COMMUNICATION FROM THE COMMISSION
TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

UPGRADING THE INVESTMENT SERVICES DIRECTIVE (93/22/EEC)
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- EXECUTIVE SUMMARY -

The Lisbon European Council has underlined the strategic importance of sustaining the greater reliance on market-based financing as a critical element for strengthened economic prosperity in the EU. The present Communication, foreseen by the Financial Services Action Plan, defines orientations and seeks public comments for a substantive overhaul of the Investment Services Directive (ISD: 93/22/EEC).

The ISD is the cornerstone of EU legislative framework for investment firms and securities markets. In the five years since its entry into force, it has eliminated a first set of legal obstacles to the single market for securities. The single passport conferred on authorised investment firms is widely used. Access to “regulated markets” and exchanges has been liberalised. Pan-European dealing in nationally-listed securities has been facilitated.

New challenges:

The ISD nevertheless needs modernisation to meet the demands of the new securities trading environment. Market forces, amplified by the single currency, are driving demand for an integrated financial market. Information technology is revolutionising business practices and paving the way for the emergence of a new generation of service providers. The drive to enhance performance, reduce costs and establish a pan-European presence is stimulating profound restructuring of the securities trading infrastructure. Proposals for mergers and alliances between exchanges are the most visible manifestation of these profound changes. Consolidation of clearing and settlement, which can substantially improve efficiency of European securities trading – is gathering pace.

Following the single currency, these structural changes are operating at a pan-European level. Deep-rooted segmentation of national financial markets is being eroded and cross-border transmission effects are being amplified. The number of cross-border transactions is rising. The value of investment decisions taken by investors and issuers in one Member State is increasingly sensitive to behaviour on other EU markets.

Achievement of the overarching regulatory objectives of investor protection, efficient and orderly markets, and market stability requires:

- confidence in the existence and effective implementation of agreed risk-management techniques;
- clarity as regards the roles and responsibilities of different regulatory and supervisory agencies;
- continuous cooperation between and convergence of the enforcement practices of competent authorities.
### Priorities for ISD revision:

These challenges require the upgrading of the ISD. This work can focus on four key priorities:

- **An effective passport for investment firms:** the usefulness of the single passport has been impaired by extensive exemptions from its scope and widespread application of host country requirements. Securing the full benefits of an EU passport for investment firms requires progress on two fronts: first, passage to home country control for all wholesale business; second, judicious ex ante harmonisation of conduct of business protection for retail investors, coupled with (non-sectoral) arrangements to facilitate the negotiation, conclusion and arbitration of cross-border contractual relationships.

- **New forms of service provision:** technology has spurred the emergence of novel forms of service provider, such as Alternative Trading Systems (ATSs) which compete with existing investment firms and, occasionally, infrastructure providers. The ISD should allow European securities supervisors to apply suitably calibrated and common safeguards to such systems, so that they can operate across the Union.

- **Effective competition between exchanges and trading platforms:** the ISD should allow newly commercialised exchanges and trading platforms to compete effectively and prudently for trading volumes without undue regulatory or supervisory impediment. Neither should competition be driven by excessive regulatory arbitrage which could jeopardise the orderly and efficient functioning of markets and investor protection. Regulatory and supervisory arrangements for European trading platforms and exchanges should reflect a collective “first-best” assessment of risks and opportunities. ISD provisions for “regulated markets” should therefore be expanded to provide a legal underpinning for these core benchmarks – particularly those relating to transparency and disclosure.

- **The growing cross-border dimension of clearing and settlement:** European level consolidation of clearing is gathering momentum. This efficiency-enhancing development concentrates systemic risk and increases the threat of cross-jurisdictional conflict. Mutual confidence in risk-management techniques and supervisory cooperation will be of central importance. Collective attention is urgently needed in the area of clearing and the remaining technical and legal impediments to linkages between securities settlement.

### An appropriate legislative response:

Europe needs financial services legislation that will stand the test of time. Prescriptive, inflexible rules which are quickly overtaken by financial innovation or market developments must be avoided. Framework legislation that enshrines high-level principles could provide the legal bed-rock for a dynamic, orderly and stable single financial market. Such high-level principles must be accompanied by mechanisms which provide supplementary guidance and ensure uniform interpretation. Without this, framework rules will remain a dead-letter.

An updated ISD must provide a common legal basis for “straight-through” supervision and enforcement. Regulatory and supervisory cooperation through Forum of European Securities Commissions (FESCO) is already paying dividends but must be stepped up. The Commission, acting within Treaty provisions and the Union’s institutional framework, and guided by the analysis of the Committee of Wise Men on securities markets will consider how best to respond to these needs in developing legislative proposals to update the ISD.
The Financial Services Action Plan underlined the heightened political urgency of reviewing and reinforcing the Union’s legislative framework for securities markets. The Lisbon European Council has underscored the importance of accelerating and completing this work before 2005. The present Communication opens an extensive consultation on the possible upgrading of one of the central pillars of this framework – the Investment Services Directive. Comments on the analysis and issues presented in this Communication are invited from the European Parliament, national regulatory and supervisory authorities, other EU level organisations including FESCO, market practitioners, market users and all other interested parties. Annex 1 summaries the specific issues on which comments are sought.

