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KEY-NOTE SPEECH BY DIRECTOR-GENERAL DR. ALEXANDER SCHAUB
(DG INTERNAL MARKET)

ECONOMIC AND REGULATORY BACKGROUND TO COMMISSION PROPOSAL FOR REVISION OF
THE INVESTMENT SERVICES DIRECTIVE.

(AS DELIVERED)

ECONOMIC AND POLICY BACKGROUND TO COMMISSION PROPOSAL FOR REVISION OF THE INVESTMENT SERVICES DIRECTIVE.

A. INTRODUCTION

The Commission applauds the decision of the Danish Presidency to organise this event, and I am pleased to contribute a key-note speech. This is a further opportunity for leading market participants and decision-makers to discuss key aspects of a proposal which will intensely occupy Member States, the European Parliament and the wider financial community starting next year. Thanks to some enterprising journalists, people are aware that the Commission services are adding the finishing touches to the text of a proposal. In the absence of a final position adopted by the College, I must confine my remarks to some general considerations concerning the forthcoming ISD revision.

B. SECURITIES MARKETS

Securities markets were the poor relatives of the original single market programme. The ISD passport was an after-thought to a programme whose primary focus was on integrating the EU market for bank lending. Moreover, the ISD passport could do little to overcome legal, structural and infra-structural obstacles to cross-border trading. Financial instruments were not fungible; disclosure was not comparable; national marketplaces were cut off from each other; final settlement of cross-border transactions presented daunting challenges.

However, a technology-driven revolution in securities trading and the introduction of a single currency have removed many deep-seated obstacles to cross-border transactions. An integrated, deep and liquid European capital market is no longer a distant dream. The US experience has pointed to the importance of competitive,

market-based financing in relaxing the investment constraints facing small and start-up companies, and supporting jobs and wealth-creation.

The FSAP (1999) heralded a new drive to create an effective regulatory framework for integrated EU financial markets. It identified the need for action in respect of financial disclosure and market abuse. The FSAP also provided the first signal of the Commission's intention to revisit the ISD. At the European Council in Lisbon 2000, this programme received ringing endorsement from Finance Ministers and Heads of State and Government. It received a further fillip from the Lamfalussy Committee of Wise Men, and the subsequent agreement on institutional arrangements to expedite the adoption of securities legislation.

.... and just as we were building up a decent head of steam, the wheels fell off the financial market band-wagon.

Recent developments have damaged the image of market-based financing in the eyes of issuers, investors and policy-makers. They have highlighted the propensity for herd-like behaviour on the part of capital market participants. They have demonstrated that market professionals can also be swept away by euphoria. The 50% decrease in market valuation since March 2000 means that retail equity investors have had their fingers extremely badly burnt. The prospect of European retail equity culture has been dealt a severe blow.

Have we come full circle? Is Europe's brief flirtation with financial markets over? Are efforts to integrate financial markets an extravagant waste of supervisory and regulatory energy at a time when the economic storm-clouds are gathering? Our view is that a coherent and effective European regulatory framework for financial markets is needed more than ever. My objective this morning is to explain why the ISD revision remains a vital part of a common EU-level response to developments in financial markets.

C. THREE REASONS

1. The first reason why ISD revision remains a key policy objective for Europe is that integrated, deep and liquid financial markets will deliver a significant economic windfall.

Integration of European financial markets has an unstoppable momentum – not because some European functionary has decided it shall be so but because business wants it – because the right to do business with counterparties throughout the European Union is a common-sense proposition.

- Issuers will be able to raise capital from investors throughout the single market without encountering regulatory barriers or additional compliance costs;
- Investors will be able to purchase a financial asset traded on a partner country market without additional impediment, delay or costs when compared to a comparable domestic transaction;
- Intermediaries will be able to transact freely with clients in other Member States on the same terms and conditions as business transacted in their home country;
- Infrastructure suppliers (trading systems, clearing and settlement) will be able to make their facilities available to market participants and users from throughout the EU.

