

Investment Services Directive (“ISD2”), now called Financial Instruments Markets Directive: Articles 4.1.7 and 27

A briefing paper by associations representing investment firms

SUMMARY

This briefing paper aims to provide a **brief explanation of the complex issues surrounding Articles 4.1.7 and 27 of the Council’s Common Position** on the proposed revised **Investment Services Directive** (now called the **Financial Instruments Markets Directive**). Article 27 concerns the obligation for ‘systematic internalisers’ (defined in Article 4.1.7) to publish quotes, and to deal against them.

We fear that the **Council’s Common Position would not provide as sound a basis for the effective regulation and development of a single integrated European securities market as the Parliament’s proposed amendments**. On a number of key Articles, including especially Articles 4.1.7 and 27, we therefore greatly prefer the Parliament’s proposed amendments.

We consider that **Amendments 7, 13, 14, 15, 16, and 17 proposed in the draft Recommendation for second reading by the European Parliament provide appropriate, technically workable solutions to remedy the problems in Articles 4.1.7 and 27 of the Common Position**.

The rest of this briefing paper is divided into 4 sections, of 1 page each, as follows:

SECTION I. ISD2 Articles 4.1.7 and 27: What are the main differences between the Commission Proposal, Parliament and Council amendments?

SECTION II. Why would the ISD2 Council text of Articles 4.1.7 and 27 be bad for European investors and markets, and what is the best way to remedy its defects?

SECTION III. In what respects does the Council text of Articles 4.1.7 and 27 impose excessive burdens and risks on investors and firms?

SECTION IV. How much harm could be done to European markets and the European economy?

We would be pleased to provide further explanation if it would be helpful.

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SECTION I. ISD2 Articles 4.1.7 and 27: What are the main differences between the Commission Proposal, Parliament and Council amendments?

Commission Proposal	Parliament amendments would retain the broad structure of the Commission Proposal, but:	Council common position changes the Commission Proposal much more extensively, though it has a similarly broad catchment:
required <i>any firm authorised to deal on own account</i> ,	narrow the obligation to publish quotes to 'systematic internalisation' : firms systematically, regularly, and continuously executing orders up to 'standard market size' within a system aimed at facilitating 'systematic internalisation', outside the rules or systems of a regulated market or MTF,	slightly narrows the obligation to publish quotes, to 'systematic internalisers' (different definition from Parliament) : firm dealing on own account on an 'organised, regular, and systematic basis' to execute client orders up to a 'size which is large in scale compared to normal market size' outside a regulated market or MTF;
to publish firm bid and offer prices in retail size,	set the quote size at 'standard market size' ,	does not specify a quote size, but could expose firms to a quote obligation at unworkably large size ;
and trade with other firms and eligible counterparties,	restrict the dealing obligation to the firm's own systematic internalisation clients , subject to objective, non-discriminatory commercial criteria for admitting new clients,	makes some provision for firms to restrict dealing access to the quotes 'in a non-discriminatory way' ;
at the published prices,	require firms to deal with systematic internalisation clients at the quoted price or better (though with some restrictions on retail price improvement) ,	requires firms to deal at the published prices with retail clients , and restricts their ability to provide professional clients with better prices than those quoted,
		applies the same price restrictions to all of the firm's off-exchange dealing, and not just the trades it executes by dealing against the quotes ;
subject to <i>exceptions for legitimate commercial considerations, illiquid shares, or if the firm was not an important provider of liquidity</i> .	broadly retain the exceptions in the Commission's Proposal.	retains some commercial considerations exceptions , but makes new provisions on quotes on request for illiquid shares, and eliminates the exception for firms which are not an important provider of liquidity.
<i>Comitology would cover retail size, illiquid shares, when a firm was not an important provider of liquidity, and quote publication methods.</i>	Comitology broadly as in the Commission Proposal , except that it ensures that 'standard market size' is defined at a level that takes account of market conditions and does not expose firms to excessive risk.	radically extends comitology to cover criteria for all aspects of Article 27, except for the restrictions on price improvement for professional customers.

SECTION II. Why would the ISD2 Council text of Articles 4.1.7 and 27 be bad for European investors and markets, and what is the best way to remedy its defects?

