

**COMMISSION PROPOSAL FOR A DIRECTIVE ON  
INVESTMENT SERVICES AND REGULATED MARKETS  
("ISD2")**

**BRIEFING PAPER BY EUROPEAN AND INTERNATIONAL  
SECURITIES AND DERIVATIVES ORGANISATIONS**

This paper analyses the main issues raised by the ISD2 Proposal and assesses whether the Proposal would achieve its main objectives.

The paper consists of three parts:

- A Executive Summary (page 2)
- B Would the ISD2 Proposal achieve its aim? (pages 3 to 8)
- C Comments on key measures aimed at protecting investors and market integrity (pages 9 to 15)

The paper has been prepared with contributions from many organisations whose Members are active in European securities and derivatives markets, including the International Swaps and Derivatives Association, International Securities Market Association, Futures and Options Association, London Stock Exchange, London Investment Banking Association, Swedish Securities Dealers Association, Danish Securities Dealers Association, Finnish Association of Securities Dealers, Association of Norwegian Stockbroking Companies, Bankers and Securities Dealers Association of Iceland, Bond Market Association, and International Primary Market Association. These organisations share broadly similar views on the ISD2 Proposal, although not all of them necessarily share identical views, and their priorities may vary.

21st March 2003

## A EXECUTIVE SUMMARY

We fully share the objectives of the Commission's ISD2 Proposal - to secure an appropriate level of protection for investors while fostering the efficient functioning of the single market. The ISD2 Proposal contains many constructive and welcome elements, such as the full application of exclusive home/branch country regulation, the improved definitions of professional investors and counterparties, the codification of proportionate conduct of business rules and the abolition of the concentration rule. However, these benefits are seriously undermined by other provisions which prescribe costly and inefficient market structures and limit investor choice.

An appropriate legislative framework is essential to achieve the proposal's objectives. Europe's securities markets require legislation which is flexible and rapidly adaptable to technological changes and market developments. In certain key areas, the ISD2 Proposal is too prescriptive and inflexible. While the appropriate balance needs to be struck in level 1 and level 2 legislation, convergence at level 3 will often be more productive and less disruptive than detailed Level 1 or 2 measures.

The legislator should ensure, when aiming at protecting retail investors, that measures intended to protect direct retail investors do not damage the interests of the majority of retail investment, which is in fact professionally managed. The definitions of professional investors and counterparties, while broadly appropriate, need some improvement to be made fully functional.

The abolition of the possibility for Member States to impose a concentration rule is welcome. However, the legislator should not impose substantial obstacles to alternative trading venues or execution off-exchange which would have an effect similar to that of a concentration rule. Several elements of the ISD2 Proposal would have this effect.

Properly drafted best execution, conduct of business, and client order handling rules are essential elements of an investor protection regime in a securities market characterised by competition between execution venues. In order to achieve this, the relevant provisions also need some improvement.

Appropriate levels of transparency of trading in securities markets are essential to maximise liquidity, engender investor confidence, assist decision-making, and promote competition for order flow.

But as all intermediaries – banks, brokers, exchanges – recognise, full transparency is not necessarily possible if investor interests and market integrity are to be properly protected. A balance must be struck. To achieve this, the ISD2 must rely on an efficient implementation of conduct of business and best execution rules, coupled with an adequate regime of post-trade transparency. In contrast, the proposed regime for mandatory limit order disclosure and mandatory market making, which is based on flawed assumptions, would seriously damage liquidity in the European market and undermine the ISD2's ability to secure investor protection while promoting an efficient market. The objective set out at the Lisbon European Council of making the European financial market the most competitive in the world could then become an even more distant prospect.

## **B WOULD THE PROPOSAL ACHIEVE ITS AIM?**

ISD2 aims to secure an appropriate level of protection for investors, while fostering the efficient functioning of the market, enhancing competition and eliminating obstacles to cross border trade.

There are many constructive elements in the Proposal. But a proper balance has not been struck between these objectives.

The following elements are welcome:

- exclusive country of origin regulation;
- improved definition of professional investors and counterparties;
- codification of proportionate conduct of business rules, with lighter rules for professional customers.

