limit order display rule and a quote disclosure rule for retail-size orders in shares;
- confine mandatory quote disclosure to retail-size transactions in highly liquid equities.

2.2 Investor protection and the investment firm regime

2.2.1 The initial authorisation and operating conditions for investment firms are to be harmonised.

2.2.2 The proposal envisages a far-reaching modernisation and reinforcement of the obligations that investment firms must comply with:

- Compliance with the prescribed and ongoing capital requirements is a pre-condition for authorisation and operation as an investment firm. Investment firms which provide only the service of investment advice are exempted from obligation under the Capital Adequacy Directive.
- Investment firms are to be obliged to, first, identify conflicts of interest that arise in their business activities and then to prevent those conflicts of interest from adversely affecting the interests of clients, and to establish organisational and administrative arrangements which allow them to manage these conflicts of interest in such a way that the interests of clients are not adversely affected.

2.3 Conduct of business rules when providing services to clients

2.3.1 Implementation of the present provisions has been hampered by a lack of clarity as to interpretation of the main operational concepts and ambiguity as regards the role of home and host authorities in enforcing these obligations. The directive provides for clear and legally binding guidance on the implementation of the broad principles.

2.3.2 A key feature of the directive is to establish a separate provision governing the “best execution” obligations of brokers/broker-dealers.

- All investment firms acting on behalf of clients are obliged to exercise due diligence to ensure that the order is executed in the conditions that are most favourable to the client.
- Investment firms must indicate that they have undertaken reasonable endeavours to obtain “best execution” on behalf of their clients. The conditions are laid down under which this obligation is deemed to be met.
- Investment firms are obliged to regularly review the procedures they operate so as to obtain “best execution” on behalf of their clients.
- Client order handling rules provide that investors should be fully aware of different channels through which their order may be executed.

2.4 The scope of the directive is to be expanded to integrate some investor-facing activities or dealing activities that are financial in character, that are widely offered to clients, and/or

that give rise to investor or market-facing risks. Investment advice is to be recognised as an autonomous and increasingly important financial business in its own right. It should not be subject to unjustified or over-onerous regulatory demands. Financial analysis must be subject to high professional and ethical standards. Commodity derivatives are included in the directive. The definition of commodity derivatives includes certain futures contracts traded on regulated markets which are physically settled where those contracts possess the characteristics of financial instruments.

2.5 Other key features

The directive confines its treatment of clearing and settlement to clarification of the rights of the investment firm and regulated market populations in terms of access to/choice of clearing and settlement facilities located in other Member States.

3. General comments

3.1 ISD revision is vital for the investment business. A new directive is undoubtedly needed. In principle, therefore, the draft directive is to be welcomed. The Committee is also particularly pleased that the draft seeks to secure the protection of investors and market integrity. However, necessary investor protection must not lead to monopolisation, which in practice puts an end to free and independent investment advice, and the rules should not go beyond what is required to secure the necessary degree of client protection and at the same time maintain competitiveness.

4. Specific comments

4.1 The draft's proposals on internalisation are moving in the right direction. However, it must be borne in mind that order internalisation withdraws liquidity from the regulated markets (stock exchanges). Although internalisation systems use the prices determined on a regulated market (stock exchange prices) and "import" them as reference prices into their own system (price-taking), they do not contribute to subsequent price development as they do not place their buying and selling orders on the regulated market. For that reason, it makes sense to oblige systematic internalisers to act as "market makers" on the respective reference market and thus pay a "liquidity contribution". This liquidity contribution should cover those securities that are part of the internalisation system.

4.2 The Committee welcomes the supervisory provisions set out in the draft directive for competition between exchanges, multilateral trading facilities and internalisation systems. The Committee also endorses the basic imposition of more stringent transparency obligations. The rules on pre-trade transparency obligations should, however, be clarified and fleshed out further, since, on such a key issue as this, a final decision should, as far as possible, be reached at level 1.

4.3 The Committee is pleased that the draft directive includes investment advice as an investment service in its own right. This underscores particularly clearly the distinction between advice and non-advisory investment services. Accordingly, in the absence of any contractually agreed advisory relationship, the obligations of the investment firm should remain confined to providing all

the relevant information commensurate with the customer's professional status. It is desirable to have an explicit provision for "execution-only" transactions so as to ensure that these well-established transactions continue to be possible in the future too.

4.4 In contrast to the proposal, most Member States do not distinguish between professional and non-professional customers. The classification should therefore also reflect, as far as practicable, the customer's personal knowledge and experience of the investment business and his or her individual needs. Across-the-board inventory protection is needed for existing customer contacts.

4.5 It must also be permitted to provide the relevant information required under Article 18 in standardised form.

4.6 It would be desirable to tie the authorisation to issue technical implementing measures for the conduct of business rules (Article 18(9)) to the prior performance of a cost-benefit analysis. Such an analysis was also called for by the European Parliament.

4.7 The Committee welcomes in principle the proposals for the best execution of client orders. The relevant Article 19(1) of the draft directive should however merely be a general provision laying down the basic meaning of "best execution." Article 19(2) would then set out the specific obligations relating to conduct and organisation, requiring each investment firm to keep appropriate technical and organisational arrangements in place to secure best execution.

4.8 With regard to best execution, a distinction should be made between the different types of transaction. The rule should only be applied where orders are not executed through a regulated market. In that case, proof would be required that off-exchange execution was under no circumstances being conducted at a price less favourable than the exchange price. Moreover, for best execution, investment firms must be granted some degree of latitude, and the possibility of reaching appropriate contractual agreements with the client in advance regarding the method of execution normally to be used.

4.9 Under the committee procedure, the technical implementing provisions should reflect the kind of service provided, the type of financial instruments and the differing business structures of the investment firms. The Committee therefore proposes expanding Article 16(4)(a) so that, with regard to the type of measures to be taken by the investment firm, consideration must also be given to whether such a firm is regularly involved in conflicts of interest, or only in individual cases.

4.10 The technical implementing measures must be based on the model of a farsighted, well-informed customer who is in a position to take independent economic decisions on his or her own authority.

4.11 The limit orders that cannot be executed should be routed onto the regulated market.

4.12 Regulating the clearing and settlement systems is a live issue, and care should be taken not to pre-empt the outcome of this discussion.

4.13 In order to avoid subjecting investment brokers, particularly small and medium-sized enterprises, to unjustified, excessive requirements, the Directive should not apply to firms which merely receive and pass on orders for shares in collective investment undertakings, without holding their customers' money, and which therefore cannot at any time enter into a debtor relationship vis-à-vis their customers.

Brussels, 18 June 2003.

The President
of the
European Economic and Social Committee

The Secretary-General
of the
European Economic and Social Committee

Roger Briesch

Patrick Venturini