Integration is widely expected to generate benefits for all constituencies at all stages of the trading chain. Awareness of the likely importance of these benefits inspired the inclusion of a strong securities market pillar in the FSAP.

Research on the impact of financial market integration has tended to focus on the benefits of competition between financial institutions and the consequent productivity gains. Deputy Prime Minister Bendtsen has already referred to the material published by the European Round Table. This research has highlighted the opportunity costs of fragmented markets for retail financial products.

The Commission will in the coming weeks add to this growing understanding of the importance of integrated markets for growth and employment. We are about to publish the results of what we believe to be the first substantive empirical research on how financial integration will affect the cost of raising finance in Europe. Preliminary drafts of this research confirm that the pooling of equity and corporate bond markets will reduce trading costs and the cost of capital. The reduction in the cost of capital is also found to boost investment, GDP and employment in the EU member States. This research considers only the static effect of financial market integration on trading spreads (implicit trading costs). Further benefits in the form of lower brokerage commissions or exchange fees can be expected to accompany increased competition between intermediaries and exchanges. More importantly, financial integration may give rise to dynamic benefits – in the form of increased productivity. The Commission will also shortly publish findings that the deepening of financial markets resulting from integration should permanently boost output growth in manufacturing industry.

Given this potential stimulus to jobs and wealth-creation, it is incumbent on the European legislator to establish a regulatory framework which facilitates the effective integration of financial markets. ISD revision is central to this objective. It will strengthen investor confidence in the quality of investment intermediation and the integrity of markets. In doing so, it will help to channel private savings towards market-financed investment and support new sources of growth and employment.

2. The second reason why ISD revision is vital is that EU financial markets have changed beyond recognition since the adoption of the original ISD.

The 1990s witnessed profound restructuring and closer integration of European financial markets. This poses new challenges for investor protection and orderly markets which were not contemplated by the original ISD. The revised ISD must therefore address the following four issues if it is to serve as an effective foundation for the regulation of EU securities markets in the medium to long-term:

- 1) Fragmentation and competition in trade-execution: Increased integration and competition between national exchanges will inevitably entail some fragmentation of trading – at least in a first phase. This process is already underway. Some exchanges are providing trading for blue-chip/Euro-top securities issued in partner countries. In addition to inter-exchange competition, we must also take account of a new generation of “marketplaces” (ATS/MTFs) and the growing capacity for large integrated broker-dealers to internalise client orders. Competition between marketplaces and from new forms of trade-execution can drive efficiency and innovation at the level of the trading platforms. However, it also raises the spectre of reduced efficiency in the pricing of any given (equity) instrument. ISD must define the conditions under which competition in trading can take place while supporting overall market efficiency.
- 2) Increased concentration of banking and securities houses: The 1990s saw further concentration in investment banking. By 1999, the top 10 firms accounted for 77% of global wholesale and investment banking (compared to 40.6% in 1990) and the top 20 firms accounted for 96.3%. In Europe, universal banks and integrated broker-dealers now account for the lion's share of client brokerage accounts. The concentration of brokerage business has gone hand in hand with an expansion in the range of activities undertaken. The end-result has been more complex organisational structures, greater frequency of, and increased scope for conflicts of interest within investment firms.
- 3) New investor-oriented services and business models: The surge in the population of retail equity investors has been matched by a proliferation of product distribution channels, the appearance of new advisory services, and “execution-only” brokerage. This “unbundling” of retail investment services calls for a coherent regulatory response to clarify the capacity in which an investment firm is acting when dealing with a client; its fiduciary responsibilities; and to ensure management or disclosure of commissions or “soft-dollar” arrangements with product suppliers.

4) Closer integration and stronger spill-over effects: The single currency has dramatically altered the geography of financial trading in Europe. Money and sovereign debt markets are nearly fully integrated. In equity instruments, the search for trading opportunities is leading investors and market participants to expand their investment horizons. Cross-border equities transactions have been growing at an annual rate of 20-25% over the period 1996-2001. European exchanges and marketplaces now provide a meeting point for traders from across Europe to buy and sell instruments issued anywhere in Europe (or beyond). In short, we are witnessing the emergence of a seamless financial market in which supply and demand for any given instrument can interact instantaneously across borders. In this market, the origin of the security, the nationality of the trader or investor and the location of the marketplace/trading system will have no bearing on the investment decision. This level of integration calls for reinforced safeguards for orderly trading, clear lines of responsibility for market supervisors, and robust cooperation mechanisms to ensure that cross-border market abuse can be quickly detected and punished.