But these benefits could be undermined by some Articles which would:

- risk over-protecting professional investors and investors who do not want a full advice-based service;
- impose, in the name of investor protection and market efficiency, a very prescriptive, inflexible, costly and inefficient market structure that would not benefit European investors and might well do them, and European markets, substantial harm.

These disadvantages would restrict competition and innovation across the whole of Europe, so limiting the benefit of removing obstacles to cross-border trade. The Proposal might achieve its objective to secure more and better regulation in those Member States where investors' interests are not, currently, adequately protected. But this goal would be achieved at the price of imposing significantly higher costs for the management of their investments on *all* investors in the EU, and by restricting their right to make their own investment decisions.

Investors need to be protected from excessive costs and limitation of choice, as well as from malpractice. Recent forecasts of the benefits of a single European securities market depend on the benefits from enhanced investor confidence not being neutralised by unnecessary increases in costs or restriction of investment opportunities.

We strongly urge legislators to recognise the important role played by competition between different types of service in developing an integrated European securities market. Competition should not be distorted, but supported by proportionate, risk-focused and properly enforced regulation. This approach will produce greater benefits for a greater number of investors and issuers than one which favours a more uniform, administratively guided and over-regulated market.

The Commission's Explanatory Memorandum endorses the competitive approach: 'as far as overall market efficiency is concerned, regulatory measures that directly restrict competition between trade execution arrangements do not seem to deliver improvements in price-formation which would justify an intrusive intervention in market structure' and acknowledges that: 'all Member State trading cultures recognise that exchange order books are not the optimal trading method for all types of

transaction'. The Explanatory Memorandum provides quantitative evidence of the merits of the competitive approach: 'EU regulatory regimes which allow for competition between exchanges and other forms of trading method are characterised by higher stock market capitalisation (170% of GDP) and liquidity (as measured by turnover 407% of GDP) when compared to Member States which favour trading on-exchange (80% and 130% respectively)'.

But the Commission's Proposal does not reflect the Explanatory Memorandum's analysis and evidence. The obligations imposed on, and privileges granted to, various market intermediaries lean too far towards the administratively guided approach. They also try to micromanage the firm/client relationship, regardless of the intelligence or freedom of action of individual investors.

### **i. Protecting investors**

The term 'investors' is often presumed to mean individual citizens. But they act in many different ways in carrying out their role as investors. ISD2 correctly identifies two main classes of investors - retail and professional.

Retail investors are either:

- investors who invest in securities directly via a bank or stockbroker, and are responsible, with or without advice, for their own investment decisions
- investors who rely on the professional skills of others to make investment decisions for them by saving through the purchase of UCITS, pensions or some insurance products.

In practice, most direct retail investors also own collective products such as UCITS. Institutional investors increasingly dominate trading in Europe's securities markets. With the emphasis being placed on encouraging the growth of private, funded pension schemes, that dominance is likely to grow.

The legislator should ensure that a measure intended to protect direct retail investors does not damage the interests of the majority of retail investment which is professionally managed.

It is therefore welcome that ISD2 proposes to specify and enforce lighter conduct of business rules for professional investors. The Directive should ensure that Member States cannot dilute this distinction or impose inappropriately intrusive rules for dealing with professional investors in such areas as best execution and suitability.

Annex II sets broadly appropriate thresholds for establishing which investors may be treated automatically as professional, though the quantitative thresholds should be brought into line with CESR's definition. The criteria which a firm must apply in considering clients' request to be treated as professional are also broadly appropriate. But the Annex states that such clients should not 'be presumed to possess market knowledge and experience comparable' to automatic professionals. This implies that firms would have to second-guess their level of expertise and knowledge - an excessive burden for both firm and customer. Investment firms should be permitted to treat clients who ask to be treated as professionals, and who meet the criteria, as they treat all other professional investors.

