

# **EUROPEAN SECURITIES MARKETS EXPERT GROUP (ESME)**

## **Report of 1<sup>st</sup> meeting on 08.09.06**

### **1. Adoption of the agenda**

Agenda was approved.

### **2. Adoption of the rules of procedure**

The Commission services explained that the draft rules were similar to those used for other groups. ESME reports and minutes would be made available on the Commission's website. Names of individual members would not be named in the minutes which would be circulated for approval in writing before being put on the site.

Sub-groups would be set up, each with a rapporteur. Commission officials would participate in the sub-groups, but the Commission services would not provide the secretariat for them.

The Commission services explained that CESR has permanent observer status in ESME. ESME members might want to suggest other observers who could be invited to attend specific meetings. Two consumer groups – ESCG and FIN-USE – could also be consulted.

The rules of procedure were adopted.

### **3. Discussion of the work programme**

The Commission services invited members to give their views on the work programme and any other issues not so far included.

Members discussed whether the topic of Clearing & Settlement could and should be included in the work programme. The Commission services agreed that Clearing & Settlement was a major topic facing markets and explained that work on a Code of Conduct in this area was currently progressing with a resolution expected by the end of October. Commission services offered to brief ESME on the progress made in this area and to keep it in mind for possible consideration at a later stage. Moreover, clearing and settlement was also being discussed in depth in other forums.

In summary, the members also raised the following main issues during the discussion:

- 1) The impact of the Directives on the global competitiveness of the EU should form a part of the economic evaluation. How could the European market be made more attractive? However, it would also be necessary to consider smaller market participants, on which the impact of EU legislation could be unforeseen or disproportionately burdensome. If a measure has been drafted with a particular bias towards either the wholesale or the retail market, this

might lead to unintended consequences on the other. Work should also focus on the extent to which the EU legislation helps end users.

- 2) The potential for amendments to current EC legislation in cases where problems cannot be resolved within the existing legal framework.
- 3) The need to have regard to a range of solutions to problems of legal uncertainty that might be identified by the Group. Practical solutions, where possible, were desirable. Some points of legal inconsistency or uncertainty would not matter in practice. Others might be effectively addressed by developing a common approach within the existing legal framework. Besides inconsistencies between directives (including directives other than those relating to securities) and the lack of legal certainty with regard to their interpretation, another useful focus might be the costs of complexity arising from the lack of harmonisation, and in particular areas where a lack of harmonisation was not supported by any rationale.
- 4) Lack of clarity in core concepts used in Directives: for example, the precise meaning for the purposes of MiFID of "receipt and transmission of orders" and "client", or the difference between a "service" and an "activity".
- 5) The differences both in the implementation of the Directives into national law and the lack of harmonisation in their application/interpretation by national regulators with the impact this has on "passporting".
- 6) The potential for ESME to make a meaningful contribution.

The Commission services explained its legal obligation to report on the functioning of the Directives and that ESME's work should concentrate on the Securities Directives before possibly extending to other Directives as well. They assured members that no course of action in response to recommendations made by ESME was excluded. In particular, they confirmed that a proposal to amend existing legislation was one possible outcome if the work of the Group exposed serious shortcomings and/or market failures, but that any change would have to be supported by serious economic analysis. The Commission services also said that they were grateful for any information members of ESME could share with them on the application of EU law and that this included also cases of misapplication which could trigger a Commission intervention e.g. the launching of infringement procedures.

#### **4. Establishment of sub-groups**

The following sub-groups have been established: i) Legal read across; ii) Market Abuse Directive, iii) Prospectus Directive; iv) Non-equity markets transparency; v) Commodities.

The Commission services explained the background to the legal evaluation to be undertaken by the ESME subgroup tasked with a "legal read-across". The purpose of the exercise is to read all the EU securities legislation together as a single corpus of law, in order to identify any inconsistencies between the various texts. The focus of this sub-group should be practical: its work should not "disappear into the library". One member identified three separate issues that needed consideration: differences (i) between the Directives, (ii) in their implementation, and (iii) in their application by regulators. Commission services confirmed that the application in practice of Community provisions is core to its task. The exercise should aim at identifying and listing all

inconsistencies, disregarding those which did not matter from a practical viewpoint. ESME should also propose ways to deal with inconsistencies which were considered to be meaningful. The Commission services explained that there were many ways to deal with inconsistencies which mattered, such as consistent interpretation agreed by regulators and the regulated community, a change in market practice and, as a last resort, a change in the law.

Regarding the risk of duplicative work by the legal read across group vis-à-vis the other subgroups, the Commission services explained that, in their view, there was a sufficiently clear distinction between the legal read across and the work of the subgroups dealing with an individual directive. In particular, the former would be concerned with the rationale – or lack of it – for discrepancies between directives, while the latter would concentrate on the impact and internal coherence of specific directives (and their implementing measures).