Comments should be addressed to the Commission before March 31st 2001 (attention DG MARKT F, avenue Cortenbergh 107, B-1040 Brussels: e-mail address: MARKT-ISD@cec.eu.int)
1. **INTRODUCTION:**

1.1. **Implementing the conclusions of the Lisbon European Council:**

The Lisbon European Council underlined the importance of establishing, by 2005, efficient and integrated financial markets as a critical component of Europe’s strategy for growth and employment. It identified integration, efficiency and stability as the key benchmarks for measuring the performance of European securities markets. EU policy should be informed by three over-arching principles of investor protection, orderly and efficient functioning of markets and market stability.

These goals are mutually-reinforcing: integration of markets will result in pooling of liquidity, will permit the most productive allocation of capital and foster competition between service providers. Efficient exchanges will experience a virtuous circle in which they attract further liquidity, reinforce their competitive edge and boost the efficient pricing of European securities. Prudential stability and trading security are essential features of any trading system.

The pooling of (previously fragmented) national liquidity will allow European savings to be put to their most productive use. Demographic trends require a secure and productive complement to statutory pension schemes. Investment in securities will be an integral part of successful medium/long-term investment strategies. In addition, pooling of liquidity will provide capital borrowers, especially companies, with a flexible and competitive alternative to bank-borrowing for financing employment-generating investment. Deep and liquid financial markets will allow companies to fine-tune their financial structures and complete the financing chain from start-up to initial public offer. Companies and issuers will obtain a better price for their securities. Access to the widest possible pool of potential investors, will strengthen the price-discovery mechanism and ensure the most competitive pricing of capital. Finally, intermediation and transaction costs – commissions and fees charged by middle-men – will be kept to a competitive minimum. The assessment that market-based financing heralds substantial benefits for European investors and issuers is not overturned by periodic bouts of volatility or occasional market corrections.

Removing obstacles to free circulation will not be sufficient. Regulatory action is also needed to correct market failure and to facilitate the efficient interaction of supply and demand for capital. A regulatory framework which emphasises open market access, shareholder rights, effective financial disclosure, legally secure clearing and settlement, and contractual enforcement is needed to secure the benefits of efficient and stable market-based systems. The Financial Services Action Plan maps out a first set of improvements to the EU legislative framework for securities markets which includes a single passport for issuers, rules on market manipulation and cross-border use of collateral.¹

The regulatory system itself has to work efficiently. EU rules must be clear and comprehensive, implemented by the Member States and enforced effectively by supervisors and lend themselves to expeditious adjustment. This will ensure that regulation keeps pace with market developments and contributes to the emergence of integrated and efficient securities markets.

1.2. Structural changes in EU financial markets:

Market-based financing is beginning to overturn the traditional predominance of bank-based lending in most EU Member States. New companies are issuing shares in unprecedented numbers. Institutional investors and a new generation of competitive brokers are mobilising household savings: in some Member States, more than one in three adults now owns shares. Trading infrastructures are also undergoing profound changes. New technology facilitates entry by service providers who can compete with incumbent players at all stages in the trading system – from rudimentary order-routing systems to fully-fledged exchange-like entities. At the level of exchanges, the race is on to provide issuers, investors and intermediaries with a platform for pan-European trading. This has spurred ambitious proposals for mergers and alliances between exchanges. Clearing (and to a lesser extent settlement) are of central importance as an important cost-centre in European trading where large benefits can be reaped from consolidation. The pressure from market users is eroding the boundary between national and European/international clearing and settlement.

Encouraged by the elimination of exchange risk in the euro-zone, these structural developments have assumed a pan-European dimension. Market inter-dependencies are being reinforced at all levels. The investment horizons of funds and private investors are becoming more pan-European. The same financial instruments are potentially tradable on competing exchanges and trading platforms across the EU. The same investment firms constitute the membership of different exchanges and serve the same national client bases. Finally, exchanges and new types of trading platforms are competing across borders for order flow and are increasingly dependent on consolidated clearing houses/central counterparty facilities.

2. **Assessment of the ISD:**

2.1. **Structure and design:**

The ISD provides the legal framework for regulation and supervision of investment firms and some aspects of the exchanges and markets on which they operate. It comprises three main pillars.