The proposed category of 'eligible counterparties', dealings with which are subject only to high level principles and normal contract law, is *essential* to maintain and enhance an efficient capital market. There are no investor protection concerns when two banks deal with each other for their own account. Nor do such issues arise when large fund managers or non-financial companies, many of which manage financial assets of a size greater than the assets of most investment firms – and have the necessary expertise, deal with banks and brokers. The Directive should not however use the eligible counterparty category to limit access to regulated markets or MTFs. Exchanges and MTFs should be free to offer access to their systems to other persons, subject to their being able to meet their obligations. If there is to be any restriction on access, it should be at Level 2 or 3, so that it can be amended in response to market developments.

## **ii. Promoting a competitive and efficient market place**

ISD2 would not achieve its goal of promoting a competitive market, nor a market where investors and issuers would be able to benefit from a range of trading options according to their requirements.

For many years the most important intermediaries in bringing together buyers and sellers in Europe's equity markets have been the national stock exchanges, entities given formal status and a number of privileges under the current ISD as regulated markets. The Explanatory Memorandum makes clear the objective to maintain a special status for regulated markets within the legislative and regulatory framework for the single European securities market.

We do not challenge that objective. Many investment firms do most or substantially all of their equity business on regulated markets or on equivalent regulated trading venues outside Europe. They are likely to continue to do so as long as regulated markets continue to enable them to offer the most effective means of transacting business for clients. However, like any other commercial entities, regulated markets need the constant spur of competition to drive them to innovate and reduce costs for their users.

ISD2 does not allow explicitly for concentration rules. But it does propose several substantial obstacles to alternative trading venues or execution off-exchange which appear likely to have a similar effect. There is the added danger that while concentration rules are now optional, the proposed new restrictions would be mandatory for all. ISD2's proposed increase in post-trade transparency, combined with proportionate best execution and conduct of business rules, provides an effective framework for investor protection and market integrity without explicit or implicit concentration requirements.

For shares listed on European regulated markets, it is apparent that regulated exchanges have retained a central and competitive position, despite the growth of competing execution methods. The maintenance of this benign balance between competition and investor-driven focus of liquidity would be hindered by the apparent bias in ISD2 in favour of the regulated market business model. Far from creating a 'level playing field', as their proponents allege, a number of proposals in ISD2 would

favour regulated markets, and are not consistent with a truly competitive European securities market. Regulated markets are, like investment firms, now commercial enterprises. Any regulatory bias in their favour has significant anti-competitive implications.

One example of this bias is the proposal to minimise the differences in the regulatory treatment of regulated markets and MTFs. This would drive MTFs into adopting the market model preferred by regulated markets and, inevitably, the higher cost level inherent in that model. These proposals, picking up elements of the work of CESR but omitting much of the flexibility built into the CESR standards, are likely to result in a barrier to entry since a new MTF would be unable to compete on costs. In practice, the fact that there are very few equity MTFs in Europe demonstrates how hard it is for them to compete with exchanges.

Article 25 would subject certain dealers executing orders in-house to mandatory market making obligations. This proposal appears to be based on an incorrect presumption that a dealer's quotes (where his capital is at risk) are in some way equivalent to investors' limit orders on the order book of a regulated market (which does not put its capital at risk) and can therefore be regulated equivalently.

Flawed in its basic assumptions, this proposal would have several undesirable consequences:

- a major barrier to entry into the business of providing risk transfer for investors via own account dealing;
- many existing dealers could be driven out of the market;
- Business would be driven towards regulated markets, and the ability to improve on regulated market prices and costs would be reduced;
- Diversity would be diminished and the liquidity provided by dealers' own capital (a key element in the growing global competitiveness of Europe's securities markets under the current ISD) would be substantially reduced, to the detriment of all issuers and investors seeking to use those markets.

In practice the best bid and offer on a regulated market represent the objectives of the most aggressive buyer and most aggressive seller among investors at that moment in time. A dealer, in contrast, is generally neutral as to whether he wants to buy or sell. Therefore his quote is unlikely to match the best bid or offer in the public order book. But to win business, a dealer typically offers to match or exceed the best bid or offer, or to offer a range of other services, such as a different size, lower cost, absorption of risk, or some other execution service demanded by the client which on-exchange execution cannot provide. An appropriately drafted and enforced best execution rule is a better way to ensure that investors receive the best deal for their orders wherever executed.