Some members suggested expanding the read across to other sectoral Directives, such as banking and insurance. Commission services considered that, in the first instance, the read across should be limited to the securities directives, although it could be extended later on to legislation in other related sectors. Moreover, it is unrealistic to expect this subgroup to consider all national implementing measures (although clearly any information about national implementation that members could provide would be valuable to the Commission Services for their role in supervising the accuracy of transposition). The expected outcome of the work of the subgroup should be diagnostic, accompanied by and recommendations to Commission services.

## **5. Transparency/non-equities**

The Commission services presented its Call for Evidence and mentioned that the closing date for submissions was 15 September 2006. The Commission services also emphasised the fact that it has a completely open mind about the outcome of the review, and that it is at a very early stage in the process. ESME's work would feed into the report the Commission would publish in the autumn of 2007.

There was significant sentiment to the effect that these were wholesale markets and regulation was not warranted on the basis of the very limited retail involvement. However, it was pointed out that in some national markets, direct retail investment in bonds is very significant. Others queried whether regulation of market transparency for bonds would have improved the situation of retail investors in bonds which had notoriously lost their value – such as Parmalat. They suggested this was more a question of suitability than of transparency.

Some members also worried about the impacts of any regulation – particularly pre-trade transparency – on liquidity, and on the relative competitiveness of the European marketplace, especially in attracting hedge funds. Any negative regulation would simply drive liquidity elsewhere. However, there were some voices in favour of establishing reference pricing for portfolio valuation purposes, either building on existing systems (like TRAX) or on alternatives.

There was broad agreement that instrument classes needed to be considered on a class-by-class basis – one size does not fit all. There was support for the view that for each instrument class, a matrix approach could be taken, mapping the various dimensions of the class in terms of retail

involvement, market structure, and other parameters that would be important in framing any policy intervention.

The group noted that the issue would be considered by the Non-equity markets transparency sub-groups.

## **6. Financial analysts**

The Group considered the draft Communication on investment research and financial analysts circulated by the Commission services.

In general terms, the group supported the thrust of the Communication, and agreed that further regulation was not needed on most of the topics identified (registration of analysts, independent research, issuer relations with analysts and investor education). However, one member raised the possibility of a 'European passport' for analysts, which he said would be useful to replace the existing registration schemes. Other members raised a concern about issuers wanting to see draft research before issuing mandates. One member noted this was already subject to heightened conflicts controls at large investment banks.

Comments made were along the lines of the documents already circulated before the meeting by members of the Group. In particular, it was emphasised that small firms should not be prevented by conflicts management principles from issuing investment research. Two members of the group queried the relationship between the MiFID and the Market Abuse Directive. One Directive seemed to proceed by assuming conflicts of interest must be managed, while the other took more a disclosure-based approach to conflicts. Also, one was a 'country of origin' approach, while the other was on a host-State basis.

Members said there were a number of issues relating to the disclosures under the MAD, in particular relating to fixed income, that the MAD sub-group should investigate. One member mentioned that there was still an outstanding debate as to whether dealing ahead of investment research could have MAD implications. He said there may be a need for further regulators' guidance on these issues, but that the paper did not need revision in relation thereto.

The Commission services thanked the members for its comments and undertook to take them into account in finalising the Communication, expected to be published in November.

## **7. Operation of Market Abuse Directive and Prospectus Directive**

### **Market Abuse Directive (MAD)**

The Commission services presented their activity to date with regard to monitoring the implementation of Market Abuse Directive and its implementing measures. The transposition exercise had been finalised and the completeness verification of transposed measures concluded. The focus now was on the quality of implementation with several areas of interest identified for further analysis. The Commission services explained that the feedback from securities supervisors and the industry on the operations of the MAD had been limited, probably due to the short period that had passed from the inception of the new rules in the Member States.

The Commission services welcomed initial written contributions received from ESME members and considered that they already set a good basis for further discussion in the sub-group on the MAD. It noted that the issues of "super equivalence" should be approached with due regard for Member States' competence in areas not covered by the MAD.

ESME members referred in their interventions to specific issues relating to the MAD application in practice, as well as inconsistencies in the transposition of a number of provisions across the EU. Issues raised by the members included: the scope of insider lists' obligation (persons to be included, permanent/temporary status of an insider etc.), conformity of relations between an issuer and its shareholders with MAD restrictions, application of MAD rules to commodity derivatives' markets and other non-equity markets, compliance costs, effects of MAD applications on listing choices by the issuers, the use of safe-harbours. The members generally acknowledged that the MAD regime established a high convergence level among the Member States in addressing market abuse situations, but some efforts were needed to ensure greater operability of the MAD. Several references were made to Level 3 guidance as a tool to effectively tackle coherence problems EU-wide.