1. **Single passport for investment firms:**

The ISD allows investment firms to provide services, or establish branches in other Member States, on the basis of home country authorisation. Reliance on mutual recognition is complemented by harmonisation of core principles for initial authorisation and ongoing operations. Particularly important in this regard are basic principles for organisational requirements and conduct of business rules for

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2 One third of the total volume of new shares issued on European stock exchanges in 99 emanated from newly listed companies.
investment firms. The key ISD provisions are supplemented by the Capital Adequacy Directive (93/6) and CAD II (98/31).³ Where harmonising provisions are included in the ISD, they are confined to statement of core principles.

The traditional broker-dealer is the business model which has inspired key ISD provisions – this is evident from the heavy emphasis on transactional requirements designed to protect investors from abusive or improper conduct by the investment firm. National implementation of these provisions has also reflected traditional modes of investment service delivery, consisting of iterative contacts between firm and client based on phone and written correspondence. Underwriting and placing also benefit from ISD authorisation in their own right. However, firms providing related services such as advising and safekeeping/administration do not benefit from the ISD passport unless they are providing these services in conjunction with one of the “core services”.

The ISD has eroded market segmentation at the level of investment firms and access to “regulated markets”. Large numbers of firms have made use of the single passport. Figures 1a and 1b in annex provide some data on incoming investment service providers or branches.⁴

2. Access to “regulated markets”:

As a corollary to the single passport for investment firms, the ISD has dismantled official restrictions to membership of or access to regulated markets which would otherwise have obviated the impact of the single passport for investment firms. It prohibits quantitative or other arbitrary restrictions on access to or membership of “regulated markets”. In addition, markets operating an electronic based trading system are required to admit “remote members” located in other Member States. EU and third country members now account for between 30-50% of total membership of Amsterdam, Paris, Eurex, Frankfurt and a sizeable share of market turnover. This pattern is widespread but not universal (some exchanges, for example Madrid, have no remote members). The ISD also provides for right of access of partner country participants to related clearing and settlement.

Regulated markets are entitled to place screen trading facilities in partner Member States, so as to serve “remote members” in other Member States. This possibility has been actively used by a small number of exchanges. In this regard, the ISD foreshadows the competitive climate which currently prevails between exchanges.

³ These Directives define the capital reserves that investment firms must set aside to cover position and market risk on their trading book. As capital adequacy issues are already the object of regulatory and supervisory review in the Community, based on the Basle Banking committee work, they will not be further considered in this Communication.

⁴ To these figures must be added credit institutions which are authorised to provide investment services under authorisations granted under the Second Banking Coordination Directive. In addition to 2BCD, these firms are subject to ISD provisions 4, 8, 10, 11, 12, 14(3), 14(4) and 15. For many Member States, the numbers of incoming partner country firms far exceeds domestic authorised companies. No data is available on national market share accounted for by partner country firms. The limited use of branching option could be attributed either to relatively onerous notification and authorisation procedures or to limited commercial interest in the branching mode.
“Regulated markets” are defined by reference to rudimentary requirements for admission of official listing, reporting and transparency. Each national authority retains responsibility for nominating markets for “regulated market” status, and awarding special or exclusive rights to those markets. Furthermore, national authorities have the option, in the interests of ensuring that investors benefit from best price inter-action, of requiring that certain transactions be performed on a “regulated market” (concentration rule of 14(3)).

3. Supervisory co-operation:

Prior to the ISD, statutory safeguards and supervisory practices differed widely across the EU. Important provisions of ISD lay down requirements for national competent authorities, assign responsibilities and obligations for supervising and policing regulatory provisions laid down in the ISD. Articles 22-27 of the ISD underpin minimum convergence in terms of supervisory responsibilities and calls for a clear assignment of lead responsibilities between different national agencies or self-regulatory organisations. These provisions have given a significant impetus to convergence of regulatory and supervisory practice. In addition, the ISD formalises mechanisms for extensive event-specific and continuous cooperation between national authorities. This cooperation is a pre-condition for the preservation of investor confidence and market integrity in an integrated market. The recent creation of the Forum of European Securities Commissions (FESCO) has placed cooperation between national competent authorities on a more organised, albeit non-binding, basis.

2.2. Structural limits to the effectiveness of the ISD:

Mutual recognition of national authorisation and supervision has, in general, served European markets well. The broad definitions and core concepts of the ISD have been flexible enough to accommodate evolution in business practices and national supervision. However, the generic nature of many ISD provisions, unsupported by more detailed guidance or implementing measures, also presents drawbacks. In particular, the effectiveness of the ISD has been mitigated by:

- Extensive dilution of the home country philosophy of the ISD. Numerous provisions of the ISD admit host country intervention or supervision to uphold the “general good”. The most notable provisions in this regard are Articles 13, 17(4), 18(2), 19. In addition, Article 11(2) entrusts responsibility for the implementation and supervision of rules of conduct to the Member State “in which a service is provided”. There are objective reasons for admitting host country interventions in the interests of protecting retail investors. However, the failure to provide for effective mechanisms to smooth a transition to home country principle or to circumscribe the scope of host country principle is a shortcoming of the present Directive;

