

Annex 2:

**REVISION OF THE INVESTMENT SERVICES
DIRECTIVE (93/22)**

**SUMMARY OF RESPONSES TO THE PRELIMINARY
ORIENTATIONS OF COMMISSION SERVICES
(JULY 2001)**

Note to reader:

The following presentation provides an illustrative and objective presentation of the comments received by the Commission services in response to the July consultation. This presentation does not reflect any judgement on the part of the Commission services as regards the different issues. The summary document seeks to provide a structured guide to the basic positions advanced by respondents in respect of the recurrent themes in the feedback to the consultation.

In drawing conclusions for the revised orientations, the Commission services have been guided not only by the number of proponents expressing a particular point of view, but also by qualitative considerations such as the arguments advanced by respondents in support of their views.

Readers of the summary document should also bear in mind some important provisos relating to the quantitative presentation:

- Few respondents answered systematically to the questions included in the consultation documents. Instead, submissions tended to deal extensively with the issues of greatest concern to the respondent. In order to facilitate presentation of this loosely structured feedback, the Commission staff have formulated a set of broad propositions which reflect the principal themes in the responses. Where respondents have expressed an unambiguous view in respect of one or other proposition, they have been counted for the purposes of the following numerical presentation. What follows should therefore be regarded as a summary of statements volunteered by respondents regarding their perceived priorities in relation to the preliminary orientations. The accompanying text commentary seeks to provide a rounded view of all submissions, including nuanced positions which could not be situated clearly with respect to the core propositions.
- All responses have been placed on the same footing regardless of the size of the constituency represented or the status of the respondent. Therefore the summary document should be regarded only as a crude head-count, and not necessarily as a weighted or representative presentation of the different responses.

1. INTRODUCTION

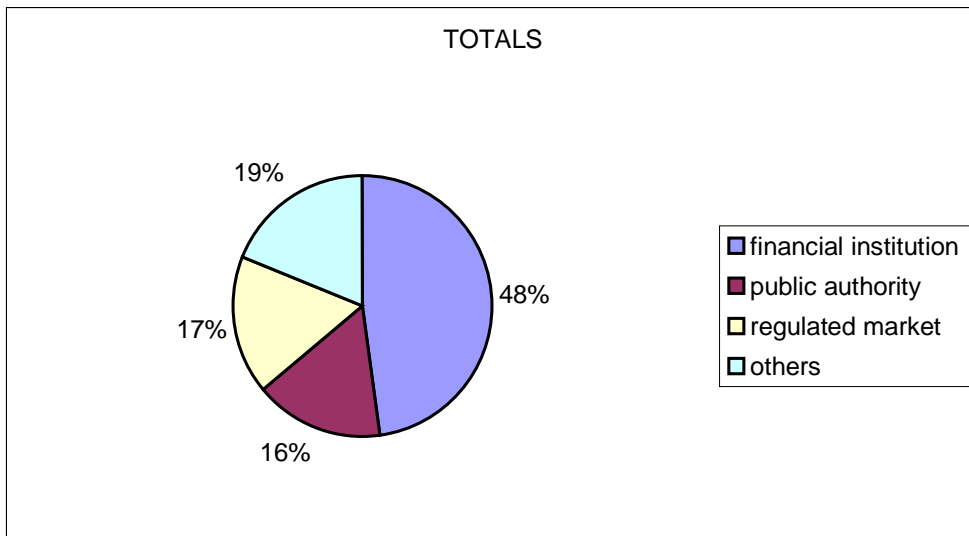
This document summarises the responses to the preliminary orientations for revision of the Investment Services Directive (ISD) which were published by the services of DG Internal Market of the European Commission in July 2001. The consultation of interested parties at an early stage, and the provision of feedback on market reactions are crucial in ensuring that proposals for European legislation in the area of financial markets are properly conceived, justified and cost-effective.

Box: core elements of preliminary consultation.

The European Commission launched an open Internet consultation on potential adjustments to the Investment Services Directive on 24.07.01. The Commission solicited input from all interested parties in respect of an extensive body of detailed proposals for possible adjustment to the structure and content of the Directive including:

1. A reconsideration of the institutional architecture of the ISD so as to address the perceived regulatory challenges relating to market efficiency caused by widespread execution of investment orders away from exchanges. The proposed adjustments sought to clarify the conditions under which order-matching systems should be regulated as “regulated markets”. They also sought to specify the necessary extensions to the investment firm regime to contend with the possible threat to market efficiency/integrity and investor protection when order-matching is undertaken by banks/investment firms.
2. a review of the scope of ISD so as to better reflect the changing nature of investment intermediation and to allow a broader range of investment services to be organised on a pan-European basis;
3. modernisation and harmonisation of the investor protection rules incumbent on investment firms so as to ensure a high level of investor protection and facilitate the cross-border provision of investment services and to promote the integrity of the market;
4. elaboration of high level principles governing the authorisation and operation of “regulated markets” which would allow ‘regulated markets’ to compete for order flow and liquidity without jeopardising the orderly and efficient operation of the European securities market system, or the interests of issuers and investors;
5. clarification of conditions under which market participants and regulated markets could make use of clearing and settlement infrastructures in other Member States.

69 replies were received in response to the preliminary orientations. Responses were received from a full cross-section of the practitioner and regulatory communities. There was limited input from the share-holder/investor (one response) and corporate/issuer (2 responses) constituencies. There was wide geographic coverage (respondents from 16 countries including 13 EU Member States).

Composition of replies by category.

In addition to text submissions, the Commission services benefited from open exchanges and discussions with interested parties throughout the consultation period. In order to facilitate this dialogue and to ensure a balanced input from all sides, the Commission services organised an open hearing in Brussels (18th/19th September) which was attended by some 150 participants.

The following broad-brush presentation highlights the main themes which were the object of extensive comment. In addition to the general messages outlined below, many other valuable insights were gleaned from the submissions. It has proved impossible to document these in a text of this general nature.

2. GENERAL REMARKS:

2.1. Process:

There was widespread support for the consultation procedure and the proposal to revisit the Investment Services Directive. 44 respondents recognised the need to modify the ISD in at least some respects and expressly commended the open consultation process launched by the Commission services. No views were expressed opposing revision of the Directive. As will become apparent, this broad consensus in support of ISD modification conceals considerable diversity of opinion regarding the scale and focus of any revision.

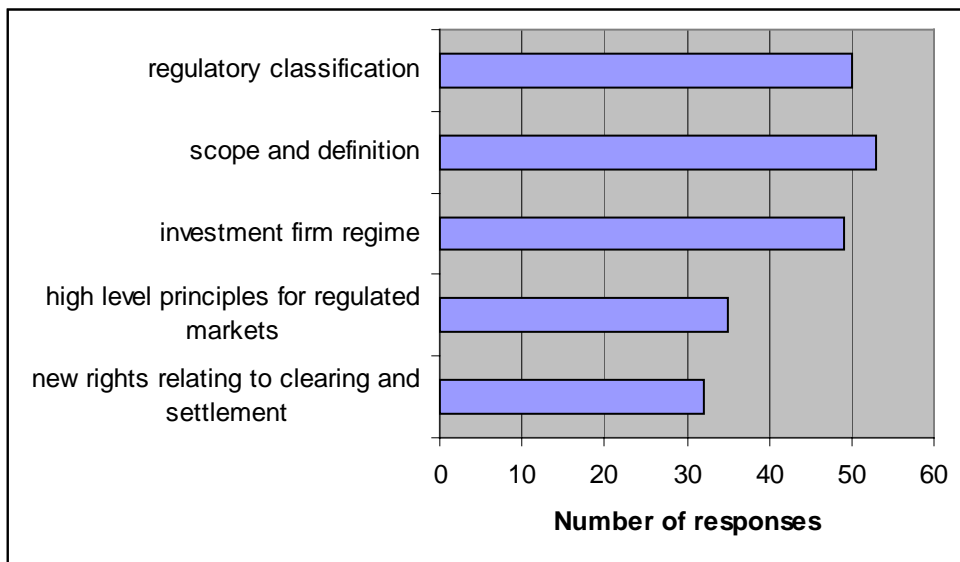
Many respondents underlined that a successful revision of ISD is instrumental in the development of efficient and integrated European financial markets. However, a successful reform of the regulatory framework for investment firms and regulated markets must also take account of related provisions of EU financial law and/or parallel legislative proposals. These related measures may have an important bearing on proposed changes to ISD rights and obligations. The related elements of EU law which were most frequently cited include:

- Capital Adequacy Directive (with a view to ensuring that any broadening of the scope of “investment firm” population did not trigger inappropriate capital treatment);
- Second Banking Coordination Directive (so as to ensure alignment of definitions of authorised services across the 2 Directives);
- proposal for Prospectus for publicly offered Securities and related work on ongoing disclosure (in view of the possible implications for eligibility of instruments for trading on “regulated markets” and by extension, for the screening of securities that a market operator must undertake in order to be licensed as a “regulated market”).

24 respondents used the occasion of the consultation procedure to reaffirm their support for the recommendations of the Lamfalussy committee on the regulation of securities markets, and urged the Commission to ensure that its proposals conformed to these recommendations. In particular, any Commission proposal should avoid over-specification of regulatory disciplines and confine itself to statement of high level principles. The need for continued openness and transparency in the promulgation of framework law and implementing measures was recalled.