### **Prospectus Directive (PD)**

The Commission services gave a summary of the key issues on which ESME's advice is being sought.

Regarding the legal issues, some members had already outlined problems or points of uncertainty in preliminary papers circulated to the group. Issues which might usefully be considered by the sub-group might include:

- the application of prospectus requirements to the onward sale of securities that were initially the subject of an exempt offer (such as placement with qualified investors), together with related questions of liability, responsibility for updating, etc;
- questions relating to the application of the Prospectus Directive to offers made to employees in the context of an employee participation scheme, and in particular the status, for the purposes of the Directive, of shares in private companies;
- "goldplating" by Member States, particularly by the imposition of additional administrative requirements (filings, publication of notices, etc.) that hampered the efficient operation of the passport under the Directive. In this context, a distinction could be drawn between those supplementary requirements that were clearly illegitimate under the Directive (and therefore an enforcement matter for the Commission), and those which reflected legal uncertainty about the meaning or effect of the Directive.

As regards the economic evaluation, the analysis should focus on two main issues: how the Prospectus Directive has affected the functioning of EU financial markets and whether the Directive has affected the competitiveness of EU financial markets in global terms, moving issuers to markets outside Europe. In this regard, questions to be addressed include:

- to what extent the level of IPOs can be used as an indicator that the market is adapting to the Prospectus Directive?
- are there indications to support the view that the bond market is becoming less liquid as a result of the Prospectus Directive? Is there any significant difference between the effect on the wholesale and retail segments?  
Are there signals in bond markets prices of a closing between bid and offer as a result of a wider offer?
- How should a cost/benefit analysis be structured? In particular, what proxy should be selected to indicate a decreased cost of raising capital in EU? What are the additional compliance costs introduced by the Prospectus Directive?

Members expressed concern about the impact of the Prospectus Directive in some markets and were generally of the view that variations in national implementing legislation created problems for market participants. One example cited was national legislation on the appropriate competent authority for the approval of advertising material. One member explained that problems in the operation of the Prospectus Directive arising from national interpretation or application were often not notified to Commission services because issuers had to maintain a working relationship with competent authorities, and accordingly were wary of reporting national regulators for fear that the relationship would be affected.

An member stated that it was not clear whether the Prospectus Directive is 'maximum harmonisation', and this uncertainty might underlie inconsistent implementation and gold-plating by Member States. Another member raised a question about its scope, and the extent to which it applies to derivative markets. One member observed that some prospectuses drawn up in accordance with the Prospectus Regulation now run to 400 pages or more, and as such might actually represent an obstacle to effective investor information. It was highly doubtful that a prospectus of this length and complexity would actually comply with the requirement in Article 5 of the Directive that it should be presented in an "easily analysable and comprehensible form". Another member remarked that EU regulations were becoming increasingly burdensome especially for smaller companies and that this effect needed reflecting upon.

Members referred to a range of practical issues of concern in the market. For example, issuers are choosing alternative markets, both in Europe (such as non-regulated markets in London and Luxemburg) and in Asia. This trend was partly due to the accounting requirements imposed by EU legislation (including the Transparency Directive) on issuers that had securities traded on a regulated market, but it was also caused in part by requirements under the Prospectus Directive in relation to the disclosure of guarantors (a practical problem, for example, in high yield issues where there were multiple guarantors). The reasons why issuers are choosing alternative markets should be examined.

One member observed that the Prospectus Directive had worked better than expected for retail debt issues, where its use has been much higher than predicted. Another member commented that the distinction, for the purposes of determining the issuer's home Member State, between non-equity securities with a unit denomination of less than €1,000, and those with a denomination of at least that sum, was superfluous. The severely limited choice of home Member State was

leading to a lack of regulatory competition. There were currently significant differences in the rules and the performance of national regulators: for example, statutory deadlines for approval not being met, variations in contents requirements for prospectuses.

On the issue of prospectuses becoming too complex for investors to comprehend, Commission services suggested that some elements of investor protection may be adequately dealt with by the conduct of business rules imposed on investment firms under MiFID. The group might wish to examine whether there was any regulatory duplication between the requirements of Article 19 of MiFID and the requirements of the Prospectus Directive insofar as it applied to onward offers of securities by financial intermediaries.

## **8. Professional Indemnity Insurance**

Due to time constraints, ESME members were asked to give any comments on the Commission services draft on professional indemnity insurance, in writing.

## **9. A.O.B.**

Next meeting is scheduled on 4 December 2006. Meetings in 2007 will be on 28 February, 23 May and 5 September.