

EUROPEAN SECURITIES MARKETS EXPERTS GROUP (ESME)

Report of 2nd meeting of ESME on 04.12.06

1. Adoption of the agenda

The agenda was approved.

The Commission services welcomed the observer from the ECB to his first meeting of ESME and thanked the sub-groups on the Market Abuse Directive ("MAD"), the Prospectus Directive ("PD") and the Legal read across exercise for providing initial papers for discussion at the meeting. ESME and its sub-groups were encouraged to invite experts/observers with specific expertise on a relevant subject.

Regarding the timing of the reports on the operation of the MAD and the PD, the Commission services indicated that it would like to receive ESME's final report on each topic by June 2007. Finally, the Commission services intend to set up a sub-group on credit rating agencies in the course of 2007, and, possibly, on issues regarding the Transparency Directive.

2. Clearing & Settlement

The Commission services gave a presentation on the recently adopted Code of Conduct on clearing & settlement ("Code"), highlighting its general features (contents, scope, timeline and consultation process) and its specific contents (transparency, access and interoperability, unbundling and accounting separation), as well as the mechanism that will be put in place to monitor its implementation (monitoring group, external auditors, user and infrastructure input).

In response to various comments and questions of ESME members on issues related to the Code, the Commission services made it clear that the monitoring group will adhere to high transparency standards. They also stressed that ECB's TARGET2-Securities initiative and the Code are complementary. As regards the limited material scope of the Code, the Commission services explained that Euroclear has already publicly announced that it will apply the Code across all asset classes and that, with one exception, all EU CSDs have (informally) indicated that they will apply the transparency measures to all asset classes. The Commission services stressed the important role that market participants will need to play in the monitoring process and therefore encouraged their input. In this context the Commission services welcomed any views ESME members may have on this process. As regards issues of concern raised by ESME members related to vertically integrated infrastructure providers, the Commission services explained that competition law has limited powers in this respect (more power only in case of mergers). Therefore, if one wanted to solve this issue, one would need to resort to legislation (cf. EU telecommunication Directive).

3. Operation of the Market Abuse Directive

The rapporteur of the sub-group analysing the operation of the MAD presented a draft discussion paper which identified various issues of concern in relation to the single definition

of inside information, delayed disclosure of inside information, transaction reporting, Accepted Market Practices, safe harbours for buy-back and stabilisation activities and sanctions. ESME members discussed the feasibility of splitting the definition of inside information for insider trading and public disclosure requirements. In addition, the Group discussed the practical difficulties in identifying the precise time of disclosure of inside information, particularly in cases where a delay in public disclosure is permitted. Furthermore, the question was raised whether it is possible that a person on insider list, who has access to inside information, could trade without using the information. In respect of insider trading, a member recommended that one should examine market practices in US and Asian markets. Several ESME members expressed the view that problems arising from the diverging reporting requirements in Article 6 of the MAD and sanctions across Member States needed to be addressed by action at level 2 or level 3. Finally, a few members called for more clarity in the relevant definitions concerning investment research.

The Commission services informed ESME that a Communication on investment research, clarifying the application of the MiFID and the MAD to investment research and financial analysts, is soon to be adopted by the Commission. Furthermore, they encouraged ESME to take account of all EU-jurisdictions in its analysis, to indicate the level of priority of its recommendations and – where the Group recommended a change in the legislative framework - to provide sound supporting evidence on the impact of the MAD provisions in question. Members were asked to provide written comments on the draft discussion paper, to be incorporated in the revised paper for discussion at the February ESME meeting. CESR confirmed that the issues identified by the sub-group's report generally correspond to the ones raised by responses to their call for evidence.

4. Operation of Prospectus Directive

A member of the sub-group presented the following key issues identified by the sub-group and invited comments.

1) Macro-issues: lack of clarity about the extent to which specific provisions are 'maximum harmonisation', allowing divergent implementation and application imposing; additional regulatory burdens on issuers; no choice of home Member State for equity securities and for bonds with small denominations and limited choice only for high denomination bonds and other non-equity securities; lack of clarity about the difference between 'listing' and admission to trading; definition of 'transferable securities' unclear in ISD, and applied differently by Member States; inconsistent transposition and application of exemptions; usefulness of a prospectus to the retail investor questionable (is the principal purpose of a prospectus to inform the investor or to protect the issuer from liability?)

Function of the prospectus and its usefulness to retail investors

ESME members discussed whether it would be useful to distinguish between retail and professional investors when drafting a prospectus. This discussion responded to the observation from the sub-group that the volume and content requirements of prospectuses made them excessively detailed and technical, and as such inaccessible to all but the most sophisticated retail investors. One member said that the PD was drafted as if the prospectus were aimed at and received directly by retail investors, which is not in fact the case. In practice, prospectuses are addressed to professional investors, and these can be informed in a less costly manner. This approach of designing prospectuses with the dual purpose of

informing both retail and professional investors was not working and the prospectus was increasingly being used as a liability shield by issuers.