Council common position	Remedy needed
<p>Is incoherent, ambiguous, or internally inconsistent. Obligations on firms would not be workable:</p> <ul style="list-style-type: none"> ▪ 'Systematic internaliser' defined very broadly: so that all a firm's regular off-exchange dealing for clients is covered; ▪ quoting obligation is vague, but could compel firms to quote in prohibitively large size; ▪ dealing restrictions could apply not just to dealing against quotes, but to broadly defined 'systematic internalisation' (i.e. most off-exchange dealing) as well. 	<p>A coherent and workable text, based on a clear policy intention of what Article 27 is trying to achieve and not imposing on firms commercially unacceptable risk. Amendments 7, 13, 14, 15, 16, and 17 would achieve this, even though they would apply Article 27 obligations more widely than is necessary or desirable.</p>
<p>Much too detailed, complex and prescriptive for a Level 1 Directive text.</p>	<p>Not remediable at this late stage, but amendments must at least be made to avoid damaging restrictions on almost the whole market. Amendments 7, 13, 14, 15, 16, and 17 would achieve this.</p>
<p>Relies too heavily on comitology to remove ambiguity and make its meaning clear.</p>	<p>Cut back comitology, as in Amendment 17</p>
<p>Actively limits firms' ability to comply with best execution obligations by restricting firms' ability to improve prices to give clients the best reasonably achievable off-exchange price.</p>	<p>No constraints on firms' ability to obtain best execution for clients. Price improvement is a vital element of this flexibility, as provided by Amendment 14</p>
<p>Actively discriminates against retail customers by denying them the ability to get better prices than those quoted, and effectively forcing retail investment on-exchange (as at present occurs under voluntary concentration rules).</p>	<p>No bias in favour of regulated markets/ MTFs; No constraints on retail clients' ability to seek a better deal from firms than the published quote. Though not ideal, Amendment 14 would improve the position of retail clients.</p>
<p>Prevents firms responding flexibly to use their capital to meet investors' needs, and forces them to use a more limited range of execution methods that will not correspond to the range of services that investors demand.</p>	<p>No constraints on firms' ability to negotiate terms of transaction with clients to enable the firm to provide the service that best meets the client's needs. Amendment 14 would solve many of the common position's problems.</p>
<p>Exposes firms to greater risk and cost by forcing them to quote in advance the terms on which they can provide investors with liquidity.</p>	<p>Obligations relating only to what firms do through their systematic internalisation system, as in Amendments 7, 13, 14, 15, 16, and 17.</p>
<p>The greater risk and cost would make firms less willing to use their capital to get a better deal for clients. Consequences would include:</p> <ul style="list-style-type: none"> ▪ Spreads would widen (OC&C report) ▪ Firms would withdraw partially or wholly from off-exchange liquidity provision (OC&C report); that liquidity would not necessarily move on-exchange ▪ Remaining liquidity would be concentrated on exchanges (this could be reinforced by Member States' ability under Article 22.2 to require unexecuted limit orders to be routed to a regulated market or MTF) ▪ European markets would become less competitive ▪ European markets would become less attractive to worldwide investors, causing a general withdrawal of liquidity to less restrictive, more competitive, better regulated markets elsewhere in the world. Once liquidity had moved, it would be difficult or impossible to recapture. 	<p>Amendments 7, 13, 14, 15, 16, and 17 would reduce or eliminate the risk that these consequences might occur.</p>

SECTION III. In what respects does the Council common position text of Articles 4.1.7 and 27 impose excessive burdens and risks on investors and firms?

The Council text subjects dealers that provide liquidity to their clients to requirements that are similar to, or even go beyond, the requirements that apply to exchanges. This attempt to 'level the playing field' ignores the fact that exchanges and investment firms provide fundamentally different services to investors, and are subject to fundamentally different risks. Subjecting investment firms to exchange-like regulation is likely to deny clients the variety of services they seek from firms, and to expose the firms to risks that would make off-exchange liquidity provision commercially unviable.

An **exchange** is a **platform for the riskless matching of investors' individual orders**. Exchanges do not put their capital at the disposal of investors to meet their dealing needs. In contrast, **dealers put their own capital at the disposal of their customers to execute the customers' needs**. When doing so, dealers must balance their commercial reluctance to put their capital at risk against their commercial need to provide good service to their customers.

When do transactions take place on exchange? – almost all share transactions are eventually executed on exchange (OC&C report). This is because exchanges are the main pool of liquidity in shares, and provide the widest publication of and access to trading interest. Intermediaries mediate between the investor and the exchange. Depending on the size and nature of the order, and in compliance with the best execution obligation, the intermediary may execute it directly on the exchange, or execute it against its own book. If the latter, the firm usually unwinds the position as soon as commercially feasible on the exchange, because of the risk of holding a position.

Why do small customers go to dealers rather than seek on-exchange execution? – for immediate execution, particularly in illiquid markets; lower dealing costs; better prices; ease of execution of cross-border business (it is easier and cheaper for the dealer to accumulate orders and execute them as a block than route each order individually to foreign exchange).

Why do large customers go to dealers rather than seek on-exchange execution? – for immediate execution and protection from adverse price movements (the dealer takes on the risk of executing the order in the market over time); to negotiate non-standard terms; to execute complex transactions, such as programme trades (a series of trades that require simultaneous execution) or VWAP trades (a series of trades executed to achieve an average price over the course of the day).

How does a bid and offer quote differ from the best bid and offer on an order book? – The **quote** is an **advertisement** to which anyone who has dealing access can respond. The **best bid and offer** each represent a **single order**. When a single order is hit, the person who placed it has no further liability. By contrast, a quote can be hit repeatedly. So a public quote is more risky than a single order. To protect against this risk, quoted spreads tend to be wider than the best bid and offer, although the need to compete for customer business puts a tight commercial limit on their width. Because it is very difficult if not impossible for a dealer continuously to match the best bid and offer, the dealer must be able to improve on its quoted prices if it is to provide best execution without being forced to execute on-exchange.