Article 20 would impose on-exchange execution unless the investor agreed otherwise, and mandatory publication of unexecuted limit orders unless the investor directed otherwise. Although the investor's freedom of choice is essential, both of these aspects of Article 20 would give the wrong emphasis because they could force execution and publication of orders onto regulated exchanges, even if this was not in the customer's interests and contrary to the investment firm's conduct of business and best execution obligations. In some cases forcing limit order disclosure could also

increase volatility and widen spreads by encouraging the market to move against disclosed trading intentions. Regulation can affect the terms of competition, and the dynamics of the market. The legislator should therefore take great care to ensure that 2ISD does not buttress the commercial position of any particular type of market intermediary.

### **iii. The function of Level 1 legislative measures**

To maintain and enhance its world-leading role, and to maintain the confidence of issuers and investors, Europe's securities market requires legislation which is able to adapt to market changes, competitive pressures from elsewhere, and new technologies.

An example of the importance of identifying the appropriate legislative and regulatory tools is provided by best execution. While the essential principle of providing customers with best execution is unlikely to change over time, its practical realisation is likely to evolve, sometimes rapidly. The adaptation of rules to the development of the internet is a recent example. The legislator needs therefore to be very careful to distinguish between those general principles which can and should be enshrined in primary legislation (level 1) and those detailed measures which are more sensitive to technological and market developments and which require the possibility of more rapid and effective adaptation at level 2 or level 3.

While ISD2 makes extensive use of comitology, and therefore provides an element of flexibility, it currently mandates many detailed Level 2 measures (e.g. Articles 12, 16, 18, 19, 20, 24, 25). Appropriate convergence of rules is desirable. But harmonisation which is too quick or too detailed may well disadvantage investors by changing the structure of well-functioning markets which have evolved to serve their users' needs. Often, convergence at Level 3, supported where necessary by a permissive (not mandatory) comitology provision, is likely to be a more practical and adaptable means of achieving convergence than mandatory Level 2 measures, changes to which will still require some considerable time and political will.

### **iv. Costs and benefits of different regulatory approaches**

Regulation of securities markets needs to be targeted, proportionate, risk-focused and effective. It needs to be supported by properly resourced enforcement mechanisms if it is to command the confidence of investors. As the Commission has recognised, many of the proposals in ISD2 call for Member States to commit greater resources to regulation. As representatives of market intermediaries, we support this. Good regulation is a friend of the market.

Mechanisms such as the concentration rule have been maintained in some Member States in the belief that they constitute a low-cost, self-policing mechanism. In practice, the implicit costs of the lack of a competitive spur to innovate to better meet investor needs, and the constraints imposed on cross-border investment flows, are substantial but ignored. Furthermore, concentration rules have also played a key part in maintaining the franchise of one group of market intermediaries (regulated exchanges) by restricting other intermediaries (investment firms) from offering investors lower cost or improved services. Regulation should not give preference to

the commercial needs of one group of market intermediaries at the expense of the interests of issuers and investors overall. Regulated markets and investment firms facilitate execution of trades in different ways. Regulation which purported to provide 'the same rules for the same function', while ignoring the differences between the ways different entities achieve investors' needs, would give preferential treatment to one particular execution model over the others.

There is an important lesson in the United States experience. Until 1975, minimum fixed commissions preserved the franchise of many small brokers who operated with relatively high fixed costs. Those at risk from negotiated commissions exploited the investor protection argument to try to ensure that lower cost brokers could not compete on price. The end of fixed commissions led, in the short term, to the failure of many inefficient small brokers. But it did not result in a monopoly for the largest brokers. It created opportunities for new types of broker to emerge. A few years later there were more small brokers servicing investors than under the minimum fixed commission regime. Investors benefited from greater choice at lower prices. This is the type of flexibility that must be enshrined in regulation if Europe is to secure the full benefits of an integrated securities market.

## C COMMENTS ON KEY MEASURES AIMED AT PROTECTING INVESTORS AND MARKET INTEGRITY

Properly drafted best execution, conduct of business, and client order handling rules are essential investor protections in a securities market characterised by competition between execution venues and diversity of choice for investors as to the execution services which best meet their needs.