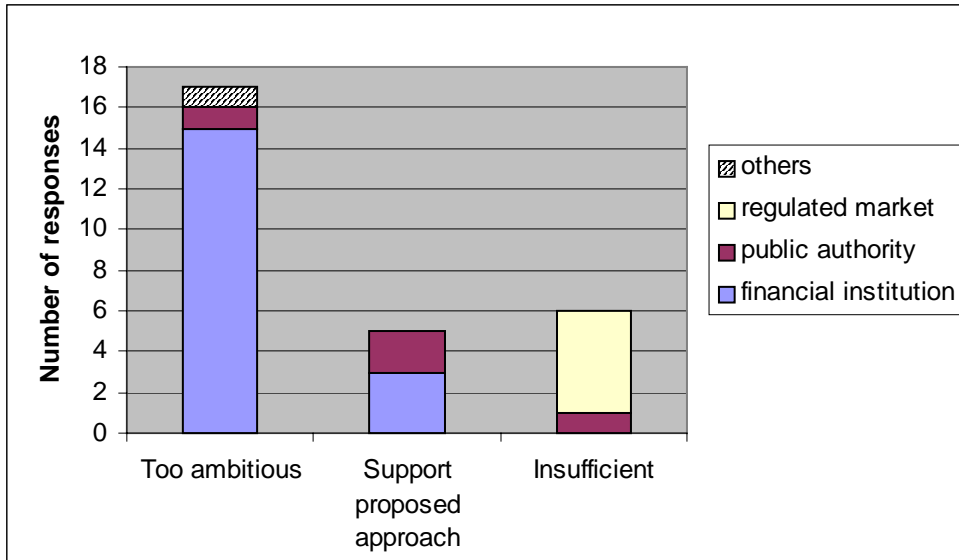
2.2. Scope and focus of ISD review:

All aspects of the preliminary orientations were widely commented. The bulk of responses contained observations in respect relating of proposals on regulatory classification (50 respondents commented), scope and definitions (53) and proposed modifications to the investment firm regime (49 responses). Half of respondents (35) commented on proposed high level principles for regulated markets, while slightly under half (32) commented on the proposed introduction of new rights relating to clearing and settlement.



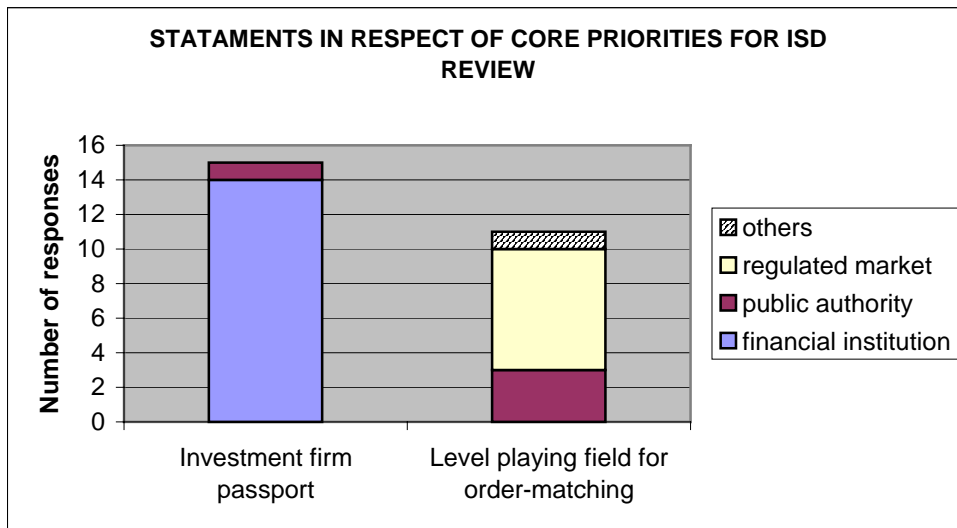
28 respondents prefaced their detailed comments with express statements regarding the desirability of undertaking a revision of the ISD on the scale proposed in the preliminary orientations. The bulk of these respondents (17) regarded the proposed

overhaul of the ISD as being over-ambitious and/or called for a more narrowly focused revision of the Directive. 15 respondents expressing this viewpoint were financial institutions or trading associations. 6 respondents – 5 of them regulated markets – regarded the preliminary orientations as being insufficient to contend with key regulatory challenges. 5 respondents supported the thrust of the proposed orientations.



A number of respondents volunteered views as regards the key priority for revision of the ISD. In particular, 15 respondents identified the delivery of an effective ISD passport enabling investment firms to provide services freely on the basis of home country authorisation and supervision, as the over-riding objective. 14 of these respondents were financial institutions or their representative organisations. This group included 12 of those expressing the view that the preliminary orientations were overly ambitious.

11 respondents expressed the view that clarification of the conditions under which different categories of operator could engage in matching of buy/sell orders was the most pressing concern. This grouping included 7 regulated markets or representative bodies, 3 public authorities/agencies and 1 other. 2 respondents regarded regulatory clarification of off-exchange order-matching as a negative priority – in the sense that preliminary orientations were misguided, unwarranted and likely to deflect energies from more pressing issues (single passport).



3. SUMMARY OF THE REPLIES

3.1. SECTION 1 : PROPOSED REGULATORY CLASSIFICATION

Synopsis of preliminary orientations regarding regulatory classification:

The preliminary orientations identified extensive order-execution outside the rules and systems of “regulated markets”, in respect of instruments admitted to trading on a “regulated market”, as a structural development warranting enhanced supervisory attention. In particular, the preliminary orientations sought to clarify the regulatory treatment of off-exchange order-execution arrangements by ATS and via systematic internalisation of order flow by authorised intermediaries. The main regulatory motive was to preserve overall market quality and efficient price formation. Widespread off-exchange order-matching could reduce interaction between buy and sell interests, thereby rendering price formation less efficient, increasing spreads and adverse price impacts.

Depending on whether this activity was cumulated with other investor-facing services, there was also considered to be a need for enhanced enforcement of investor protection safeguards for clients and users of non-exchange order-execution facilities. In particular, it was considered important to verify that end-investors receive “best execution” when their orders are offset against the proprietary trading interests of the firm acting on their behalf. Finally, off-exchange order matching may be a conduit for abusive practices in the same way as on-exchange trading. It was proposed that operators of non-exchange trading systems be willing to implement appropriate monitoring and surveillance arrangements.

The proposed regulatory classification was based on fixed regulatory/institutional definitions. These were to be used to determine whether different entities were to be classified as “exchanges/regulated markets” or “investment firms” for the purposes of the ISD. A definition of “organised market” was proposed as the basis for distinguishing between:

- order-execution venues which could be authorised only as a “regulated market/other organised market” because they contributed significantly to price-making for financial instruments;

- and those which could engage in order-execution on the basis of an investment firm licence on the grounds that they did not provide true “market” functionality, in the sense of being price-taking systems.

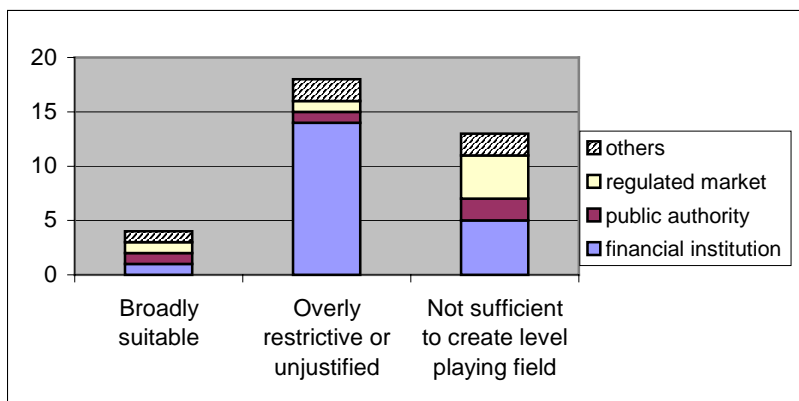
On the basis of this regulatory classification, different regulatory disciplines were to be applied specifying the conditions under which a regulated entity could engage in order-execution. “Organised markets” wishing to support order execution in respect of instruments admitted to trading on a “regulated market”, would have been obliged to obtain authorisation as a “regulated market”. Operators licensed as investment firms would be allowed to match orders on the basis of their investment firm licence. When doing so, they would be subject to more stringent application of investor facing obligations (best execution, order routing disclosure) plus new market facing obligations (trade reporting/transparency, system surveillance).

The 50 respondents who commented on the regulatory classification expressed wide-ranging views regarding:

- the motivation for these proposals and their conception;
- the extent to which they would effectively achieve the intended objective;
- practical considerations such as compliance and practicability of mechanisms.

The main positions adopted by most of these respondents can be situated with respect of 8 propositions.

1. Do the proposals for a new regulatory classification represent a suitable basis for clarifying the regulatory treatment of different types of order-matching systems?



The overwhelming body of respondents regard the proposed classification as either an inappropriate or insufficient approach to resolving the regulatory concerns. Only 11.4% endorse the proposals.

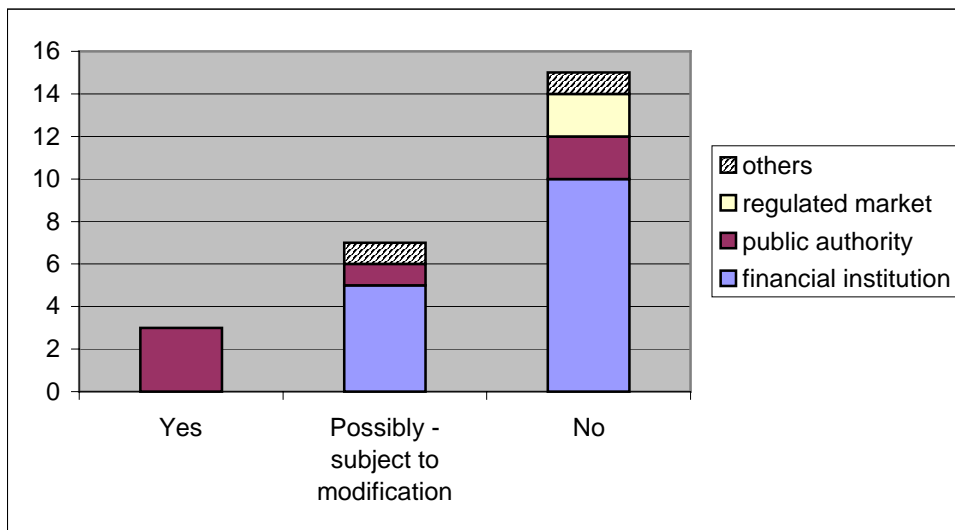
Respondents have contrasting reasons for opposing the classification. The predominant view is that the proposals threaten to create institutional rigidities, stifle structural change and innovation. Many proponents of this view caution against any approach based on the introduction of rigid regulatory demarcations and advocate retention of the flexibility of the existing ISD (whereby trading systems and regulators have some discretion as to whether a particular entity is regulated as an

investment firm or a “regulated market”). This group is essentially comprised of financial institutions, but also includes 1 public authority and 1 regulated market.