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5 In the absence of a clear understanding as to how to determine the Member State where the service is provided, almost all national authorities apply local conduct of business rules to incoming services provided to nationally-domiciled investors.
• Unclear provisions or definitions which have paved the way for widespread discrepancies in interpretation and implementation at national level – for example, as regards implementation of core service definitions, application of conduct of business principles, designation of “regulated markets” and provisions for use of emergency powers under Article 19. ISD provides no mechanism which could be used to provide further guidance or forge common approaches to the interpretation and implementation of harmonising measures.

A wide-ranging overhaul of the ISD is required to overcome these difficulties so as to seize the unprecedented opportunities and rise to the regulatory challenges of the new securities trading environment. Based on its assessment of the regulatory implications of current market developments, the Commission has identified a number of themes which could be the focus for ISD revision. These themes are grouped under two headings – one set of issues relates to the functioning of the single passport for investment firms and service providers. The second set of issues arises from structural developments at the level of exchanges and the trading infrastructure.

3. A FULLY OPERATIONAL SINGLE PASSPORT:

3.1. Clarifying and extending passport rights:

The scope of the ISD passport is limited by numerous exemptions. Articles 2(2) and 2(4) provide for a wide range of exemptions, some of which may no longer be pertinent⁶. Some non-core services – in particular custodians – might also benefit from ISD authorisation in their own right. In re-assigning services from non-core to core status, consideration would need to be given to whether ISD provisions are adequate for dealing with the supervisory issues related to the service in question. Moreover, the tangible benefits from ISD passport should outweigh the costs of compliance with regulatory provisions (e.g. capital adequacy).

Competent authorities differ in the extent to which they apply different ISD provisions to specific core investment services. For example, Member States diverge in they extent to which they tailor conduct of business regimes for reception/transmission services and/or “execution only” brokerage. Firms authorised in one Member State may be subjected to a qualitatively different supervisory regime when operating in another. Greater consistency of national approaches should facilitate cross-border service provision and the emergence of new technology-based business models. New methods and formats for investment service provision can be compatible with existing conduct of business principles. Therefore, providing greater certainty as to how different ISD provisions can be applied and adapted to individual core services can have a double dividend.

The effective operation of the single passport for investment firms requires a reconsideration of the exemptions of Article 2(2) and 2(4), and an assessment of whether some or any of the non-core services should be upgraded to core service.

⁶ In view of changing market practices, particular attention should be given to the relationship between services foreseen under Art. 2(2)g and services relating to the reception and/or transmission of orders.
3.2. Protecting investors and managing supervisory overlap:

The most widespread difficulty encountered in the operation of the ISD passport is the scope for jurisdictional uncertainty and conflict. As admitted by key provisions of the ISD, host country authorities generally apply domestic conduct of business and advertising rules and some organisational/prudential requirements (holding of client money) on services provided to domestic investors. This resulting duplication of supervisory regimes inhibits cross-border provision of brokerage and dealing services in particular.

Ultimately, a single passport will require systematic reliance on the home country principle for supervision of firms’ obligations to the market and fair dealing with clients. At present, a number of ISD provisions privilege host country implementation, or give unqualified prominence to “general good” exceptions. These exceptions to the underlying home country philosophy of the Directive need to be carefully examined. This should not result in a watering-down of investor protection: home country authorities are frequently best-placed to supervise and enforce investor protection requirements once they are detected.

In promoting a more effective single passport, a distinction should be drawn between services provided to professional counterparties and those provided to retail investors. Insofar as services provided to professional investors are concerned, progress towards exclusive reliance on home country enforcement of prudential rules and conduct of business does not require further harmonisation. Commission Communication on Article 11 of the ISD provides a detailed and non-binding analysis of practical and substantive considerations which support this approach. The revision of the ISD should seek to give full legal underpinning to this approach – not only in respect of conduct of business rules for fair dealing, but also as regards advertising and the firms’ obligations to the market.

As regards retail investors, the transition to home country supervision of investment services will need to be carefully managed. It is currently the case that host country authorities may have a comparative advantage as a first-line of defence in detecting and initiating action against firms which transgress in their dealings with retail investors. Moreover, conduct of business rules in the different Member States cannot be assumed to offer comparable protection to retail investors. Consequently, retail investors may derive benefit and confidence from the possibility of seeking redress within their own jurisdiction.