Appropriate levels of transparency of trading in securities markets are also essential to maximise liquidity, engender investor confidence, assist decision-making, and promote competition for order flow.

But as all intermediaries - banks, brokers, exchanges – recognise, full transparency is not necessarily possible if investors' interests and market integrity are to be properly protected. A balance has to be struck taking account of the factors such as those set out in Section B above and recognising that at different times, and to fulfil different objectives, individual investors will have different needs.

### **Conduct of business (Article 18)**

Article 18 is correct to specify exclusive country of origin regulation (home State control, but branch State control for services provided from branches), and to provide for lighter regulation for professional investors. A similar regime should also apply to other Articles which have a 'conduct of business' character, including best execution and order handling. The Directive's definition of professional investors is broadly appropriate, though it needs to be further refined in certain respects (see Section B(i) above).

However, Article 18 does not provide sufficiently for conduct of business rules to be disapplied in two circumstances where it is appropriate. First, suitability and risk warning rules should not apply to professional customers, whose knowledge and experience makes a regulatory obligation inappropriate. Second, suitability and risk warning rules should not apply to execution only and direct purchase business, where investors want to execute trades cheaply without any professional investment advice.

Retail customers have shown that they want to be able to trade on an execution only basis, or buy products straight off a leaflet, without incurring the delay and cost required by a full financial suitability check. This has two benefits; enabling banks and UCITS fund managers to offer more products to more customers as the value size of each transaction can be smaller; and reducing transaction costs that customers incur. Straightforward, standardised products are intended to play a growing role in increasing long-term savings by individuals. The Commission's proposals could unwittingly deter consumers from purchasing them. Given the EU-wide concern over retirement provision for an ageing population, this would be a backward step.

### **Best execution (Article 19)**

Article 19(1) is correct to emphasise the diversity of elements which contribute to best execution. For any one client the relative importance of these elements may vary from trade to trade. It is important that investment firms can satisfy those fluctuating client

needs without risk of breaching the rule. The requirement to ‘ensure’ the ‘best possible result’ is thus an unattainable standard which would not necessarily benefit investors. Best execution is better understood as a process, which should consistently deliver the result that the investor wants if it is properly monitored and managed. Article 19(1)’s emphasis on ‘outcomes’ is therefore not right.

Articles 19(2) and 19(3) similarly set a standard of compliance with which it may prove difficult and expensive to comply. The policy goal appears to be to promote competition between execution venues by imposing high transparency, order disclosure or quote disclosure standards on them, and requiring brokers to search out the very best price available in the market rather than, as may be the case today in some jurisdictions, to rely on one central execution venue such as the local regulated market. To impose high search costs on all transactions, and high transparency costs on all execution venues, regardless of the needs of investors, is an excessive response to the perceived problem. Brokers should be able to offer a range of services with varying search costs, and investors should be free to choose among them. Regulation should focus on clear and comprehensive disclosure of the execution policy offered, and measurement of best execution against it.

#### **Client order handling rules (Article 20)**

Article 20(1) and 20(2) set an appropriate standard on which CESR should develop detailed implementation (at level 2 or possibly level 3). Further detail is not appropriate at Level 1 for the reasons set out in Section B(iii) above. Some of the detailed provisions in Articles 20(3) and 20(4) would be inappropriate at any level.

***Annual renewal of investor’s consent to have orders transacted outside a regulated market or MTF*** - The ‘default rule’ in Article 20(3) would not protect investors. It presumes that ‘in-house’ matching results in a lower quality of execution than on-exchange execution, a presumption that is not borne out by the evidence. The ‘default rule’ would discriminate against firms that aim to improve execution for investors by routing their orders off-exchange.

At the very least, this rule should not apply to professional investors for whom the choice of execution venues should be a contractual matter.

Retail investors may enter into standardised agreements under which investment firms offer dealing services to many investors, so they cannot negotiate specific terms. Retail investors have a right to be informed, as part of the written customer agreement at the outset of the relationship what mechanisms the firm may use to execute orders, including whether they may be executed outside a regulated market or MTF.