Respondents opposed to the regulatory classification on these grounds encompass some who do not regard off-exchange order-matching as an issue warranting regulatory intervention at this stage, but also includes some who consider it a priority but feel that the proposed regulatory classification is not the appropriate response. The positions reported below in respect of propositions 2-5 shed further light on some particular concerns regarding the inflexibility of the proposed classification.

A countervailing view, supported by a large minority (37.14%), is that the proposed regulatory classification is an inadequate response to the challenges posed by off-exchange order-matching. These respondents contend that the proposed approach will legitimise systematic off-exchange order-matching without imposing the disciplines needed to avoid reduced order interaction and erosion of market efficiency. A number of these respondents explicitly identify order-internalisation on proprietary/in-house trading systems as a major threat to the efficiency and quality of European financial markets. Proponents of this view-point include 2 public authorities and 4 regulated markets.

2. Is the definition of “organised market” a clear, operational and/or suitable basis for determining whether entities should be regulated as markets/exchanges or as investment firms?

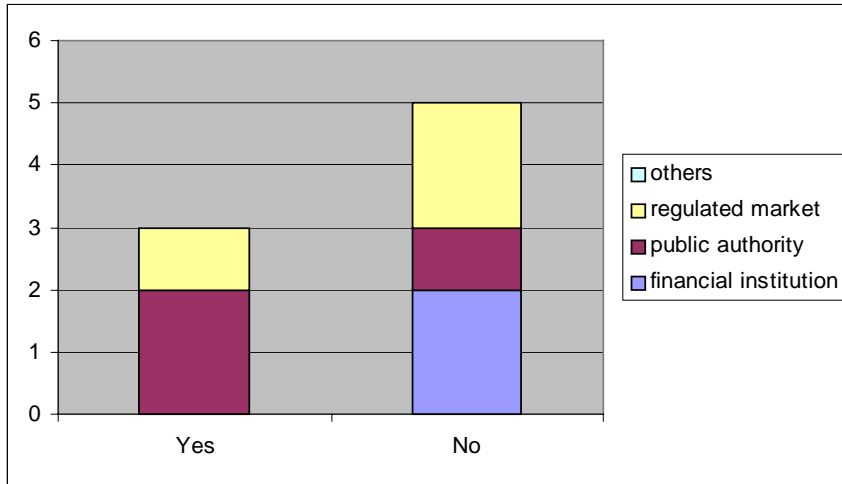


While only 3 respondents supported the definition in its present form, 7 others broadly supported the introduction of a definition subject to greater clarity. Some of these respondents also sought an explicit widening of the definition to capture certain types of “Alternative Trading System” (ATS). The proposed exclusion of price-crossing systems was queried.

Those expressing a negative opinion on the definition of “organised market” were opposed both to its intended purpose and to the fine-print of the definition. On the latter, some respondents challenged the validity and practicability of the criteria on which it was proposed to distinguish between price-making and price-taking trading systems.

Commission services note that respondents drew widely divergent and mutually inconsistent conclusions as regards the types of trading system which would be caught by the definition. This uncertainty suggests that the definition as set out in the preliminary orientations is unlikely to provide the necessary legal certainty.

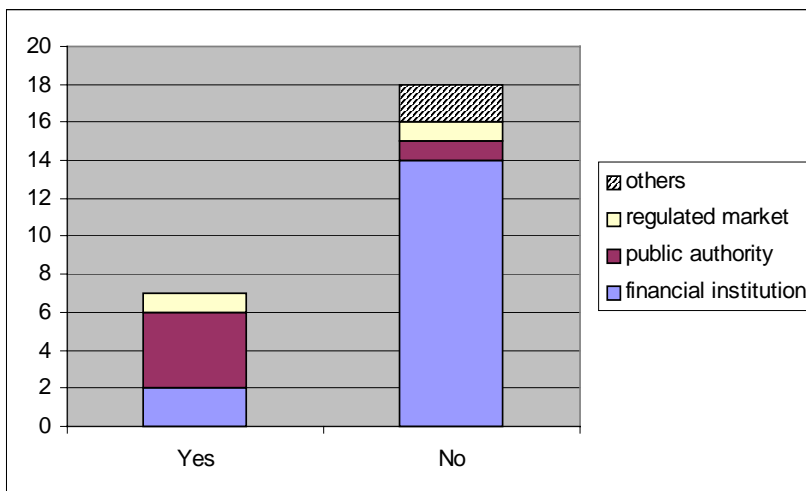
3. Does the proposal to provide for a category of “organised markets” outside the scope of ISD (unregulated organised markets) add value?



The majority of those expressing a view queried the utility of establishing a special subset of “organised markets” which would be exempt from ISD rights and obligations. There was considerable uncertainty as to the precise nature and extent of business that would be conducted on these markets. Doubts were also expressed as to the legal value of merely recognising the existence of these markets in the ISD without subsequently conferring any rights and obligations on them.

A number of respondents sought clarification of whether “regulated markets” would be entitled to operate “unregulated” segments.

4. Is it appropriate/proportionate to prohibit the admission of trading of instruments to trading on a non-ISD organised markets once those instruments are traded on a “regulated market”?

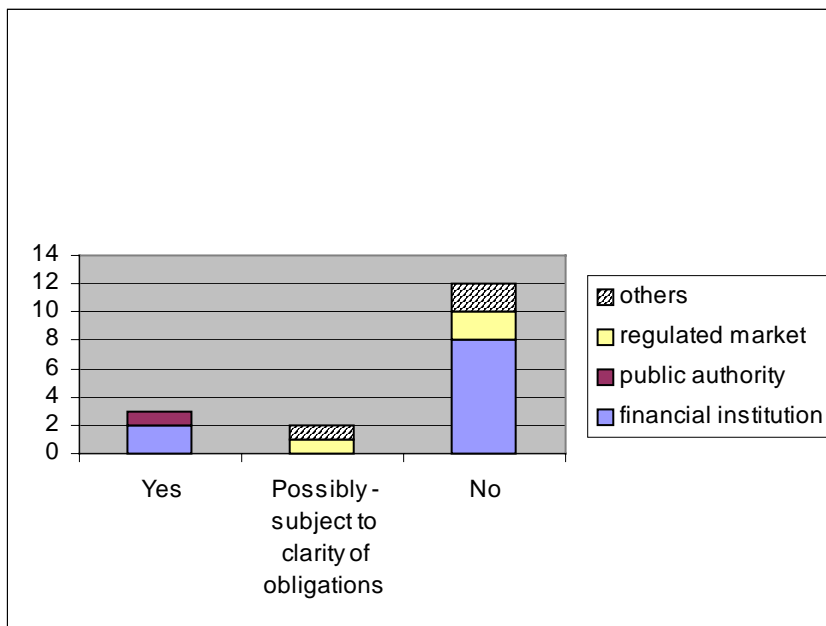


A clear majority opposed the proposal that instruments admitted to trading on regulated markets be ineligible for admission to trading on “unregulated organised markets”. Reasons for opposing this proposal included concerns relating to the possible deleterious effect on competition between different categories of marketplace, and fears that unregulated markets would be effectively forced to obtain recognition as a “regulated market” if they were to be viable. Respondents also voiced concern that “regulated markets” would be able to appropriate trading in instruments successfully incubated on the “unregulated” segments, thereby preventing unregulated markets from profiting from innovation.

Those supporting the proposed prohibition regarded it as the logical corollary of seeking to avoid arbitrage between markets operating under markedly different regulatory regimes.

In addition to those taking an unambiguous position on this proposal, a number of other respondents regarded the proposal as being devoid of practical effect in view of the fact that investment firms would be freely able to match orders in instruments admitted to trading on “regulated markets”.

5. Should a revised ISD emphasise statutory limitations on the quality of instruments admitted to trading on regulated markets (i.e., disclosure and proper market tests) as the distinguishing feature of “regulated markets”?



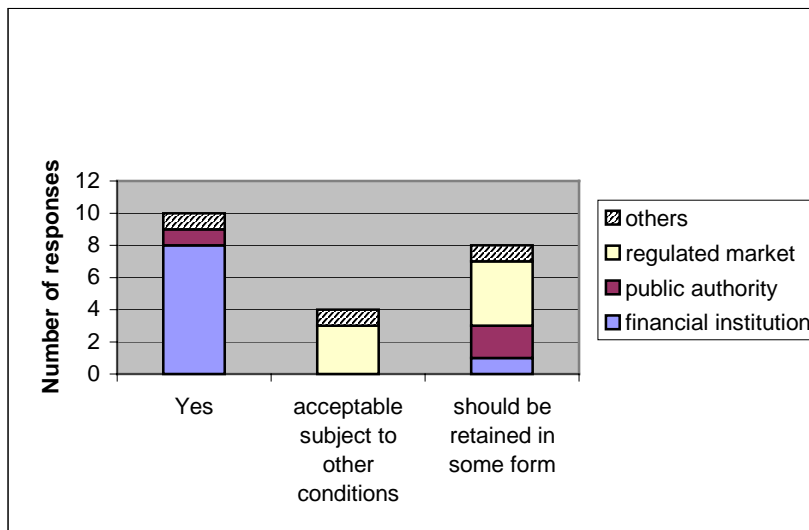
A minority (5) of respondents were positively disposed towards the suggestion that the regulatory framework for “regulated markets” be anchored by binding obligations to screen the “quality” of instruments admitted to trading on the market. Of this group, 3 were unequivocally in favour. A further 2 responses agreed with the underlying philosophy but stressed the need for clear operational obligations so as to avoid exposing operators of regulated markets to legal risk.

12 respondents argued in favour of leaving discretion to and responsibility for admission of instruments to the operator of the “regulated market” – with the

possible exception of an obligation to verify that the issuer of a security comply with any statutory disclosure obligations. Some respondents noted that imposing this obligation effectively presupposes some direct understanding/contractual relationship between the issuer of the security and a regulated market – and noted that this could run counter to the objective of promoting competition between “regulated markets”.

Those opposed to a regulatory focus on instrument quality also cited the conceptual and practical difficulties of designing and implementing meaningful tests for derivative instruments or even fixed income securities.