The Commission is considering practical means of meeting these concerns. Retail investors clearly need to benefit from key elements of the domestic supervisory and legal regime. The Distance Marketing Directive will harmonise requirements relating to generic information supplied to purchasers of financial and investment services, marketed and sold at a distance. Ongoing FESCO work aims to approximate conduct of business rules for retail investors. Other practical difficulties remain. For example, where customer agreements or other contractual arrangements underpin the firm-consumer relationship, the determination of the law applicable to the contractual obligations will be governed by the Rome Convention. This may result in some of the mandatory rules of the consumer country being applied through the contract governing the firm-client relationship. Finally, mechanisms for supervisory co-operation may need to be intensified so as to foster mutual confidence as regards the practical implementation and enforcement of common investor protections. Solutions to these challenges – which are not specific to investment services – will also be needed.

The E-commerce Directive already entails a decisive shift towards the country of origin principle for all investment services provided electronically. Revision of the ISD must pave the way for further systematic move to the home country principle. Henceforth, residual host country responsibilities must be strictly demarcated, and should be confined essentially to conduct of business rules for fair dealing with retail clients. Where host country responsibility is exceptionally permitted, conditions should be identified which, once fulfilled, should lead to their automatic expiry.

- **Home country supervision should be implemented without pre-condition for services provided to professional counterparties.** Apart from conduct of business rules, are there other ISD provisions which could incorporate a clear and operational professional/retail distinction?

- **Respondents are invited to comment on regulatory and supervisory issues which call for residual host country role on a transitional basis.** What flanking conditions are needed as a precondition before the phasing-out of residual host country responsibilities?

In replying to these questions, respondents are invited to take account of the analysis presented in the Commission Communication on Article 11 of the ISD.

### 3.3. New players – Alternative Trading Systems:

Information technology has reduced entry barriers at all stages in the securities trading business – from provision of brokerage/dealing services, through pure order-routing and transmission, to the establishment of advanced platforms for order matching and execution. At this end of the spectrum, new entrants may be functionally similar to fully-fledged exchanges and several have been authorised as “regulated markets”.

Greater uncertainty has surrounded the appropriate regulatory and supervisory treatment under EU law of Alternative Trading Systems (ATSs) which are currently authorised as investment firms in different Member States. Users of these systems must be adequately protected and the interaction with the overall securities trading environment must be optimised. The key issue is whether ISD (and national) provisions relating to investment firms are sufficiently responsive to the potential
regulatory risks presented by these new entities. ATSs do not constitute a homogeneous group. However, detailed analysis undertaken within FESCO reveals that these systems can very often be assimilated with investment firms. Based on a case-by-case assessment of the regulatory risk-profile of individual ATSs, a graduated application of organisational requirements (Article 10) and conduct of business rules (Article 11) could be applied to counter any supplementary risks for investors or the orderly functioning of markets.

National securities regulators propose to implement this policy as the preferred short-term approach to the supervision of ATSs. Subject to any interpretation of the ECJ on the consistency of this approach with the ISD, the Commission considers that this an expedient transitional solution. It will be crucial that any supplementary requirements be applied in a uniform manner so as not to infringe passporting rights of authorised investment firms.

This pragmatic solution cannot be the final word. Certain ATSs may be the focal point for organised trading in financial instruments. They will thus be vulnerable to the same risks as exchanges and “regulated markets” in terms of preserving market confidence, transparency, and orderly and efficient trading. This may call for the application of provisions of the “regulated market” regime. Currently, there is a strict dichotomy in ISD between “investment firms” and “regulated markets”. This precludes the extrapolation of elements of the “regulated market” regime to investment firms. Revision of the ISD could therefore allow for a (proportionate) application of provisions relating to reporting, transparency, and disclosure requirements to those ATSs which closely resemble exchanges.

4. **Regulated Markets and the Trading Infrastructure:**

By broadening the membership base of exchanges and regulated markets, the ISD has indirectly facilitated competition between trading systems. The incentive to increase trading volumes has been accentuated by the move to a “for-profit” basis. Many exchanges have embraced the opportunities implicit in open membership networks. Competition between exchanges is intensifying. Further reductions in transaction costs through application of new technologies are limited as many European exchanges are operating at the technological frontier. The most promising route for future revenue growth will be increased trading volumes, resulting in scale and scope economies. Some exchanges and new entrants are seeking to achieve pan-

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8 Some ATSs provide a rudimentary electronic meeting-point (bulletin-board) for matching orders whereas others closely can be equated with electronic inter-dealer-brokers or dealer order-books.

European reach through organic growth. However, other exchanges are looking to far-reaching alliances or fully-fledged mergers with potentially significant concentration in trading volumes and deeper and more liquid securities markets. The benefits are not limited to scale and scope efficiencies in the execution of trades: the more elusive improvements in terms of increased liquidity and better price interaction will ultimately be much more significant. Adjustments or extensions to the ISD may be needed to optimise these developments to:

1. Support effective competition for order flow between exchanges (“passport”);
2. Clarify the regulatory requirements for “regulated markets” so as to preserve the benefits of orderly and efficient trading (“high level principles”);
3. Promote transparent pricing of securities on individual exchanges and across the trading system as a whole;
4. Forge a collective approach to the integration and supervision of clearing and securities settlement functions.