It is appropriate to ensure that investment firms inform retail investors regularly of any changes in their execution policy. This could be achieved cost-effectively by one-way notification, or by disclosure on the firm’s web site of any material change. Unlike the ‘default rule’, this would provide relevant information to investors and would not be a harmful barrier to competition. It would require some ‘due diligence’ by investors, but unlike the ‘default rule’, it would enable them readily to compare the services offered by competing investment firms.

In contrast, the proposed annual renewal of consent, alone of all the many terms and conditions in the investor's relationship with an investment firm (many of which, such as commissions payable and custody fees, may change from time to time,) would increase costs and put considerable obstacles in the way of investment firms which wish to offer clients the service of execution 'in-house'.

Experience shows that where customers are asked to renew agreements annually, or to confirm the assets held on their behalf, there is a low response rate even when firms seek diligently to obtain confirmations. This is because of customer inertia rather than dissatisfaction with the service. The annual renewal of consent would thus contribute to greater inefficiency, as a barrier to new entrants and a constraint on existing firms who offer improved off-exchange execution.

It has been suggested that the 'default' rule is necessary to remind investors that their orders may not be executed on a regulated market as they might have presumed. Such an argument ignores the importance of the investor's informed consent to the execution policy, and would undermine investor protection by preventing firms from gaining best execution without customers' permission to do so, even when the best terms for the transaction were only available outside a regulated market or an MTF. This is the norm, in some markets, such as that for corporate bonds.

The 'default' rule is unique since it imposes an obligation on investors, not firms. Any oversight by a customer would deprive him of the opportunity of best execution in many circumstances – contrary to his best interests. ISD2 should regulate the conduct of investment firms, not the conduct of their customers.

In the context of the radically improved investor protection environment which best execution and general order-handling rules provide, the 'default rule' and annual renewal provision are redundant.

***Publication of the terms of client limit orders.*** In article 20(4) the presumption that, unless a client expressly instructs otherwise, limit orders must be made public, raises concerns at the level of both practice and principle.

As with the 'default rule' limit order exposure would not intrude on the relationship between an investor and a firm which only routes orders to a regulated market or an MTF. In other cases, such as where the firm offers an 'in house' matching service, it would add further complication to the process of taking, recording and processing an order and would therefore result in increased errors and disputes. It would increase the costs of 'in-house' matching and so bias the economics of trade execution in favour of regulated markets. Indeed, some regulated markets have suggested that Article 20.4 be amended to require all equity limit orders to be routed to a regulated market or MTF. This is in effect an explicit request to reinstate the concentration rule (since equity MTFs are practically non-existent in Europe).

Article 20(4) would apply to all 'limit orders' as defined. These would include: orders where the limit is not a price limit; orders from professional customers which are conditional on the execution of one or more other orders; orders which, though smaller than the 'large scale' determined under Article 41(2), are nevertheless large

enough that their exposure would lead to the market moving against the investor; and orders whose limit is outside the best bid and best offer, so that their disclosure would not narrow the spread. Whilst the provision for the client to specify that the terms of the order should not be disclosed is an essential safeguard, the 'default' presumption that the terms of such a broad range of orders should be published misrepresents the nature of such orders, and assumes that immediate execution is the only criterion. It is a disproportionate, inflexible and over-intrusive overlay on Articles 20(1) and 20(2). The purpose of the proposal, to prevent investment firms from 'warehousing' customer limit orders until it suits them to execute those orders, should be achieved by rigorously enforced detail at Level 2 or 3 of the order handling rules in Articles 20(1) and 20(2), conflict of interest rules (Article 16), and best execution rules (Article 19).

Pre-trade transparency which serves the needs of investors is an essential element of efficient markets and investor protection. But Article 20(4) is too prescriptive and could force disclosure which is against investors' interests and harmful to liquidity.

### **Obligation for investment firms to make public firm bids and offers (Article 25)**

Article 25 would force certain firms dealing on own account to make markets for retail-size transactions, even if this was not part of their intended business.