6. Should the possibility for Member States to impose “concentration rules” be removed in the context of ISD revision?

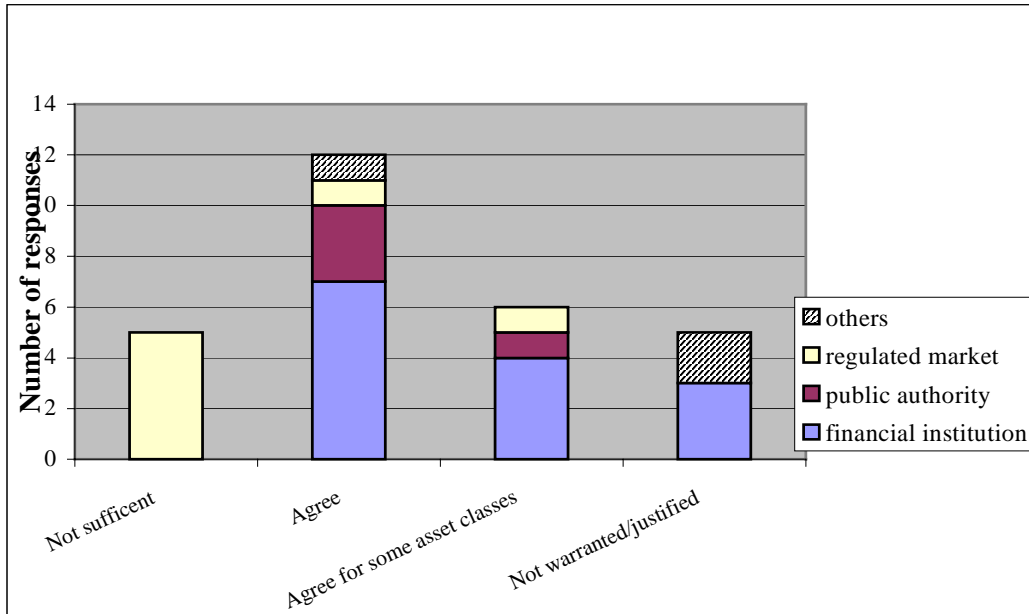


As a corollary to remedying the impact of off-exchange order-matching on market efficiency through enhanced transparency and other disciplines, the preliminary orientations proposed to dispense with the current option for Member States to insist that retail investor orders be “concentrated” on a “regulated market” (article 14(3) 93/22). Just under half (10 out of 22) of respondents unreservedly called for removal of the concentration rule option. This group comprised essentially financial institutions (8 of the 10).

A further 4 respondents, including 3 representatives of the “regulated markets” community, could countenance such a step with the proviso that effective steps were taken to place non-exchange and exchange trading on a similar regulatory footing.

A significant minority (8 out of 22) argued for retention of concentration rule in some form. Some of these respondents argued that the obligation to route retail investor orders for execution on a regulated market represents a justifiable policy option when confronted with the detrimental consequences of off-exchange order matching for the efficiency of the price formation process. It was also suggested that if the concentration rule were to be repealed that it should be replaced by statutory recognition that performance of a transaction on a “regulated market” benefit from a presumption of “best execution”.

7. Can, *in principle*, enhanced transparency obligations for order-matching investment firms effectively counter the potential adverse consequences of off-exchange order-matching for market efficiency/integrity?

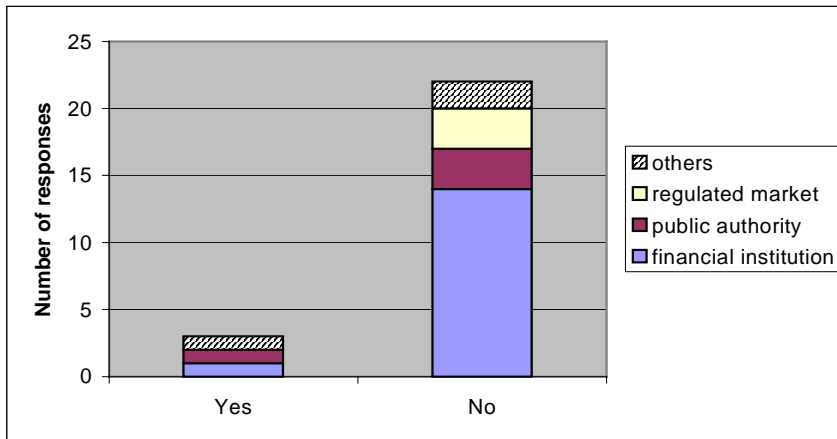


There is a substantial middle-ground which, in principle, regards effective transparency rules as a promising basis for managing any negative repercussions that might ensue from widespread execution of investment orders outside the rules and systems of regulated markets. 12 out of 28 respondents supported the development of high level principles for transparency which could encompass all instruments. A further 6 endorsed the promulgation of transparency obligations provided that these took sufficient account of the characteristics and price formation processes for different assets. In particular, it was contended that the transparency benchmarks set out in the preliminary orientations might be broadly pertinent for equity markets. However, extension of similar levels of transparency to other asset markets – fixed income securities and derivatives – would be meaningless (in terms of price relevant informational content) and/or counterproductive.

5 respondents took the view that no case had been made for the imposition of onerous transparency obligations and, in view of the potential deleterious consequences (see below), should not be introduced.

An equal number were of the opinion that transparency obligations could not ensure the interaction of buy and sell interest across fragmented trading platforms.

8. *Are the concrete mechanisms proposed to promote transparency of off-exchange order-matching by investment firms suitable and viable?*



Notwithstanding the broad support for the principle of reinforced transparency obligations for off-exchange order-matching, there was strong opposition to the mechanisms whereby non-exchange order-matching systems would disclose trades to the wider market. The proposal for a blanket real-time reporting obligation and the absence of provision for deferred reporting of large trades were roundly criticised. The absence of block-trade facility was considered to have potentially significant effects for market liquidity as participants would be reluctant to take on large positions.

The contrary view was also expressed – in particular, the exclusive focus on post-trade transparency was challenged as being too lax. Proponents of this viewpoint considered that the absence of an obligation for order-matching investment firms to disclose pre-trade (bid and offer) information rendered the regime toothless. The proposal to route trade details to the market of first quotation or leading market were regarded as impractical and/or potentially anti-competitive.

3.2. PROPOSED ADJUSTMENTS TO SCOPE AND DEFINITION

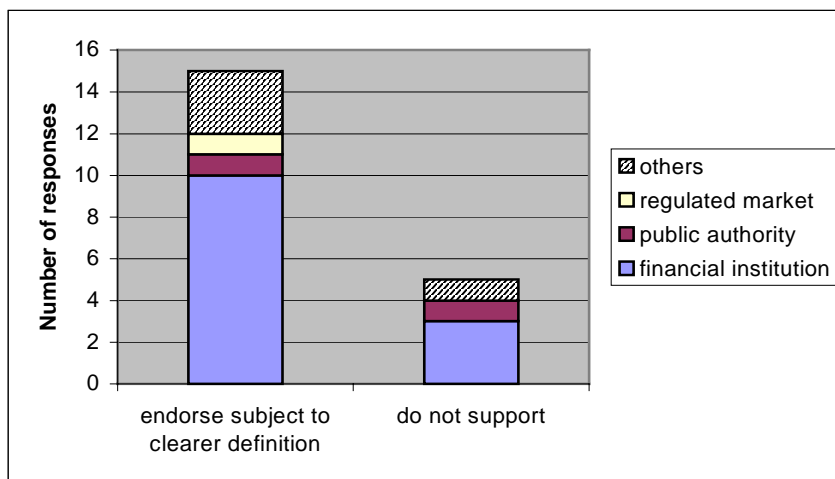
Section 2 considers responses to the proposed modifications to the scope and definitions contained in the existing ISD. The essential changes proposed in the preliminary orientations involved:

- inclusion of arranging/facilitation and investment advice as core services;
- expansion of the list of financial instruments subject to ISD rules (in particular to commodity derivatives);
- inclusion of a definition of professional investor with a view to facilitating the differentiated application of CBR in accordance with Article 11.

“Arranging/facilitation”: 15 out of 20 respondents consider that the ISD should include arranging/facilitation as a core service subject to the caveat that the Directive clearly define the services covered. The definition should exclude activities such as Internet Portals, purely promotional activities, Infomediaries. In addition, the respondents considered that a “light touch” regime for CBR and capital requirements should apply to these companies.

On the other hand, 5 out of 20 respondents oppose the introduction of arranging as a core service. They consider that the boundaries of the ISD should be limited to firms which are directly involved in the processing or execution of orders on behalf of investors/clients. ISD disciplines should in particular clarify the obligations of such entities to investors/clients when acting on their behalf. ISD obligations and rights are not relevant to entities that provide information of general interest (as with bulletin boards) or which simply transfer (order-routing) communications relating to an order to qualified intermediaries. ISD framework and passport should not be artificially extended to cover such activities

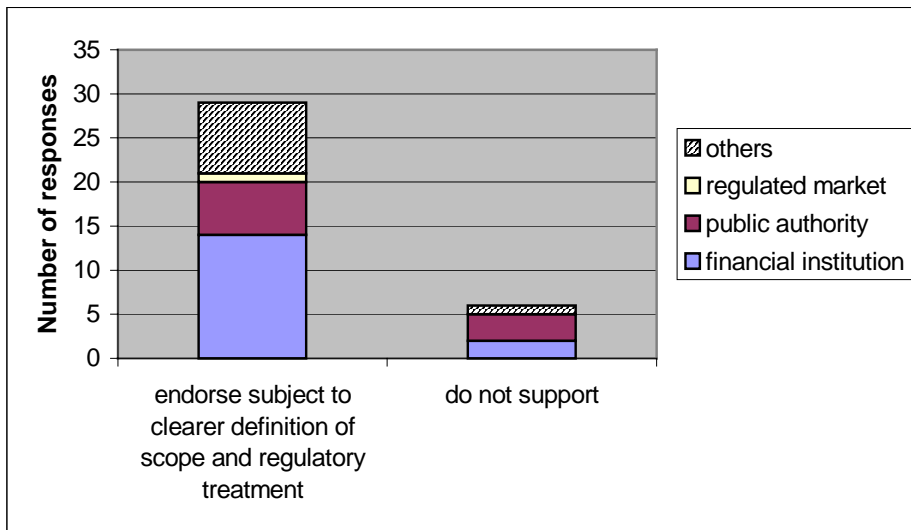
9. *Do you support the inclusion of arranging/facilitation as a core investment service?*



Investment advice: A broad consensus exists, encompassing all types of respondents, that the ISD should cover the business of investment advice. However, this acceptance is subject to a clearer definition of the service¹ and to appropriate consideration of difficulties in its practical implementation.