4.1. A single passport for “regulated markets”:

Although the right for electronic-based markets to operate screen trading facilities in Member States may be seen as a fore-runner, the ISD does not confer full passporting rights on “regulated markets”. To facilitate the provision of trading services for a broad range of European of securities, the ISD definition and provisions relating to “regulated markets” will need to be examined.

Currently, the concept of “regulated market” in Article 1.13 is defined partially by reference to the requirement for admitting securities to listing (including the the conditions for the admission of securities to official stock exchange listing laid down in Directive 79/279). Conditions for admission to listing are the front-line of defence in ensuring the quality of the instruments which are traded on markets and adequate disclosure to investors. Difficulties arise because of prevailing uncertainty as regards the way in which “regulated markets” should fulfil their obligations to ensure that all securities comply with the requirements for “official listing” (as specified in Directive 79/279). In essence, the practice to date has been that the regulated market should provide listing functions in respect of all securities which are dealt in on that market. This practice for “regulated markets” officially to list securities prior to trading can add significantly to costs and limit the scope for competing markets and exchanges to admit the same security to trading. Admission to listing and admission to trading must therefore be decoupled if more active competition between trading systems is to be facilitated. Furthermore, structural changes such as the demutualisation of exchanges call for a redefinition of how listing and public disclosure objectives are realised. However, before such far-reaching adjustments can be envisaged, an equitable basis must be found for sharing the regulatory overheads of listing and fulfilling related requirements such as dissemination of price-sensitive information. Without appropriate arrangements, profit-driven

10 Dir. 79/279 of 5.3.1979 (OJ L 66, 16.3.1979). Uncertainty as regards compliance with official listing requirements is exacerbated in respect of securities to which Directive 79/279 is not applicable. Here, the need to prepare a public offer prospectus for all transferable securities issued on a market provides one safeguard.
Exchanges may seek to divest costly listing functions, particularly if they perceive competitors as “free-riding” on their listing services. This would jeopardise the important “public good” functions served by listing. Implementation of this approach should be foreshadowed in an updated definition of “regulated markets”. It also calls for a re-examination of the provisions of Directive 79/279.\(^{11}\)

The concentration rule of Art. 14(3) of the ISD offers Member States the option of requiring the execution of transactions in certain financial instruments on a “regulated market”. This provision was intended to enhance investor protection by limiting “off-market” transactions to professional investors. However, trading in financial instruments could be artificially diverted to a particular regulated market. Investor protection is better served by appropriate provisions addressed to market participants acting on behalf of investors, and by strict enforcement of “best execution” requirements. In order to avoid arbitrary or disproportionate restrictions on competition between “regulated markets”, it may be appropriate to examine the continued rationale and/or present form of the “concentration rule”.

Article 15(5) ISD empowers Member States to restrict the establishment of new markets on their territory. As recognised by IOSCO, there are legitimate concerns relating to governance and orderly operation of markets which call for appropriate licensing and authorisation arrangements for exchanges. However, the current provision should be reviewed to ensure that it is not used to obstruct the activities of “regulated markets” authorised by partner country authorities.

The Commission also notes that nurturing competition between commercially-driven exchanges will also call for vigilance on the part of anti-trust authorities to curb any anti-competitive control over access to proprietary trading networks. New technology-based entrants or competition from overseas markets may limit this danger by increasing contestability at the level of trading systems/exchanges. Nevertheless, excessive concentration of trading volume in one or more privately-owned trading systems may give rise to concerns. These would be particularly pronounced if horizontal concentration at the level of the trading system was accompanied by vertical integration spanning trading, clearing/central counterparty systems. The advantages of cost-reducing “straight through processing”, could then be outweighed by the anti-competitive consequences of dominance in the trading infrastructure.

- The requirements for “regulated markets” in terms of compliance with listing conditions and criteria for admission to trading need to be clarified. This will also require a parallel update of Directive 79/279. What conditions are required for the successful implementation of such an approach so as to preserve disclosure and safeguards the quality of securities trading.

- The concentration rule of Article 14(3) and the right of prohibition of Article 15(5) need to be reviewed with a view to reducing any disproportionate or unnecessary restrictions on the cross-border activity of “regulated markets”

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\(^{11}\) In addition to the issue of the linkage between listing and admission to trading, Directive 79/279 lacks clarity as regards the scope of certain key concepts such as “official listing” and “stock exchange”. Discrepancies in the quality of securities traded on different “regulated markets” and the associated level of disclosure could arise.
4.2. **High-level principles for “regulated markets”:**

The ISD provides for limited convergence of the conditions which markets and exchanges should respect so as to uphold confidence in and stability of the market. Recent structural developments have highlighted how divergences in regulatory and supervisory requirements can complicate integration of trading. Harmonisation of trading rules is a precondition for a unified market. There is also a need for common regulatory and supervisory responses in other areas.