3. The third reason why ISD revision is important: now more than ever - we need an effective regulatory framework to protect investors, and sustain confidence and orderly trading.

Like their US counterparts, European market participants, regulators and supervisors have learnt some hard lessons over the course of the last 18 months. Knee-jerk responses must be avoided. Nevertheless, recent developments have underlined some elementary regulatory home truths.

I. The first lesson concerns the enduring importance of meaningful protection for retail investors. The value to investors of being able to count on professional and ethical support by investment firms has been starkly underlined by recent market developments. Statutory investor protection should not be expected to eliminate the inherent risk associated with investing in financial instruments.

Financial regulators should not assume responsibility for bad investment decisions. However, regulators should not stand back and allow retail investors to trade without protection in unsuitable instruments on the basis of incomplete information and flawed investment analysis. That is a recipe for scandal, permanent investor distrust and withdrawal of liquidity from financial markets. Effective due diligence and respect of business rules remain crucial lines of defence for all investors save the most seasoned and regular traders.

- II. A second lesson is the need for effective regulatory checks and balances to manage conflicts of interest. Conflicts of interest are endemic and unavoidable in the “universal-bank” based European financial system. However, the concentration of the financial sector and the provision of an ever-expanding range of services under one roof has amplified the scope for conflicts of interest. The absence of a coherent regulatory approach to managing conflicts of interest is a glaring omission from existing EU financial legislation. The Market Abuse and Investment Services Directive together seek to remedy this lacuna. They do so not by forcing institutions to divest themselves of business lines when faced with intractable conflicts of interest. Instead, the EU regulatory framework seeks to bring these conflicts out into the open and to ensure that they are managed in such a way that they do not work to the detriment of clients.
- III. A third and more general lesson is that “reputational” disciplines and the self-interest of market participants in sustaining investor confidence cannot be relied upon to guarantee market integrity. Even if it is a matter of only a “few rotten apples”, the systemic damage that questionable market practices or incomplete disclosure can cause to the markets is now plain for all to see. There is a need for enlightened regulation to define the rules of the game and for strong policemen to enforce these rules. The fact that the worst of recent excesses have been detected in the US should be no comfort to Europeans. While US regulators may have been criticised for being slow out of the blocks,

they have a clear mandate and the powers to punish improper conduct. Nobody doubts the capacity or political willingness of the US to put right the failures that have become evident. Can we be equally confident of our capacity to prevent or respond to disorderly markets or improper conduct on a cross-border basis?

Faced with these challenges, there is a need for European regulators to be clear about the rules of the game - to define what is expected of marketplaces and market participants particularly when they are acting on behalf of clients. The ISD revision aims to establish overarching regulatory principles to enable market-based financing to play a sustained role in creating wealth and jobs in Europe. I would like to recall briefly some of the guiding principles which were already laid down in the November 2000 Green Paper and the successive ISD consultation documents:

- 1st principle: A true single market based on home country supervision: ISD revision must provide the regulatory foundation for a truly integrated market, characterised by the degree of harmonisation needed to underpin home country supervision of cross-border investment service provision. It must also establish a common – as opposed to optional - approach to regulation of trading infrastructures. Mutual recognition of national regulatory regimes has proved insufficient to the task of creating a single financial market. The Lamfalussy recommendations implicitly recognise that the solution to market fragmentation is more harmonisation of regulatory disciplines – to be achieved through more flexible and dynamic decision-making arrangements. More single market, not less – but to be achieved by more rational and flexible means.
- 2nd principle: Protect “public goods” not particular market players: ISD should not engineer market outcomes, pick winners or favour one set of market participants over another. The Commission has consistently disavowed direct regulatory intervention to dictate where and how different classes of investment transaction should be executed. Instead, it has sought to establish a