*What does it mean?* There are two key points of uncertainty about this obligation:

1) The nature of the 'firm' quote. It is being argued, including by Commission Services, that the legal effect would be to prohibit a dealer from improving on its public quote if requested by an investor or a broker acting on an investor's behalf. This would threaten the whole basis of market making or own-account dealing - the ability of buyer and seller to negotiate a price. The ability of many investors to obtain the best price would be badly damaged. There can be no justification for denying an investor the right to seek price improvement on a dealer's quote.

2) The obligation to deal. It has been suggested that Article 25 would require a dealer to deal with any investment firm or eligible counterparty whether or not there was an existing business relationship, or the trade would breach the credit limit set by the dealer for transactions with that firm. This would lead to very significant increases in credit risk for those dealers still prepared to quote prices on this basis and therefore a significant increase in the level of systemic risk in the securities market overall. The 'retail size' of the proposed quote would not remove this risk: a dealer's book can be hit repeatedly in rapid succession so that a large number of 'small' orders will accumulate to a large absolute credit exposure. Article 25 would thus undermine both risk management and prudential regulation.

An essential element of any securities market must be that investment firms are entitled to choose their counterparties based on risk-based criteria. In Europe, regulated markets have had to set up central counterparties to guarantee member firms' trades, since firms have been unwilling to accept others' compliance with regulatory capital minima as automatically sufficient to sustain a dealing relationship. Prudential supervisors have supported this approach. A key feature of most central

counterparties is that their conditions for membership require capital several times greater than regulatory minima. Small brokers must thus use larger firms ('clearing brokers') to settle their trades.

***Who would it apply to?*** Is it intended to apply only to firms which are 'making markets' to retail investors outside regulated exchanges? Or would it apply also to a wider range of wholesale market firms such as those which arbitrage small differences in prices across markets, or certain hedge funds, which deal in large size and have no intention of making markets to retail investors? Would it apply to firms which trade on-exchange? All these categories include firms which are sufficiently active traders to be defined as 'important providers of liquidity on a regular or continuous basis'. Under the comitology procedure it appears that CESR would have a free hand to apply the obligation to a broad range of firms. This would cause major harm to the liquidity of wholesale markets.

However the Article is to be interpreted, it would discriminate in favour of Member States where there is little or no provision of liquidity to clients by investment firms putting their own capital at risk to execute client orders (where Article 25 would have minimal effect on current activity) and against Member States where this is an important contributing factor to deep liquid markets (and Article 25 risks inflicting serious damage).

***Why comparison with the US is not appropriate.*** The Explanatory Memorandum, at page 22, gives the NASDAQ Small Order Execution Service (SOES) as an illustration of a market in which a 'quote and deal' requirement can be introduced without damaging investors' interests by causing dealers to withdraw liquidity from the market. This rationale is fundamentally flawed. It ignores the fact that the infrastructure of the US securities market has been integrated, for many years, at a number of levels not limited to trading. Rules are not implemented until the appropriate infrastructure has been built. In particular, all trades are settled through a central clearing and settlement system which guarantees performance of matched trades and minimises credit risk. No such system exists or is contemplated in Europe for OTC transactions. Without it, Article 25 would lead to a large amount of dispersed information, but inadequate mechanisms to access it.<sup>1</sup>

***Problems of definition.*** There would be enormous problems in establishing Europe-wide definitions. There can be no absolute definition of a 'liquid market' for individual shares. That will vary from Member State to Member State and over time within each Member State. Similar variations would arise in defining retail order size. The exclusion of firms 'which do not represent an important provider of liquidity for the shares in question on a regular or continuous basis' recreates the concept of 'systematic' and 'incidental' internalisers which was rejected as impractical by most respondents to the Commission's consultation.

***What would be its effects?*** Even if the obscurity in the drafting of Article 25(1) could be clarified so as not to mandate increased levels of counterparty risk on own

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<sup>1</sup> A letter from the US Securities Industry Association to the Commission which compares the ISD2 Proposal with the US requirements in detail is accessible on <http://www.sia.com/international/pdf/ISDco1.pdf>.

account dealers, it is far more likely to reduce than increase the amount of capital that investment firms commit to own account dealing in Europe.