Timely and high-quality disclosure of material information on an equitable basis requires uniform listing requirements, prospectus, regular reporting and disclosure of price-sensitive information. A common model for transparency and reporting is essential especially where transactions are highly sensitive to transparency requirements. Disparities within a system will lead to concentration of this trading at the point where transparency obligations are least demanding, thus compromising efficient price-discovery within the unified market. Rules on market membership and standards for market access must be aligned to prevent participants arbitraging between different points of entry to the integrated platform. The content and implementation of any membership or admission criteria be non-discriminatory and objective. Finally, equivalent approaches to monitoring, enforcement, and disciplines are required to ensure equal levels of risk-deterrence and severity of punishment.

The regulatory and supervisory challenges of managing the implications of inter-exchange competition for the transparent, efficient and orderly functioning of the European market system as a whole are formidable. Two issues call for particular attention. First, closer integration of securities markets increases the possibility that regulatory or supervisory differences influence competition between exchanges for trading volume. Where trading is sensitive to regulatory overheads, there is a risk that competition between regimes will come at the expense of transparency and efficiency of EU securities markets as a whole. Secondly, EU regulatory approaches need to be re-appraised in the light of increased transmission effects. Developments in one regulated market could well have immediate and potentially major repercussions on the trading environment in other Member States. Measures to uphold market integrity, confidence and stability can no longer be designed or implemented in isolation.

A shared EU regulatory perspective is needed. The interests at stake are not confined to Member States which are home to merging exchanges: investment firms, investors, issuers and infrastructure providers throughout the EU are directly concerned. Regulatory or supervisory arrangements governing a large share of European securities trading cannot be permitted to evolve on an ad hoc basis in response to the technical challenges presented by a particular merger/alliance. Such an approach also threatens to perpetuate regulatory and supervisory diversity in Europe if each large-scale merger/alliance gives rise a distinct set of regulatory and supervisory solutions.

ISD provisions on “regulated markets” should be reinforced to provide a common set of principles in respect of orderly trading, disclosure and transparency, market integrity and standards of monitoring and enforcement. Incorporation of high level principles in EU law can smooth structural changes at the level of exchanges by:
• Limiting legal uncertainty over applicable law or jurisdiction in respect of “regulated markets” which are present, active or susceptible to review in different Member States;

• Giving legal teeth to obligations for cooperation between market supervisors, including the definition of practical arrangements to facilitate cooperation between administrative authorities and commercial Self-Regulatory Organisations (SROs);

• Building on mechanisms and provisions effectively applied in other EU financial services legislation. In this regard, attention could be given to capital adequacy requirements (to ensure that “regulated markets” possess the capacity to maintain systems), large exposure requirements, “fit and proper” tests for management and mechanisms on acquisition of qualifying interests (to provide control over emerging conflicts of interest in governance structures);

• Enhancing transparency by the market operators and supervisor as regards rules for fair and orderly trading, operating conditions and ownership structures.

National securities supervisors, meeting in FESCO, have produced a set of generic “standards for regulated markets”. These standards provide a useful reference point for further reflection in the above areas.

A final consideration relating to the fleshing out of high level principles for “regulated markets” in the context of ISD revision concerns the coverage in terms of securities trading. One option would be to limit the focus to “regulated markets” which provide for publicly accessible trading in equity, on the grounds that the real economy and the retail investor are most heavily exposed to this type of securities business. Consequently, it is here that the need for transparency and disclosure is greatest. A second approach would be to encompass all organised systems providing for publicly accessible trading, irrespective of the financial instrument (including commodity derivatives and any other instruments excluded from annex B of the ISD). This approach may require a graduated application of high-level principles to take account of the fact that organised trading in different instruments gives rise to different regulatory issues depending on the market model and the extent to which trading is dominated by inter-professional business.

• The current definition and provisions of the ISD relating to “regulated markets” are inadequate to contend with regulatory and supervisory challenges which result from the intensification of competition and cooperation between exchanges. In which areas could regulatory arbitrage across exchanges compromise the orderly, efficient and transparent functioning of securities trading?

• Should high-level principles for markets be restricted to publicly accessible trading in securities, or extended to organised in all financial instruments. Should high-level principles be tailored to the regulatory and supervisory risks associated with different types of market or trading? Which provisions should be applied in a graduated fashion?