Another member acknowledged that the level of familiarity of investors with the content of prospectuses varied greatly, but disagreed that this justified a lower level of disclosure for retail investors. This member pointed out that some securities are so complex that they cannot be explained in simple terms, and if a retail investor cannot understand the prospectus, he should not invest in the securities. The prospectus should achieve both objectives: a liability shield for issuers and a tool for effective investor protection. In response to this point, another member questioned whether the prospectus is the best means of conveying the information needed by retail investors. The other member conceded that retail investors rely almost exclusively on investment advisers, but nevertheless a single reference document – the prospectus - was needed as the ultimate and unique source of information about the securities.

Further comments were made to the effect that there is a general move towards more disclosure of information and that investors are demanding more information from issuers. However, one member pointed out that at the same time, and contrary to what was previously said, issuers were being advised to limit the information as far as possible in order to avoid creating legal liabilities. Another member stressed that while promoters and intermediaries may prefer to use simplified prospectuses for their clients, from a legal point of view there must be only one prospectus. Overall, a majority of those who commented opposed different types of document for different investors.

Other topics:

- definition of transferable securities: One member commented that harmonisation was required because the fact that stock options were considered transferable securities in some jurisdictions but not in others was causing difficulties for issuers.
- definition of public offer: One member asked for clarification as to whether custodian banks passing on information about rights issues, as required by their duties as custodians, would be caught by the PD requirements. Commission services said that this issue was being considered by CESR.

2) Micro-issues: lack of harmonisation of liability regime; use of the supplement, lack of certainty and the circumstances in which it is required and problems with the right of withdrawal; use of final terms and lack of clarity as to information that can be included in final terms (as opposed to supplement); uncertainty about the application of the contents requirements for a prospectus, and the liability regime, in cases where securities sold through intermediaries ('retail cascades'); effect of exemption for offers of securities with a denomination above 50.000 Euro (limited availability of retail bonds?); practical problems with the language regime of the Directive, including the lack of approval or other validation of translations

On the issue of retail cascades one member said that banks acting as intermediaries were asking issuers for open-ended offer periods, which in practice made issuers liable for their ongoing reporting, thus extending the traditional scope of liability for such reporting to prospectus-level liability (that is, liability to potential investors rather than to existing shareholders). In addition, the need to issue prospectus supplements during that open-ended for every significant development effectively gives investors an extended right of withdrawal. To limit the problems of open-ended liability of issuers for the contents of the offering prospectus, a US-style limited offer period (length to be discussed) could be introduced. Another member gave the example of a regulator who had required a prospectus for on-

selling by intermediaries of shares included in a rights issue that had been admitted to trading without a prospectus under the exemption for the admission of shares representing less than 10% of shares of the same class already admitted to trading, on the grounds that the on-selling constituted a public offer, even though it was carried out through the regulated market. The Commission services commented that there was an inherent lack of clarity in the PD regarding primary and secondary offers and what constitutes an offer to the public when securities are already traded. Because there was no clear answer in the text of the PD, the Commission services would work with regulators to agree an interpretation and ways of applying the PD that did not prevent the market from operating.

One member commented that the propensity of regulators to extend the requirements of the PD in a disproportionate way risked harming the competitiveness of European markets. Another said that one reason for the increased use of denominations above €50,000 in the bond market was a desire for legal certainty about the application of the directive where the securities are distributed through intermediaries (selling through 'retail cascade'). Issuers and their advisers find it very difficult to obtain a definitive answer from anyone to questions regarding the PD. Another member commented that there were doubts whether following guidance issued by Commission services or CESR would protect issuers in the case of legal proceedings.

3) Transposition (failure of competent authorities to comply with time lines for approval or passporting can make it difficult for issuers to time the launch of a security to take advantage of optimal market conditions; divergent national requirements relating to publication of notices an obstacle to cross-border offers; practical difficulties caused by different MS interpretation of right to control advertising)

One member commented that it was very expensive for issuers to check the requirements on notices and advertising for each Member State. In addition, translations imposed significant costs, and this member would not support any proposal to extend translation requirements beyond the summary (for example, to information contained in final terms).

The observer from CESR commented that most of the issues raised by members related to Level 1 rather than Level 2, and that the Group should not confuse provisions in the Directive that might not be to their liking, on the one hand, and ambiguous provisions that lead to divergent interpretation or application, on the other. On the issue of European market competitiveness, CESR pointed out that the disclosure requirements in the US are more burdensome compared with those in the EU. CESR added that it was currently calling for evidence on the functioning of the PD, and would hold a public hearing for this purpose on 16th January 2007. The call for evidence would ask for views on whether the range of investment opportunities had increased or decreased as a result of the PD and on whether the level of disclosure required was appropriate.

ESME members were asked to provide written comments on the draft discussion paper, to be incorporated in the revised paper for discussion at the February ESME meeting.

