

Towards Efficient and Integrated European Financial Markets

An Action Plan for the Wholesale Sector

It has become a truism to argue that Europe needs a single capital market to underpin its single currency. European Councils have repeatedly called for action in this area. Cardiff in June 1998 noted the importance of financial services to the process of economic reform, competitiveness, growth and job creation and asked the Commission to table a framework for action. Cardiff also noted the importance of efficient capital markets to the supply of much needed "Risk Capital". The Cologne summit a year later endorsed the subsequent Action Plan for financial services produced by the Commission in conjunction with the new high level Financial Services Policy Group. The Action Plan contained a welcome focus on moving towards "a single EU wholesale market" in what it called "Strategic Objective 1". It noted that meeting the timetable for action it prescribed would

- *enable corporate issuers to raise finance on competitive terms on an EU-wide basis*
- *provide investors and intermediaries with access to all markets from single point of entry*
- *allow investment service providers to offer their services on a cross-border basis without encountering unnecessary hindrances or administrative or legal barriers*
- *establish a sound and well integrated prudential framework within which asset managers can put funds at their disposal to their most productive use*
- *Create a climate of legal certainty so securities trades and settlement are safe from unnecessary counterparty risk.*

From an industry perspective, we wholeheartedly endorse this vision. As we argue below, we furthermore think it rapidly attainable in a relatively short timescale.

We also welcome the more recent political support for a single capital market given at the Helsinki European Council, which endorsed the Commission Communication on a Strategy for the Internal market, and at the Special Lisbon summit on economic reform, which reinforced the political imperative of efficient and integrated capital markets by calling for the full implementation of the Financial Services and Risk Capital Action Plans. Under Strategic Objective 2: To Enhance the Efficiency of Community Product and Capital Markets, the Commission paper on the Internal Market argued

"Financial services represent a key sector, which is expanding and changing profoundly and which will significantly contribute towards making the Internal Market a reality for consumers and industry. The benefits to financial services of the introduction of the Euro in terms of greater transparency and greater facility to trade across frontiers need to be reinforced by a concerted effort to give consumers access to a greater choice of competitive retail financial services products in which consumers can trust, to give industry (especially SMEs) easier access to a single deep and liquid market for investment capital and to ensure the continued

stability of financial markets. Implementation of the May 1999 Financial Services Action Plan, which specifically centres on these issues, will be an important element in the overall Internal Market Strategy.”

Again, as organisations representing both the suppliers and consumers of wholesale financial services we endorse the Commission’s position. We collectively represent exchanges, dealers, end users and other participants at the more sophisticated end of the financial spectrum and we have similarly consistently supported action to remove obstacles to cross border wholesale securities activity in the European Union. The advent of the Euro has reinforced the international nature of Europe’s wholesale capital markets – from a practitioner perspective, European primary markets and secondary market trading should by now be borderless. E-commerce now certainly allows participants to trade in markets and products from wherever they choose. Market infrastructure is already adapting to this new environment. Recent developments in terms of consolidation of firms and of linkages and mergers between exchanges are evidence of the force of that market pressure.

We believe it is now time for regulators too to respond constructively. The positive steps being taken to facilitate the development of e-commerce in Europe are encouraging – particularly the recognition that regulation can only effectively take place on a country of origin basis. But we find it disappointing that the regulation of the highly international, interprofessional financial markets we represent continues to be handled at a national level and lags significantly behind the market. Regulatory obstacles to an integrated European capital market remain in place despite all the recent political statements in favour of reviewing them. The creation of a single wholesale market is one of the priorities of the Financial Services Action Plan discussed above. It is striking that little progress has yet been made in this direction.

We would suggest that progress could be made relatively quickly in the following areas.

1. **The regulation of cross-border wholesale business can and should be on a country of origin basis.**

Problem: EU banks and investment firms conducting cross-border business with counterparties in other Member States continue to face overlapping and possibly conflicting conduct of business and marketing rules imposed by both the Member State from which they are conducting their business and the Member State in which the counterparty is located. This is the case even when they are conducting business with other professional or sophisticated counterparties. This creates barriers to cross-border wholesale business that impede the development of the single market. It is also inconsistent with the proposed E-commerce Directive, which enshrines a country of origin approach to the regulation of cross-border information society services, including financial services.