The most likely result would be to increase investors' reliance on each other to provide liquidity. Regulated markets would come under less competitive pressure to reduce trading costs or to develop new services to better meet investor needs. Firms would also be constrained from providing a range of execution services to investors, mixing off-exchange and on-exchange execution, which firms and their customers see as genuinely complementary, to obtain the best deal for the investor. The advantages of executing off-exchange include: lower costs (saving exchange fees, net settlement); management of trading risk via controlled exposure of larger orders; immediacy of execution; tailored services, including programme trading and swaps; and the ability to execute trades in times of volatility when the natural order flow does not provide enough liquidity to the market.

This may have a particularly serious impact on cross-border investment in the securities of companies in Member States with less developed capital markets, including the accession countries, since the removal of the ability to meet investor demand for such securities from a dealer's own book may make such cross-border investment uneconomic.

Furthermore, this rule would impose regulatory bias towards on-exchange execution for the first time in Member States that have not imposed concentration rules and which, as the Commission's evidence demonstrates, already have the largest and most liquid equity markets in Europe.

***Effect on spreads.*** The argument that investors would benefit from reduced investor choice and enforced concentration of pre-trade information and trading activity assumes that permitting investors a choice of execution venues widens spreads.

It assumes, incorrectly, that investors' decision-making is a static process, and that an investor enters a limit order on the basis solely of the price at which he wishes to carry out a transaction. In practice, if an investor wishes to carry out a transaction within a reasonable time period, he will base his price limit partly on the price he thinks is necessary to attract a matching order, and will adjust his limit as market conditions vary. This need for bids to attract offers and offers to attract bids will tend naturally to limit the breadth of spreads. Internalisation should not affect it, provided the exchange continues to provide an execution facility that serves the needs of investors and therefore attracts a substantial proportion of liquidity.

It should be noted that markets which allow internalisation have low market impact costs (sometimes called the 'effective spread') for larger deals, since internalisers can take on some of the risk and feed the order slowly into the market. This has been shown in a number of recent studies, including the November 2002 Commission-sponsored London Economics Study. This is one example of a range of services at a variety of costs that regulated markets are unable or unwilling to offer investors.

***Conclusions on Article 25.*** For all these reasons, Article 25 should be deleted. Very substantial gains in size, liquidity and depth of Europe's securities market will be achieved if investors are offered greater choice and obstacles are not imposed on

current business practices or the development of new and innovative ways to meet investor needs. It is right to make investor choice more informed via conduct of business, best execution, and post-trade transparency rules. But mandatory limit order display rules or mandatory market making rules would harm, not promote, the interests of investors, competition between execution venues, and market efficiency. The Explanatory Memorandum recognises this: ‘Transparency may come at a price in terms of liquidity provision to market participants. Forcing dealers and broker-dealers to display the terms at which they are willing to buy and sell instruments may reduce their ability to trade at a profit, and expose them to strategic trading by other market participants’; ‘caution is needed before extrapolating exchange-type regulation and transparency rules to off-exchange trading where market participants place their own capital at risk’.

### **Post trade disclosure by investment firms (Article 26)**

It is right to limit transparency requirements to equities. Article 26 reflects a broad consensus that investors’ decision-making will benefit from the extension of post-trade transparency to OTC transactions in equities and, in principle, that the benefits outweigh the costs which will ultimately be borne by investors.

But the proposal calls for immediate, across-the-board publication of transactions, subject to possible limitation where the price is not based on the current market valuation (Article 26(3b)). Many other transactions also convey little information of immediate significance to investors (for instance because the stock is infrequently traded), and some may be misleading: the exclusions should be extended to such transactions as well, so that Article 26 focuses properly on liquid stocks, where prices are formed by active trading.

Whilst we accept that securing the integrity of the information provided to investors by the off-exchange publication of transactions remains an issue which needs to be resolved, it will also be important to ensure that the solution does not lead to a reintroduction of the proposal that only regulated markets should be allowed to receive and publish reports