¹ The boundary between advice and promotional or commercial advertisement must be clearly defined.

10. Do you agree with the proposed inclusion of independent investment advice as a core investment service?



There was much comment as to how the “independence” of the advisor is to be determined. Respondents considered that the focus should be on guaranteeing the independence of the advice received by the customers. It was not considered necessary to insist that independent advisors should only be remunerated by client fees. The possibility of inducements should be allowed, subject to the proviso that any conflict of interest be effectively managed. This will call for greater emphasis on aspects such as conflict of interests (e.g. obligation to establish effective Chinese walls) and rules of conduct.

Some respondents expressed concerns relating to the capacity of competent authorities to license and monitor a potentially large and heterogeneous target population. They asked for particular attention to this proposal from a cost-benefit analysis perspective.

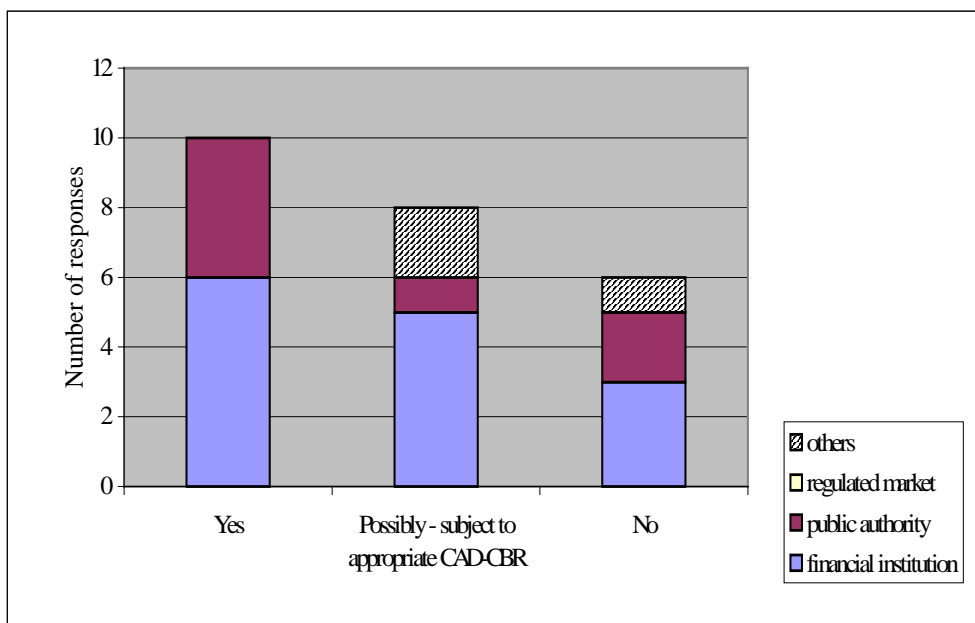
Other noteworthy comments in respect of this proposal included:

- requests to consider the alternative of a separate directive establishing a consistent approach for the “giving of advice” across the full range of savings products (not just ISD products);
- the need to ensure consistency of the proposed approach with the one followed in the Insurance Mediation Directive;
- concerns regarding capital treatment for this activity. Some respondents argued that capital provisioning should be replaced by an obligation to have appropriate professional indemnity insurance.

The “slight” modifications proposed to the definition of some of the services that are currently part of the core services such as brokerage and underwriting and placement are broadly welcomed. A number of respondent welcomed the proposal to broaden the non core service of “foreign exchange” to transactions which are not directly linked to the provision of core services.

Commodity derivatives: 18 out of 24 respondents support the inclusion of commodity derivatives as an ISD Instrument so as to allow investment firms to benefit from passporting rights when providing intermediation services in these products cross-border. Nevertheless nearly half of those that endorse the proposal commented extensively on the need to ensure that inclusion did not trigger the application of inappropriate regulatory requirements. In particular, they argue that is inappropriate to impose full weight of CBR on investment firms when dealing with experienced corporate traders in these products. They also call for the imposition of appropriately calibrated capital requirements on those firms that provide ISD services in commodity derivatives.

11. On balance, do you believe that commodity derivatives should be included as an ISD instrument with the result that trading in commodity derivatives be subject to ISD disciplines?



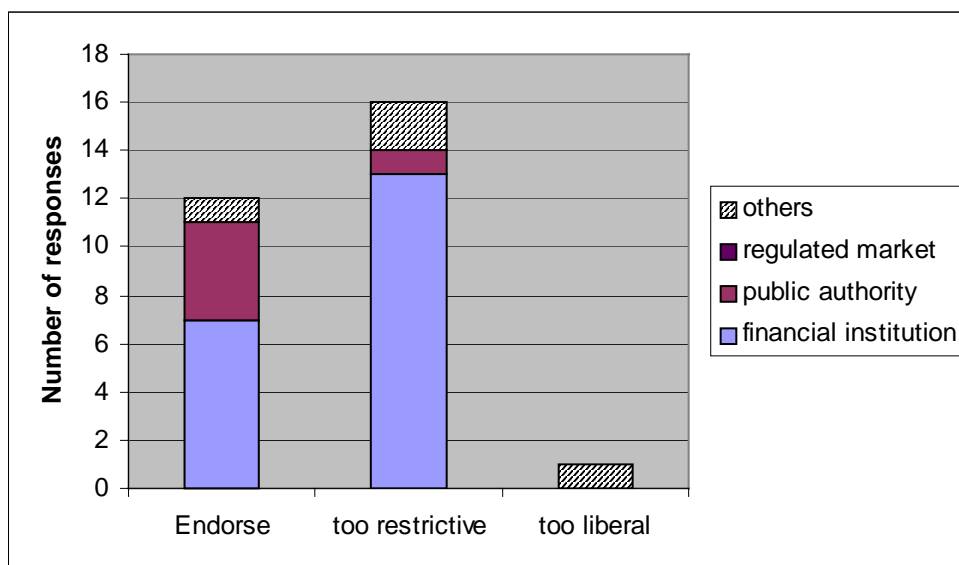
The six respondents that oppose the inclusion of commodity derivatives under the scope of the ISD (including all of the specialised commodity traders that answered the Commission’s consultation) also cited concerns relating to the imposition of inappropriate capital adequacy regime as the principal objection to the inclusion of commodity derivatives in the scope of the ISD. They also expressed the view that predominantly wholesale corporate markets dealing in this kind of instruments did not give rise at this stage of their development at EU level to regulatory issues related to investor protection or market efficiency and integrity. In view of these considerations, these respondents proposed retaining the current article 2§2.i exclusion for firms whose business consists exclusively in trading in commodity derivatives.

Some respondents pointed out that the Commission should clearly define the concept of “commodity derivative” in order to determine whether it covers only cash-settled contracts or whether it also includes contracts settled through physical delivery. They also recommended that a distinction be drawn between (potentially) physically-settled forward positions and “financial” derivatives.

The implications of including commodity derivatives under Section B for markets or the trading platforms that currently deal in these instruments or to the trading activity itself (such as transparency measures for instance) were not directly addressed.

Professional investor: The proposal to categorise the different investors that purchase investment services and to explicitly define the category of “professional investor” was welcomed as an important contribution to removing uncertainty surrounding the application of conduct of business rules under the ISD. Respondents consider that professional investors are in a position to exercise independent and expert judgement on the management of their financial positions and do not need full hand-holding protection.

12. Do you endorse the proposed system for categorisation of professional and retail investors for the purposes of CBR appropriate?



Notwithstanding this general acceptance, more than half of the replies deemed it necessary to revise the proposed definition of “professional investor”. In particular it should be aligned with the definition which is being finalised in the context of CESR work on core standards for investor protection.²

There were also some respondents that considered that this differentiated approach to CBR based on the professional/retail distinction could also be applied to other issues related to market efficiency and market functioning. For instance, this definition could also be used to determine whether an investor could have access or not to a market of a given instrument or to an specific trading platform or even to justify different transparency regimes.

² This latter provides for a broader concept of professional investor which includes in addition to groups foreseen in ISD preliminary orientations: local, regional and public authorities; large privately own companies; non-EU companies; companies in the same group as large or listed companies/corporates..

Most of the respondents agree with the operational issues related to the definition such as the possibility for any investor to opt down/up to be categorized as professional. It was also argued that professional investors should never be allowed to opt for the retail regime and that the administrative procedures for the implementation of the mechanism should not be very burdensome.

3.3. INVESTMENT FIRM REGIME

July 2001 orientations relating to the investment firm regime:

The preliminary orientations envisaged extensive updating of the existing ISD provisions applying to investment firms. The most substantive changes foreseen by the preliminary orientations centred on:

- Conduct of business regime: the principles of the existing article 11 relating to obligations owing to clients arising from provision of investment service were to be fleshed out both in the Directive and at level 2. This enhanced harmonisation aimed to establish a high level of investor protection throughout the single market, and thereby pave the way for provision of investment services on the basis of home country supervision to both professional and retail clients. This harmonised CBR rule-book would also differentiate in the application of the requirements to be met when providing different investment services;
- Tied agents: the preliminary orientations proposed to clarify the obligations incumbent on investment firms when employing tied agents for purposes of representation and order-collection;
- (quarterly) Order-routing disclosure: in view of increased array of order-execution venues, and greater difficulty of defining a reference market for “best execution” purposes on an ex ante basis, the preliminary orientations proposed that investment firms periodically report on venues used by them to execute client orders. This was proposed as a basis for competent authorities to police “best execution” on an ex post basis by verifying that the execution facilities regularly used by a firm were in fact those where the best prices pertained for the type of order in question.
- Obligations of the investment firm to act in a manner consistent with integrity of the market: the preliminary orientations proposed the introduction of a provision which specifies the particular obligations incumbent on investment firms so as to uphold the integrity of the market.
- Obligation of firm to report transactions to competent authority: it was proposed to broaden the existing article 20 transaction reporting requirements to all instruments admitted to trading on a “regulated market”;
- Obligations of the firm to report post trade details of off-market transactions to the “leading regulated market/market of first quotation”.