Action required: The only acceptable way forward is to recognise the logic that the Member State from which a firm conducts its cross-border business with professional and sophisticated counterparties is best placed to implement the relevant rules of conduct and marketing restrictions and to supervise them:

- As a first step, the Commission should issue a Communication making clear the Investment Services Directive (ISD) and the Treaty impose significant limits on the extent to which Member States can impose their rules on cross-border business with professional and other

sophisticated counterparties. The Commission should take action against Member States that impose inappropriate obstacles to the conduct of cross-border business with local professional and sophisticated counterparties. **This was a priority 1 item in the Action Plan with a deadline for end 1999. Action on the ISD was also a Lisbon priority issue. No action has yet been taken, although the Forum of European Securities Commissions (FESCO) suggested a common definition of professional investor in March 2000. Rapid Commission action with the support of Member States is now needed.**

- As a second step, the EU should amend the ISD (and the Second Banking Co-ordination Directive) to make clear that Member States cannot impose their conduct of business and marketing rules on firms conducting cross-border business with local investors or counterparties unless the investor or counterparty is an unsophisticated individual consumer.

2. **National regulations should differentiate between professional and non-professional investors**

Problem: The rules of conduct and marketing restrictions imposed by a number of Member States do not adequately differentiate between the treatment of wholesale and retail business. This results in the imposition of unnecessary and inappropriately burdensome regulation on banks and investment firms participating in wholesale markets business. It is also inconsistent with the ISD which requires that rules take into account the professional nature of the person to whom the service is provided. The initiative of FESCO to develop common standards for the categorisation of investors as "professionals" is welcome. However, it does not go far enough, in particular as it suggests that Member States can continue to impose full retail conduct of business rules on business with all large and institutional investors who do not opt to waive the protection of those rules and that implementation of its proposals should await full harmonisation of the conduct of business rules.

Action required: The Commission should issue a Communication making clear that Member States are required to ensure that the full range of their rules, including on solicitation and advertising, differentiate between sophisticated and retail investors. In particular, firms should only be required to provide an intermediate level of protection where sophisticated counterparties, such as large corporates, do not elect to be treated as full professional counterparts. The Commission should take action against Member States disregarding their obligations. **As noted above, a Commission Communication on professional investors is overdue.**

3. **EU wholesale markets should be open**

Problem: Wholesale markets are now global markets. Participants need to be able to deal cross-border with all major players worldwide in those markets. However, the laws of many Member States do not address in any satisfactory way the issue of when third country firms, including the non-EU affiliates of EU banks and investment firms, can deal cross-border with local professional and sophisticated investors and counterparties. This creates barriers to the

integration of EU markets with international markets to the detriment of EU users of financial services.

Action required: Member States should amend their laws to make clear that third country firms are not subject to local licensing requirements when they deal cross-border with local professional or sophisticated counterparties. At the very least, third country firms should not be subject to local licensing requirements when they deal cross-border with local counterparties through the agency of a properly licensed EU bank or investment firm.

4. It should be easier for corporates to raise capital on an EU basis.

Cross-border institutional placements

Problem: Notwithstanding the Public Offers Directive, Member States adopt differing approaches to when exemptions from prospectus requirements are available, even for placements with professional or other sophisticated investors. In addition, some Member States impose filing, approval or other requirements or restrictions on offers of securities even where no full prospectus is required. This restricts the development of a fully integrated primary market for the institutional placement of securities of both new and established issuers. Similar restrictions apply to the placement of participations in venture capital and other funds with professional and other sophisticated investors. The introduction of a single passport for issuers of the kind contemplated by the Commission would address some of these concerns. However, there is a simpler and more effective way of addressing the key issues for the wholesale markets.

Action required: The EU should amend the Public Offers Directive to *require* Member States to exempt certain types of offers from prospectus requirements, including in particular offers to professional and sophisticated investors. The amendments should also prevent Member States from circumventing this requirement by imposing additional approval, reporting or filing restrictions relating to exempted offers. Similar exemptions should be available for institutional placements of participations in venture capital and other funds. **An upgrade of the prospectuses directives was a priority 1 item in the Action Plan with a proposed directive due by mid 2000. A “single passport” for issuers was a Lisbon priority.**

Cross-border rights offerings

Problem: The shareholder base of EU companies includes increasingly significant numbers of shareholders, in particular institutional shareholders, in other Member States. However, legal requirements and investor pressure often require EU companies to conduct secondary capital raising by way of rights offering to existing shareholders. But many Member States do not exempt such offerings from local prospectus requirements. This means that issuers may have to comply with local prospectus requirements across the EU or use the cumbersome mutual recognition procedures of the Public Offers Directive (involving complying with local translation and additional information requirements). In some cases, this may lead issuers to exclude shareholders in other EU Member States from participation in the rights offering. In any case, this represents a significant barrier to secondary capital raising by EU companies.