How would the Council text limit the services that firms could provide to investors?

1 **The definition of 'systematic internalisation'** is very broad. So effectively all firms that routinely provide off-exchange dealing services in below block size could be subject to the risks of the quote obligation (see previous para

2 **The possible obligation to quote in very large size, restrictions on withdrawal of quotes, non-discrimination conditions on control of multiple transactions, and limitations on price improvement**, would all increase the risk and reduce the commercial viability of making quotes. But because Article 27 would mean that 'systematic internalisers', broadly defined, could not deal without also quoting, its effect would be to deter off-exchange liquidity provision. Competition would be inhibited. Investors would be forced to rely on less flexible on-exchange execution. In effect Article 27 would be imposing a de facto concentration rule on all Member States, whereas the existing ISD permits each Member State to choose whether it wishes to opt into the concentration provision.

3 **The restrictions on price improvement would apply to all client orders** (except professionals' programme trades and orders subject to non-price conditions), not just to orders that respond to Article 27 quotes. So for all retail and much professional business firms would be constrained from providing the services that their customers demand.

SECTION IV. How much harm could be done to EU markets and the EU economy?

Accurate prediction of how much harm the Council's text would do is very difficult, partly because it is so ambiguous and open to different interpretations, and partly because key elements have no parallels in other major financial markets. However, it is possible to draw some quantitative conclusions from "The Potential Impacts of ISD Article 25", an August 2003 study by OC&C Strategy Consultants, and by examining its conclusions in the light of the European-Commission-sponsored London Economics study, published in November 2002.

The London Economics study

London Economics forecast that the integration of European markets would yield a 1.1% per annum growth in real GDP. A major element of the forecast extra growth was caused by the expected reduction in cost of capital, itself made possible by reduced trading costs in the integrated market. The London Economics study (published before the ISD2 Proposal) assumed that liquidity in integrated European markets would remain unchanged. However, for the reasons set out in the previous pages, a wide-ranging Article 27 will impose significant risks and costs on investors and firms that would **reduce liquidity** in European markets. It is these risks and costs that the OC&C report deals with.

The OC&C study

OC&C based its study mainly on the Commission's original Proposal. However, it also identified elements of the draft Council texts (some adopted in the common position) that would worsen the harm. OC&C identified two key consequences of the risks to which Article 27 as proposed would expose firms:

- Widening of spreads, as firms seek to protect themselves against the risk of being exploited by other market participants because of having to quote and trade at firm prices if they want to trade on a principal basis. OC&C estimated the cost to investors at €300 million per annum, with a 10% widening of spreads for retail investors.
- Total withdrawal of dealer-provided liquidity, most likely in the shares of smaller companies, if firms decided that the risk was too great to justify providing off-exchange execution. OC&C estimated the cost to investors at a further €75 million per annum.

OC&C identified that these costs would worsen, perhaps substantially, because of factors such as having to make a quote up to very large size, as in the Council text, as well as new restrictions such as limits on firms' ability to withdraw quotes except in extreme market conditions. This detriment could be diminished if firms were able to limit their risk exposure, for example by withdrawing quotes because of internal constraints (such as compliance with regulatory capital obligations, as in the Parliament's text), or to control the flow of business by being able to decline multiple hits at the quoted prices more widely than in the Council text, which allows firms to do so only in relation to each client. But the Council text severely constrains firms' freedom to do so.

OC&C also cast doubt on the proposition that off-exchange execution by firms is detrimental. Firms perform a valuable intermediation role between investors and exchanges: by 'aggregating' retail orders (which reduces costs); by smoothing large orders into the market (which reduces 'market impact' and volatility); by providing investors with the ability to do large trades at an immediate price (which helps to stimulate trading). In addition, most 'off-exchange' trading eventually finds its way onto the exchange (see Section III, para 3 above). OC&C estimated that only about 14% of total traded value is genuinely 'internalised'— in a way which means it is done completely off-exchange. OC&C thus concluded that the fear of 'market fragmentation' in European markets is exaggerated.

Possible consequences for European growth

Proponents of a wide-ranging Article 27 have asserted, from a theoretical standpoint, that broad pre-trade transparency is necessary to improve price formation. OC&C's study, in contrast, estimates the likely quantitative effects of an Article 27 obligation. Consistently with other recent independent research (such as the report by the Centre for European Policy Studies), it shows that too much pre-trade transparency can reduce liquidity, which will in turn worsen prices and drive up investors' costs. Medium-sized companies could be hit particularly hard.

Moreover, the OC&C conclusions provide evidence that London Economics's forecast increase in European growth could be significantly reduced by the extra cost of capital that this reduced liquidity would cause, unless Article 27 is amended so that it does not reduce liquidity in European equity markets. OC&C's estimates of increased trading costs from an inappropriately restrictive Article 27 could, using London Economics's methodology, cut its forecast of increased growth by 10% to 15%, or even more.

The improvements to the Council text suggested in Section II above would avert most of these unnecessary increases in trading costs, without harming the quality or competitiveness of European markets. Amendments 7, 13, 14, 15, 16, and 17, while not removing the risks, would diminish them significantly.