3.3.1. *Organisational requirements:*

Some respondents expressed concerns about the level of increased prescriptiveness proposed in respect of organisational requirements. They consider that the existing ISD already deals adequately with these issues and that there is no reason for introducing new excessive and disproportionate obligations. The concrete criticisms include concerns that:

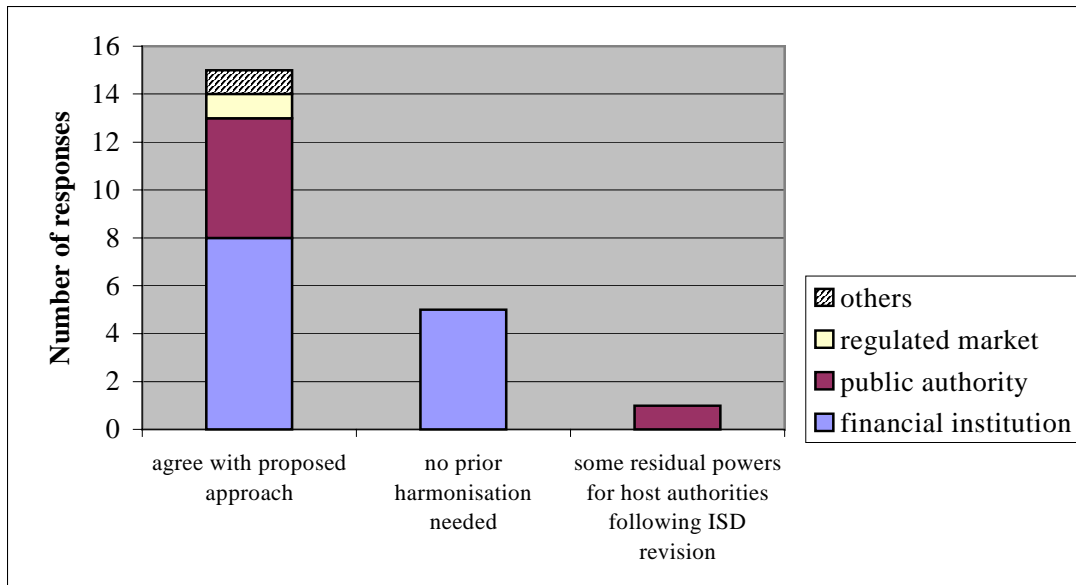
- The stipulation requiring that an investment firm’s IT be able to contend with large fluctuations in levels of demand/usage, and that adequate contingency arrangements be available was viewed as excessive and very costly.
- The need for prior authorisation wherever an investment firm relies on a third party for the provision of services which are important for the performance of its functions (outsourcing) faced strong opposition (13 replies). Those opposed considered the proposal an invitation to authorities to micro-manage firms – a task which they are ill-equipped to do.
- The home country principle for supervising and enforcing these organisational requirements was very much welcome. Nevertheless, some respondents deemed useful to confer certain monitoring functions (where these are closely related to client interest i.e. audit trail, record keeping, client money/asset issues, management conflict of interest) to the host country in the case of branches.
- Concerning conflicts of interest, respondents argued that regulation should ensure that they are managed properly but should not seek to eliminate them. Recognition of Chinese walls as safe harbour was requested.

3.3.2. *Conduct of business rules and dealing requirements:*

The Commission proposed to review the current article 11 so as to modernise investor protection safeguards, to provide a clear framework for supervision of firm-client relationships, and to establish sufficient convergence of supervisory practice so as to allow free provision of services on the basis of home country supervision.

There is a wide consensus that supervision of CBR should be undertaken solely by the home country supervisor. The current position where conflicting conduct of business and marketing rules need to be complied with by investment firms carrying on business cross-border in EU jurisdictions constitutes an unacceptable barrier to the efficient conduct of cross-border business. There is also an agreement that the ISD should only contain the high level principles, further developed in the so-called level 2, based on CESR standards with full legal effect.

13. Do you agree with the proposed allocation of supervisory responsibility for supervision of conduct of business rules for retail investors under a revised ISD? (home country supervision with prior harmonisation of CBR)



15 of 21 respondents called for its application based on full prior harmonisation of CBR. 5 respondents, all of them financial institutions, argued that it should not be conditional on CBR harmonisation. All these expressing a view supported the proposal that services provided through branches be subject to supervision by authority in country where branch is established.

Residual powers for host authorities were requested in one reply: who queried whether supervision on home country basis can deliver effective investor protection.

The proposed differentiation of CBR by type of investment service was welcomed. The precise consequences and implementation of differentiation according to the type of service provided should be further clarified at level 2. CBR should make sufficient allowance for different business-lines and focused services should only have to comply with limited CBR. 16 replies, including 11 financial institutions, pointed out that Commission’s proposals did not provide for sufficient differentiation in application of CBR.

Particular concern was expressed in respect of “execution-only” activity. Some respondents called for exemption from suitability/know your customer requirements for these services. They argued that Commission proposals threatened to impose excessive “know your customer” obligations, as those rules are calibrated on “advisory/handholding” relationships that execution-only brokers do not provide. “Execution only” clients buy speed and inexpensive transactions but not suitability.

Some commentators called for introduction of explicit statement that certain CBR principles do not apply to professional investors (e.g. suitability obligation, best execution etc.). The proposal that transactions between investment firms authorised to deal on own account be exempted from the CBR requirements was fully supported. Some commentators suggested that this waiver from CBR be further

extended to transactions with other types of market counterparty which are not licensed as financial institutions.

On “best execution” 9 respondents agreed that this concept should be updated and reinforced. The following adaptations which were proposed reflect very different conceptions of the role of “best execution” as an investor protection discipline:

- Best execution should not only be understood in terms of best price but also take account of other criteria (speed of execution).
- any order routed through an exchange (regulated market) should be considered to comply with best execution.
- Investment firms should advise investors of where their orders will be executed and obtain their consent for matching orders outside regulated markets. Investment firms should also inform clients on the markets systems to which they have access. Best execution would be defined by reference to these markets.

The proposed adjustment of the “look-through” was challenged on the grounds that it would over-extend the fiduciary obligations of investment firm.. According to the majority of respondents, the investment firm that has direct contact with the client is the one that should be held responsible even if it is not the one that arranges the final trade.³

3.3.3. *Tied agents:*

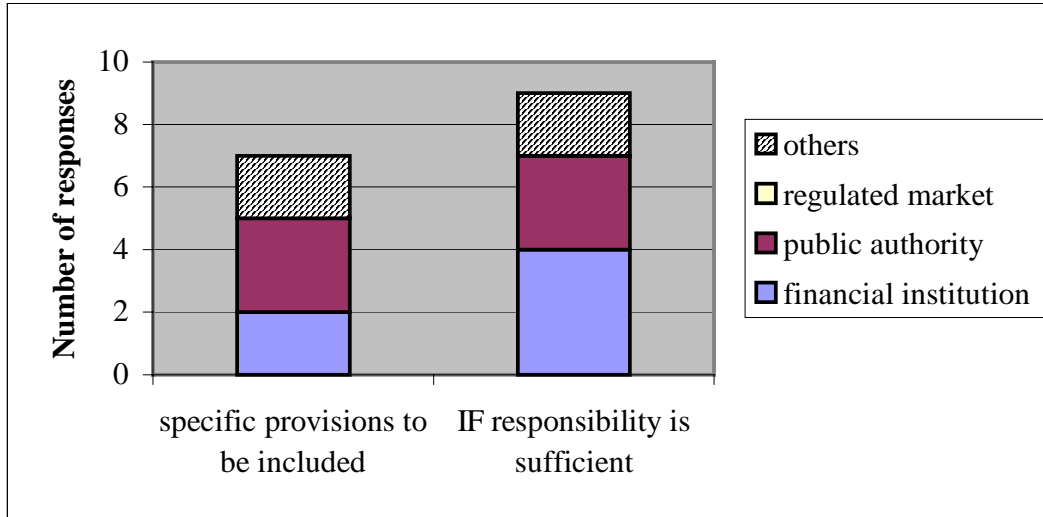
The Commission services proposed to review and clarify ISD provisions related to tied agents with a view to removing uncertainty as regards the manner in which investment firms may use them for the purposes for providing services to clients or potential clients, under the full responsibility of the investment firm. It was also

³ Other comments received in respect of the proposed CBR policy (Obligations of the investment in conducting business on behalf of the client) included:

- The obligation to keep a detailed documentary record of the agreements between the investment firm and the client could result in the imposition of an unnecessary documentation burden. This matter is better addressed through civil or contractual law.
- Some respondents welcomed merging of advertising and marketing rules with CBR. New ISD should ensure clarity on which jurisdiction is responsible for advertising. However, others considered that marketing issues should be regulated by civil and commercial law and there is no need to add any specific rule at ISD level concerning investment services.
- Disclosure of inducements should be considered as a general obligation not related to any specific transaction and only upon request. Otherwise it will result in a disproportionate and impracticable obligation for the firms.
- On the obligation to provide information about the investment firm, there should only be an obligation to put at the disposal of the customers upon request all necessary information. An automatic obligation to send or provide that information to any customer could result in a disproportionate burden for the firm.
- The obligation to communicate information to the client regarding financial instruments goes too far in that it will oblige each investment firm to engage in continual supervision of each client’s portfolio. It could imply continuous monitoring by the investment firm of the client’s portfolio blurring the boundaries to asset management.

proposed to introduce some licensing and operational requirements for these agents⁴. Despite these additional provisions, tied agents would not be regarded as “investment firms” within the meaning of the ISD.

14. Should ISD directly regulate the licensing and activities of tied agents? Is it sufficient that the investment firm(s) on whose behalf they operate be liable for them?