5. Legal Read Across

The rapporteur of the sub-group introduced the work of the sub-group. Members presented the four papers prepared by the sub-group on the topics of:

1) Definition of qualified investor vs professional client

- 2) The various definitions in the securities directives of the related concepts of financial instruments and transferable securities
- 3) Definition of durable medium in the Distance Marketing Directive ('DMD') vs that under the MiFID
- 4) Difference between listing and admission to trading

On topic 1) the presentation noted the difference between the approaches to investor protection in the PD (which is product driven) and MiFID (which is service driven), and analysed whether the differences between the PD concept of 'qualified investors' and the MiFID concept of 'professional client' are justified by those respective approaches. The static treatment in the PD, with its absolute categorisation of certain entities as qualified investors and a limited scope for individuals and SMEs to opt in to that status, was contrasted with the more dynamic regime in MiFID which allows movement between the classes of non-professional and professional client and eligible counterparty, and with the option of different treatment for different services. The presentation concluded that the lack of a consistent approach might present an obstacle to the internal market for financial services and an effective passport for investment services. The lack of alignment prevents certain categories of persons who may be professional clients for the purposes of MiFID from being treated as qualified investors under the PD, and vice versa. This added a layer of complexity for firms and might increase compliance and IT costs. In particular, it was recommended that a qualified investor for the purposes of the PD should be presumed to be a professional investor for the purposes of MiFID (so that the suitability and appropriateness tests for the provision of investment services would not apply).

On topic 2, the presentation noted the differences between the definitions of transferable securities in the ISD and MiFID, the effect of the repeal of the ISD and its replacement by MiFID on the definition of 'securities' for the purposes of the PD and the Transparency Directive, and the inconsistencies between the definitions of 'financial instrument' in the MiFID and the MAD. It was considered whether these concepts could be replaced by a single concept, and concluded that that some differences were justified by the different purposes of the various directives. However, there were merits in replacing the range of different concepts and definitions with a single concept which could then be adjusted as appropriate by carve outs etc. in the individual directives. Such a central definition could either be contained in MiFID, or in a new instrument defining all the terms in EU financial law.

During the discussion that followed ESME members commented mainly on points 3) and 4) as follows:

On topic 3) the presentation focussed briefly on the central question explored in the sub-group's paper: that is, the circumstances in which a website could constitute a durable medium. Members agreed that this question raised needed to be answered to facilitate the continued use of websites for the provision of financial services. One member said that the high degree of sophistication of web instruments used by professional investors prevented any tampering with data in process, while retail investors could obtain instant confirmation of transactions by email to exclude the risk of interference. A member of the sub-group stressed the importance of obtaining positive guidance on the circumstances when electronic communications could be considered durable media and suggested that ESME could help the Commission services and CESR to clarify this issue.

On topic 4), members expressed a range of views about the usefulness of retaining the concept of official listing alongside that of admission to trading on a regulated market. Some

members defended the concept of a two-tier system with official listings as a 'kitemark' that could be chosen by issuers, entailing more rigorous standards of corporate governance. One member said the two concepts were separate and a discussion was required as to what each concept meant in practice. Another suggested that the primacy given to admission to trading on a regulated market as the central organising concept for regulation was misconceived, and may not be the most appropriate trigger, for example, for the application of the insider dealing regime.

Commission services proposed to single out the two topics of admission to trading vs. listing and durable medium for the next ESME plenary meeting in order to undertake a more detailed discussion.

6. Transparency/non-equities

The Commission services gave a short presentation of the main lines of the feedback statement recently published on this, the CESR initial assistance document, and the mandates to ESME. In the mandate, ESME is asked to comment on the feedback statement and to answer a number of specific questions. ESME is to be asked to focus on the cash bond markets, but to investigate other markets to the extent necessary to address particular questions. The main issues to be resolved by ESME revolve around whether:

- There is a market failure in the bond markets that mandatory transparency could solve;
- It could be desirable to consider extending mandatory transparency only to certain segments of the market or certain types of investors;
- ESME sees merit in any of the suggestions for non-price market transparency put forward by respondents to the call for evidence and identified in the mandate;
- ESME supports moves towards establishing a self-regulatory solution to issues of:
 - a) retail access to information about bond market transparency; or
 - b) the need for better information on overall market activity.

The rapporteur of the relevant sub-group gave a brief presentation of the approach the sub-group intends to take to this question. They agree to act in their personal capacities, to aim to deliver a single report if possible, but with the possibility of dissenting opinions. The sub-group will aim to present a report to the ESME meeting to be held in February 2007 and a draft of the advice to the May ESME meeting. ESME members and observers were asked to provide written comments to the rapporteur of the sub-group.

7. Commodities

The Commission services presented a brief overview of the content of the Call for evidence on the review of commodity and exotic derivatives and related business as required by the MiFID and recast CAD, which is to be published on the 8th of December 2006.

Comments received from ESME members referred to: a) the need to streamline collaboration between the Commission and ESME in this area and in particular to get some Commission's feedback as to which should be ESME's role and b) the importance of dealing with issues that were left aside in the MiFID agreement, especially those referring to super-equivalence.

The Commission services expressed its willingness to collaborate with ESME and considered that the ESME commodity sub-group could start by examining the call for evidence. It also

agreed that aspects related to super-equivalence are of particular importance in the context of the revision of the commodities business.

8. A.O.B.