comprehensive package of regulatory safeguards to ensure that competition in trade execution does not compromise market efficiency, integrity and the quality of investor protection. The Commission has also sought to extend comparable and proportionate disciplines to off-exchange trading and in-house execution of retail investor orders. In this regard, the Commission has targeted transparency and “best execution” as vital for supporting cross-market arbitrage. This will ensure that liquidity flows to the most efficient marketplaces, it will ensure convergence on a visible, single market price. The Commission hopes that this package of regulatory safeguards will allow Europe to reap the benefits of competition and innovation in trade execution while safeguarding the public goods of efficient price formation, high-quality execution of investor orders and liquidity provision.

- 3rd principle: Establish clear “lines in the sand” to protect investors: ISD revision should equip regulators with a comprehensive set of regulatory disciplines to tackle the risks to which the modern retail investor is exposed. We must give real teeth to the main lines of defence for investors – conduct of business, management of conflicts of interest, best execution. A high level of protection is crucial in its own right. It is also a pre-condition for the effective operation of the ISD passport.
- 4th principle: Provide for rigorous and even-handed enforcement: ISD revision should establish base-line requirements for competent authorities in terms of powers and mandate. It must also establish clear obligations and effective mechanisms to support real-time cooperation in investigating and pursuing breaches of ISD obligations. Without the necessary confidence in the effectiveness and quality of supervision and enforcement throughout the single market, the trust and confidence needed to underpin exclusive reliance on home country supervision will not be forthcoming.

D. CONCLUDING REMARKS:

ISD is a central pillar of a regulatory framework needed to support the sustained orderly development of EU financial markets. This framework comprises related EU measures for public offer prospectus, regular reporting and market abuse – as well as the ongoing preparation of Capital Adequacy review. Together, these measures will contribute to a financial environment characterised by prudential stability, full and fair disclosure of financial information, robust safeguards for investors, and efficient and orderly trading by market participants. In the absence of such safeguards, issuers and investors will lack confidence in market-based financing and new issues will dry up.

An ISD which provides the regulatory foundation for an effectively integrated financial market, establishes high levels of investor protection and introduces principles for marketplace regulation will, by necessity, be more far-reaching and ambitious than the existing Directive. There should be no illusions about the scale of the undertaking. The emerging proposal represents a considerable amplification of the provisions of the existing Directive. It entails a deeper level of harmonisation – to be achieved primarily through the adoption of level 2 implementing measures rather than on the face of the Directive. It will demand intensive investment by the Commission, CESR and market participants in the formulation of the detailed implementing measures. It will imply a realignment of supervisory practice. However, these efforts will hopefully result in an enduring, enlightened, and principles-based securities code.

Faced with this prospect, market participants may be concerned that they are being asked to sign a blank cheque. They do not yet know the precise form of the rules that will give effect to the high-level principles contained in the Directive. We are sensitive to these concerns over the course of the ISD consultations, and are seeking to lay down clear parameters which detailed implementing measures should respect. Furthermore, the crucial CESR advice to the Commission on the content of detailed implementing measures will itself be subjected to rigorous and systematic scrutiny by market participants.

My final message today is a simple one - consultation works. The enormous investment by European market participants and competent authorities in the ISD consultation exercise has paid dividends. On all counts – conception, technical and legal drafting, fit with supervisory and market practice, cost-benefit considerations – Commission work has benefited from exposure of early drafts to critical scrutiny. This is not to say that all constituencies will find their preferred solutions perfectly reflected in the proposal. Open consultation is not an exercise in negotiation between the Commission and vested interests: it allows the Commission to ensure that it is addressing real concerns, and to verify the viability, soundness and proportionality of envisaged solutions. It falls to Member States and the European Parliament to negotiate and conclude a final political settlement. The role of the Commission is to table a sound and viable proposal as the starting-point for the co-decision procedure. We hope that we are on a good way to delivering such a proposal.