7 out of 16 replies supported the need to include specific provisions in the ISD related to tied agents. 9 out of 16 argued that ISD revision should not seek to prescribe requirements for these entities. They add that the basic fiduciary relationship is between the investment firm for which the agent works and the customer. Consequently, they consider it sufficient that the investment firm on whose behalf the tied agent operates, assumes responsibility for the actions of the agent. Commentators also highlighted possible administrative bottlenecks in the registration and supervision of a large number of tied agents.⁵

⁴ Inspired by proposal for Directive on Insurance Mediation.

⁵ There were some requests for further clarification of the tied agents regime. This regime should deal with:

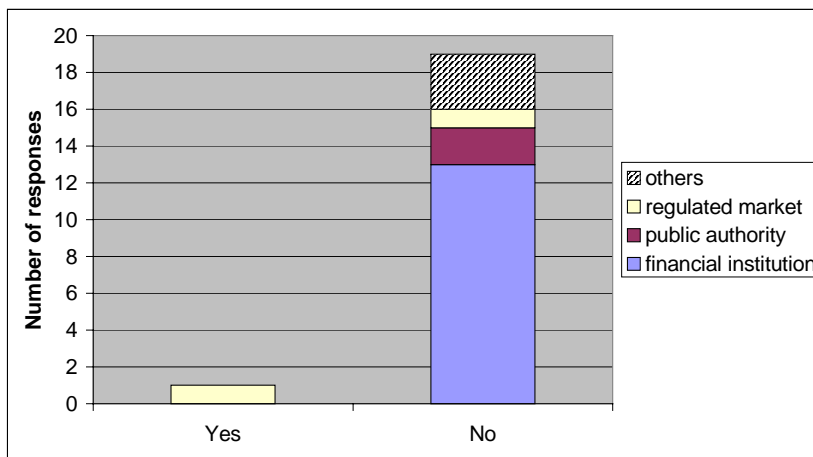
- a clear definition of tied agent and its legal nature,
- whether to require any type of license
- requirements applicable to them,
- competent authority in charge of the regulation and supervision of tied agents.
- solvency requirements, as the need for an insurance was questioned if their activity is to be backed by the investment firm.
- the rights of tied agents (i.e. establishment of branches in other Member States).
- the possibility of holding clients’ assets or funds,
- the list of activities tied agents would be entitled to perform
- whether tied agents could offer their services to one or more investment firms and if so, clarification of which entity is responsible to the client.

3.3.4. *Disclosure of order-routing practices:*

In order to increase transparency regarding order-execution venues and to promote more effective monitoring of compliance with “best execution” obligations, the Commission proposed to introduce a new quarterly reporting requirement for all authorised firms executing orders on behalf of third parties in respect of their order-routing practices. The Commission considered that this measure would help to promote investor confidence in a situation where there are multiple venues for order execution, and there is greater difficulty in identifying a “reference market” for the purposes of determining a useful price benchmark.

Although there is a large consensus on the need to increase transparency, the bulk of respondents (19 of 20 comments received) did not regard this mechanism as a suitable means of verifying performance of “best execution”.

15. *Do you regard the proposed order-disclosure mechanism as a viable/suitable mechanism for supervisors and investors to assess delivery of “best execution”?*



Most of these opposed expressed doubts about the utility of this information for competent authorities. Its collection will impose disproportionate costs. A minority held the view that this obligation is not enough, and that it should be coupled with adequate transparency measures.

3.3.5. *Obligations of the investment firm to the market:*

The aim of the proposed provisions elements is to complement the obligations and prohibitions contained in the Commission’s proposal for a Directive on market abuse. The proposal contained general provisions for investment firm operating on a “regulated market”, and more specific obligations for those matching client orders on proprietary trading book.

4 respondents were in favour of the proposals provided there is a consistent approach with the Market Abuse Directive. Overlap and conflict between both Directives should be avoided.

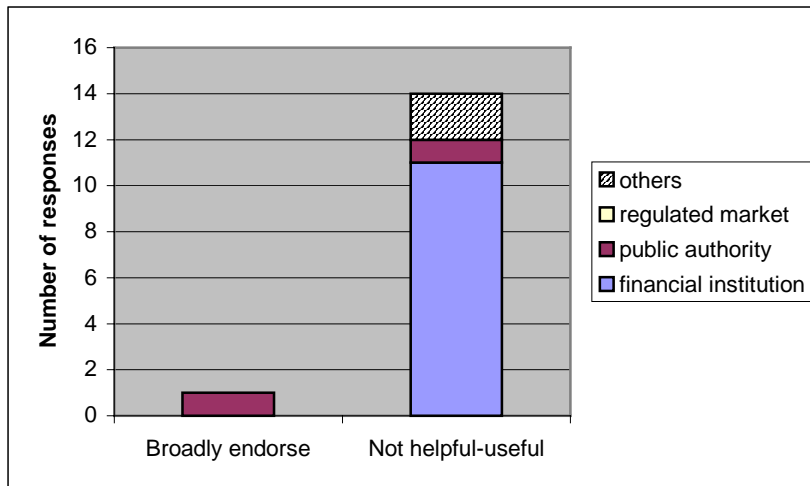
Six replies from financial institutions expressed reservations regarding potential duplication or inconsistency with Market Abuse Directive provisions. They disagreed

with the establishment of a special regime and additional client surveillance obligations for investment firms matching client orders on proprietary trading book on the grounds that particular risk attached to that type of dealing.

3.3.6. *Reporting of transactions to the competent authority:*

The Commission services proposed to extend the scope of the existing ISD provision governing reporting of transactions by investment firm to the competent authority.

16. *Transaction reporting: Is it useful to modify scope and content of transaction reports along proposed lines?*



14 of 15 comments received in this point did not consider it useful to modify the scope and content of transaction reports for the following reasons:

- The reporting of the trades to the competent authority is seen as a duplication with reporting to market that should be avoided. Obligations to report transactions to competent authorities and off-exchange trade reports to “regulated market” should be rationalised.
- On the content, there are some doubts as to whether the obligation to disclose details regarding of the investor is consistent with data-protection rules.
- Reporting is deemed as useless in connection to “best execution”, which can not be verified on a post-trade basis because it depends in many more factors than the price.

Extension to all Financial instruments was also commented. Detailed information on the client-facing level should be kept on record by the investment firm and be submitted at the request of the competent authority. A respondent argued that current art. 20 is completely unproductive. Co-operation mechanisms are not sufficient to allow any simple authority to have a complete picture of trading in domestically issued instruments.

3.4. HIGH LEVEL PRINCIPLES FOR REGULATED MARKETS:

July 2001 orientations relating to “regulated markets”:

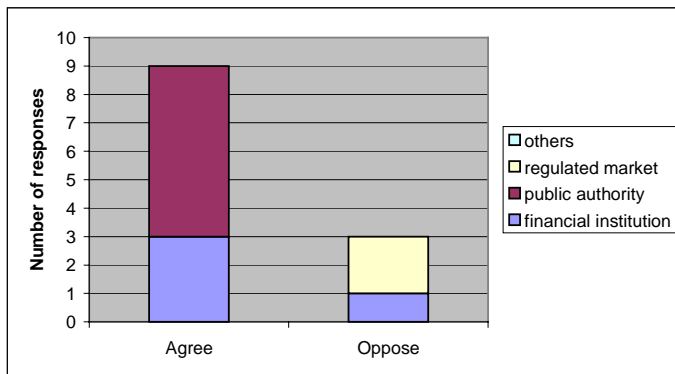
The preliminary orientations envisaged the introduction of an extensive series of requirements relating to the authorisation and operation of “regulated markets”. These requirements amounted to a significant extension to existing cursory ISD provisions applying to “regulated markets”. They were intended to provide a common corpus of regulatory principles to be satisfied by all “regulated markets” so as to ensure that overall market quality and confidence was sustained in an environment where “regulated markets” compete for liquidity.

The principles were largely derived from FESCO (CESR) standards for regulated markets, and IOSCO core principles. The most notable elements foreseen by the preliminary orientations included requirements relating to:

- Procedures for authorisation and commencement of operation as a “regulated market”, including an obligation to have sufficient financial resources;
- the management and owners of the market;
- the rules, procedures and processes governing the execution of orders;
- publication of pre-trade and post-trade information;
- the admission of instruments to trading on the market, including a requirement for the market operator to satisfy itself that conditions existed such that a “proper market” in the instrument could emerge prior to its admission to trading;
- the admission of market participants;
- the rights of market operators.

Of the 35 respondents who commented on this Section 8 expressly commended the usefulness of introducing the “high level principles” for Regulated Markets in ISD. No respondents challenged the utility of clarifying conditions under which a “RM” should be licensed or approved. Many of those commenting urged the Commission to build high level principles around existing CESR/FESCO standards⁶. They were particularly concerned that over prescriptive provisions could result in micro management of business decisions of RM by administrative authorities.

17. Do you agree, in principle, with proposed inclusion of requirement relating to financial resources for operator of regulated market?



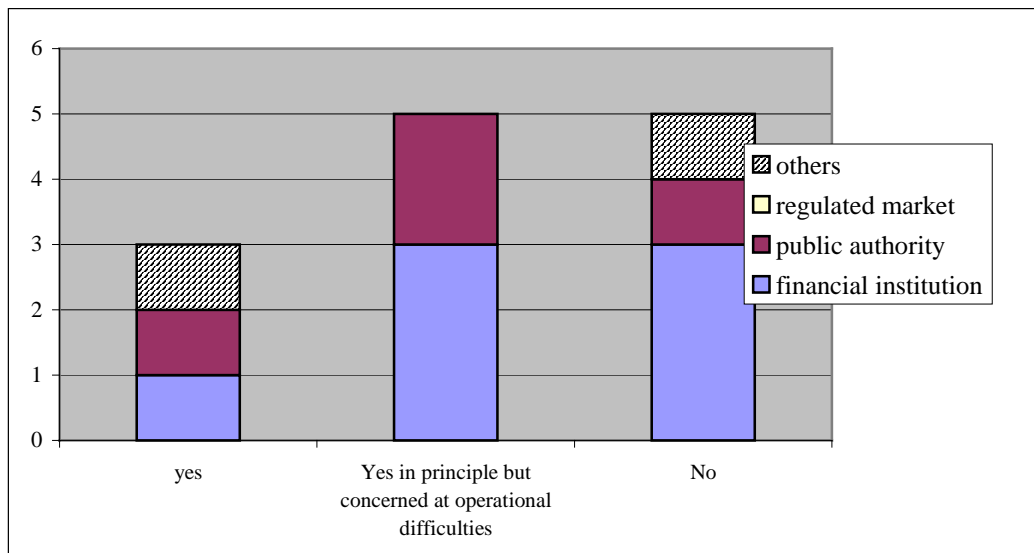
⁶ FESCO standards for Regulated Markets under the ISD (Dec. 1999) 99-FESCO-C.