Action required: The EU should amend the Public Offers Directive to require Member States to exempt rights offerings from local prospectus requirements, at least where the securities are to be listed on an EU stock exchange.

5. **New forms of electronic trading systems offers scope for greater efficiency and competition and should be subject to an appropriate regulatory regime.**

Problem: New technology is creating opportunities for the launch of new forms of trading system. Some of these may compete with existing regulated markets while others may create new ways of trading instruments that have not previously been traded on a regulated market. There is a danger that premature EU (or national) action in this area could stifle these developments to the detriment of investors and intermediaries. While we accept that a fair, open and transparent capital market is essential to minimise the cost of capital and maintain the confidence of investors, on the other hand, existing EU law clearly allows Member States discriminate against the use of alternative trading systems - concentration rules that require certain transactions to be executed on a regulated market even where the use of alternative systems may provide investors with an equivalent quality of execution for their trades are an example of this.

Action required: The EU should balance the need for an appropriate risk sensitive level of regulation for new forms of trading systems with the need to foster innovation and competition. Discrimination against the use of such systems in the form of concentration rules should be ended. **A Green Paper on the ISD was a priority 2 item in the Action Plan and was due by mid 2000. Lisbon also made this a priority issue.**

6. **Investors should be free to invest prudently cross-border.**

Problem: Existing national restrictions on pension fund investment restrict the development of new sources of investment, in particular equity investment. In addition, restrictions on cross border management of pension funds restrict cross-border competition. Regulated investment funds (UCITS) similarly remain subject to unnecessary restrictions

Action required: The EU should press forward with measures to remove national restrictions on pension fund investment that do not accord with the "prudent man" principle. In addition, the EU should remove national rules that restrict the ability of firms to offer pension fund management on a cross-border basis. Restrictive measure applicable to investment funds should also be removed. **A Commission Communication on pension funds, agreement on revisions to the UCITS Directives and a pension fund directive were all priority 1 in the Action Plan and were given high priority at Lisbon. Only the first has been achieved so far. Progress on UCITS is disappointing.**

7. **Cross-border wholesale markets require greater legal certainty for collateral**

Problem: It is important that the single market in financial services be underpinned by a robust legal infrastructure. In the wholesale markets, counterparties take collateral and net positions in order to reduce credit exposures to one another and it is essential that there is legal certainty for both netting and collateral arrangements. The provision of collateral cross border in Europe is, however, subject to a range of legal uncertainties which in turn limits cross border securities activity.

Action required: The EU needs a modern legal framework for collateral. The industry has elsewhere mapped out what the main problems in the different Member states are and suggested what principles an improved environment would follow. Careful consideration of these issues by experts is required, followed by a directive establishing a new form of collateral instrument. This would provide a significant boost to legal certainty for collateral in the EU. **Consultation followed by a draft directive were priority 1 in the Action Plan. Good progress seems to be being made.**

8. **EU banks and securities firms need modern, competitive, and risk-sensitive capital requirements.**

Problem: The 1988 Basel Accord, which is reflected in the EU's Directives setting capital requirements for banks and securities firms, is out of date. The current credit risk regime no longer represents a risk-sensitive, accurate measure of risk and regulatory capital is becoming misaligned with economic capital. The Basel committee has proposed reforms that would align credit risk requirements more closely with actual economic risk, by allowing firms to apply their own more sophisticated risk assessment techniques, and that would take greater account of credit risk mitigation techniques.

Action required: The Commission needs to move quickly to ensure that EU requirements remain competitive with the new G10 standards, once agreed. A draft directive will need to avoid the excessive level of prescription that exist in the existing texts, in order to facilitate future modernisation. **The Commission's consultative process is running satisfactorily in tandem with that of the G10 Basel Committee. The EU institutions need however to agree soon on a new form of legislation to avoid the excessively detailed directives of the past.**

9. **We must be vigilant against the creation of new barriers to cross-border business**

Problem: The Action Plan for Financial Services suggests the introduction of a directive to address market manipulation. We agree that national authorities should have adequate and appropriate powers to address market manipulation, but suggest that the case for a directive has not yet been made. Any directive that sought unduly to extend the scope of prohibited conduct could threaten legal certainty and create new barriers to cross-border business. In addition, member states apply their current regimes in different ways and it is unlikely that a new directive would achieve significant harmonisation in this area unless these differences are resolved.

Action required: Before any action is taken towards a directive, the Commission should publish a detailed survey of existing laws demonstrating where there are gaps. Any need for a common

understanding of core elements to be prohibited could be adequately met by a Commission and FESCO recommendation. If there is to be a directive, it should be limited in scope and any definition of prohibited conduct should be based around tests of intention.