This requirement has been broadly supported (75%). Opposition was greatest from regulated markets, whilst public authorities have given full support to this proposal.

Many respondents underlined that the ISD should fix the rules and conditions under which the authorities could calculate such financial requirements. Moreover, some respondents noted that there is a benchmark for this provided in CAD for Investment Firms order –matching systems.

The ISD reference to this area will be restricted to an enumeration of criteria of which detailed guidance could be provided through comitology procedure.

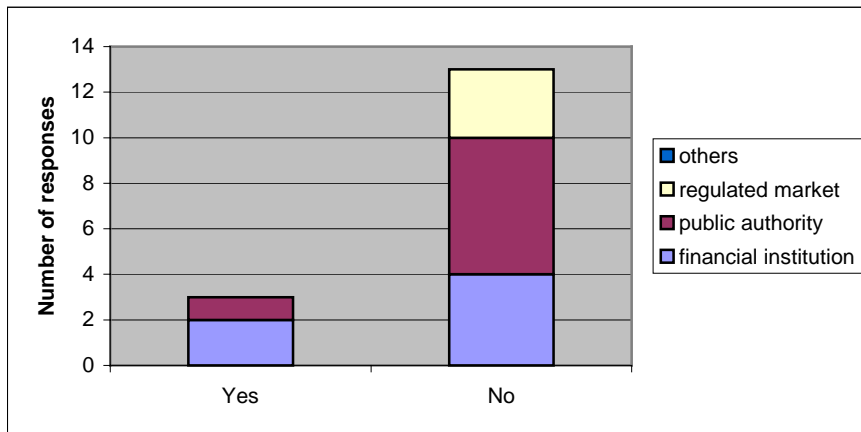
18. Do you regard the proposal that regulated markets should only be allowed to admit instruments to trading which satisfy a proper market test as desirable and/or operational?



There is a division between respondents who support this proposal and those who are concerned at its operational difficulties (38.46 % each). Operational difficulties are thought to be particularly pronounced for derivative - including cash derivatives. However, problems were not seen as being limited to derivatives and could even arise in case of plain vanilla equity or fixed income securities.

Most respondents supported the proposal that Regulated Markets should verify that issues of securities subject to initial or ongoing disclosures obligation should have taken steps to meet these obligations. However, some respondents were concerned that such a provision could be tantamount to requiring Regulated Markets to have a contractual relationship with the issuer. Such an outcome could severely impede scope for competition between Regulated Markets for order flow, and Commission was asked to clarify this aspect in future proposals.

19. Do you regard the proposal to recognise a branching right for “regulated markets” as being legally or commercially relevant?



The vast majority of respondents (81 %) rejected this proposal as being devoid of commercial relevance and potentially counterproductive in that it risked exposing regulated markets to conflicts of law.

3.5. CLEARING AND SETTLEMENT:

Synopsis of preliminary orientations in respect of clearing and settlement:

The preliminary orientations proposed to supplement the existing remote access rights for market participants (under article 15(1)) to partner country clearing and settlement systems with the following additional options for market participants and regulated markets:

- (1) Possibility for market participants to make use of partner country clearing/central counterparty facilities for “off-market” positions;
- (2) Possibility for market participant to request that a position be settled in a settlement system of its choice provided that the market and/or central counterparty has links to the designated settlement system (as opposed to being obliged to use the “default” settlement arrangements imposed by the market);
- (3) Possibility for a “regulated market” to route some or all confirmed trades to central clearing counterparty in another Member State, subject to approval of the competent authority responsible for oversight of the market.

Central clearing counterparties and securities settlement embody functions and risks which are very distinct from the regulatory concerns at the heart of the ISD. In view of the distinct risk-profile of these entities, and the absence of sufficiently developed consensus on common prudential standards for these clearing and settlement systems, it was considered that these activities should not be regulated under the ISD.

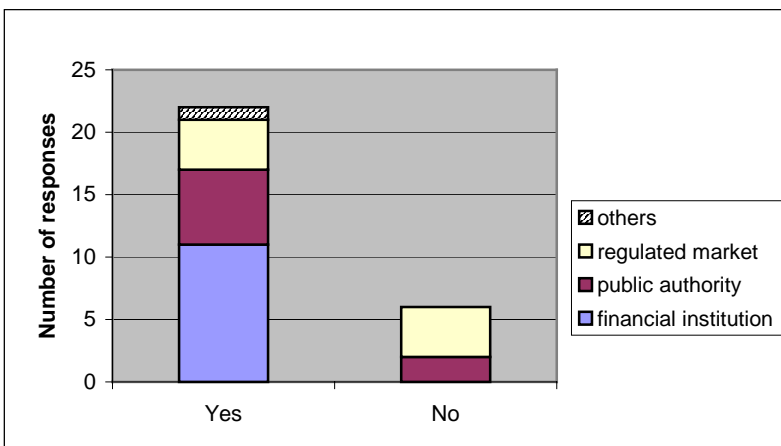
32 responses contained some comment in respect of proposals relating to clearing and settlement arrangements. Much comment consisted of general expressions of support for proposed rights of market participants to designate settlement system of choice, or for regulated markets to make use of clearing houses/central counterparties

in other Member States. Only 2 respondents commented (both supportive in principle assuming commercial viability) of the proposal to allow market participants to make use of clearing and central counterparties in other jurisdictions for netting/novation of bilateral positions.

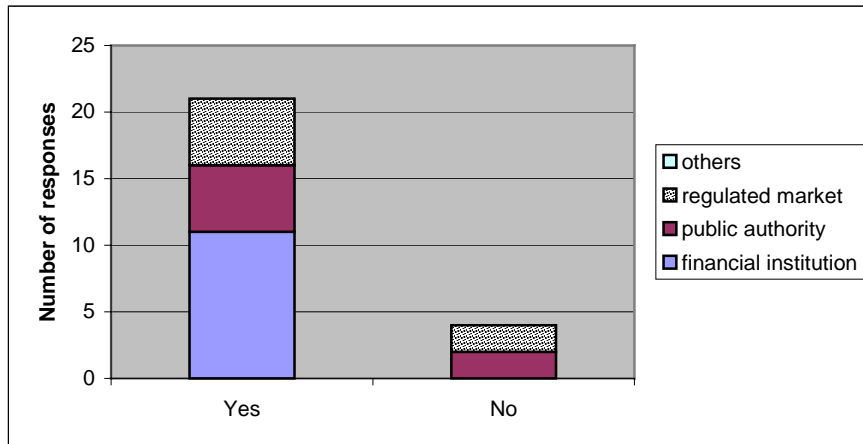
There was strong support for the introduction of the proposed new access and choice rights for market participants (in respect of settlement) and regulated markets (as regards clearing/central counterparty). Support was expressed by all market segments whereas opposition was confined to public authorities and regulated markets. Those in favour of these rights, expressly supported an EU policy which focused on inter-connectivity between markets and different clearing and settlement facilities as the most pragmatic approach to fostering competition and efficiency in Europe’s fragmented post-trading infrastructure. The proposed clarification that netting, novation of settlement of trades be governed exclusively by the law of the country where the clearing/settlement system is established was also welcomed as an important contribution to legal certainty.

Those opposed to the new rights cited commercial and technical complications that might ensue from introduction of obligations to establish links between markets, clearing and settlement facilities. There was concern that the proposed rights could be used to force operators of clearing and settlement facilities to build links which would not be commercially viable. It was also remarked that giving the market participant the right to designate settlement system could compromise the ability of the regulated market to make adequate arrangements for the efficient and timely finalisation of transactions. Furthermore, if a business case for building links existed, the imposition of statutory obligations to make access available would be redundant as it will be in the interests of exchanges or clearing/settlement systems to provide this service to their members.

21. Do you agree with the proposed introduction of a (conditional) right for market participants to designate preferred settlement location?



Q.22: Do you support the introduction of a (conditional) right for operators of regulated markets to make use of clearing/central counterparties in other Member States?



Despite the strong interest in enshrining these new rights in a revised ISD, there was some scepticism as to whether they would give rise to tangible increase in choice and access. 15 respondents were concerned that allowing these rights could be effectively negated by expressly allowing prudential or commercial/technical considerations to over-ride them. This risk was exacerbated by the open-ended nature of the proposed over-rides which could give rise to unjustified and arbitrary denial of access. Some respondents noted that flanking measures could be required to underpin common approaches to risk-management in clearing and settlement networks. Ongoing standardisation, in different European and international fora, was identified as a possible basis for the necessary convergence of risk-management practices.

Finally, 4 respondents challenged the premise that the ISD was not the appropriate legal instrument for establishing a regulatory framework for these systems. They urged that the opportunity presented by ISD revision be seized so as to provide a clear legal framework within which these systems could serve users and members across the single market. This viewpoint was offset by 4 respondents who explicitly endorsed the proposal to leave the licence and operation of clearing and settlement outside ISD.

Those arguing for inclusion of clearing and settlement in the scope of the ISD explicitly called for early progress in respect of custodianship so as to clarify the regulatory and competitive relationship between bank-licensed custodians and non-banks CSDs. 2 respondents proposed that the preferred solution would be to include custodianship as a core ISD service subject to bespoke licensing and operating requirements. Other respondents argued that revision of the ISD should not call into question the possibility for banks and investment firms to act as custodians on the basis of their ISD/banking license. However, one respondent challenged the proposal to include internal settlement within the scope of “custodian definition”.