• Respondents are invited to comment on whether and how certain principles might be enshrined in EU law and which regulatory objectives should be the focus of attention?
4.3. **Transparency:**

A high level of transparency is the hallmark of an efficient market, and is the best safeguard for investor interests. Despite Article 21 ISD, there are enormous discrepancies in the level of transparency across EU regulated markets. With the emergence of electronic order-driven systems as the dominant market model for equity trading, provisions to promote effective transparency in the part of the market which stands to benefit from it the most. Requirements should be formulated in terms of the results to be achieve, rather than prescribing detailed market practices.

Divergences are particularly marked as regards transparency requirements for trading with institutional investors. On several European markets, this business is conducted “off market”, possibly impairing overall liquidity and price-discovery for securities. In a context where markets are competing aggressively for this type of business, common solutions may be needed to ensure that opaque block-trading does not unduly diminish the quality of securities pricing for retail and other investors.

The segmentation of securities trading based on national administrative and currency frontiers must not be replaced by a market-based solution involving insufficient technical or regulatory links between trading systems. If there are several European trading platforms, interaction between the separate price-discovery systems may need to be promoted. However, regulation should not seek to dictate market structures or solutions. It should, instead, enhance the benefits of transparency and effective price-interaction. Without this the potential opportunities of a single integrated market will not be optimised. A further consideration is that price-sensitive information may not be made available to investors at the same real-time across different trading systems.

| • How should ISD provisions on transparency can be usefully upgraded? To what extent are common approaches required to ensure that “off-market” trading does not unduly impair efficient pricing of securities for all investors? |
| • Does the fragmentation of trading across different systems represent a threat to liquid and efficient securities markets? What practical steps could be used to promote effective and efficient price interaction across competing “regulated markets”? |

4.4. **Clearing and settlement:**

Remote access: Clearing and settlement functions are addressed indirectly by Article 15(1) ISD which requires that access to regulated markets be accompanied by access to underlying clearing and settlement functions. Some Member States have obliged remote members to rely on the offices of locally-established intermediaries for the purposes of clearing and settlement. This indirect access increases complexity and costs, and interferes with timely and effective execution of transactions. The Settlement Finality Directive removes one uncertainty by eliminating complications arising in the event of insolvency by a counterparty in another Member State. However, difficulties remain. One example is the reluctance of monetary authorities

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12 The US precedent (dating back to 1970s) demonstrates how effective mechanisms for cross-market price transparency can be in fostering the pooling of liquidity.
to offer partner country investment firms account facilities needed to settle transactions in “central bank money”. This forces remote members of the local “regulated market” to rely on local correspondent banks with a view to definitive settlement (in legal tender) of the cash-leg of the securities transaction. In the absence of solutions to these issues, remote membership of clearing and settlement system will be fatally undermined.

**Settlement:** Despite the blurring of the boundary between national Central Securities Depositaries (CSDs) and International CSDs (ICSD), the cross-border settlement of securities transactions is fraught with technical and legal difficulties. The ESCB is currently seeking to overcome technical obstacles to effective linkages between securities settlement systems by building on standardisation work in international fora\(^\text{13}\). To be fully optimised, remaining legal impediments to the cross border transfer and perfection of property titles should be removed\(^\text{14}\).

**Clearing:** Now well-established in trading in derivatives and fixed income securities, multilateral netting and central counterparty functions are also becoming central to mainstream equity trading. While this development supports efficient trading, it also entails a concentration of systemic risk on the books of central counterparties. This will be exacerbated by geographic consolidation which may result in some trading systems being dependent on clearing functions performed in other Member States.

All authorised clearing houses are subject to continuous supervision and extensive risk-management techniques\(^\text{15}\). The definition, supervision and enforcement of these standards is undertaken predominantly at national level. EU level consideration of these issues may now be warranted. This could focus on the key principles and elements for regulation and supervision of clearing and the mechanisms needed to ensure effective cooperation and communication between relevant supervisory authorities.

In parallel with ISD modification, this common reflection should aim to establish a clear understanding of the supervisory arrangements for clearing houses needed to preserve the stability of an integrated system for securities trading.

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\(^{13}\) G-10/IOSCO (International Organisation of Securities Commissions) joint task force for defining principles for securities settlement transactions (modelled on the “Lamfalussy” standards for systemically important payment systems.

\(^{14}\) These problems are particularly marked for bearer securities.

\(^{15}\) These arrangements include regular mark-to-market revaluation of positions, calling in of losses, use of initial and intra-day margin requirements, standards for money settlement, membership requirements and capital adequacy provisions. These safeguards are subject to intensive surveillance.
5. **THE WAY FORWARD:**

A comprehensive review of the ISD, as foreseen by the Financial Services Action Plan, is a key element in the reform of the European legislative and supervisory framework to meet the challenges of the new securities landscape. Updating of the ISD can facilitate European progress towards enhanced liquidity, efficiency and stability. Inaction risks undervaluing the positive externalities and public goods that efficient securities markets, characterised by transparency and integrity, embody for the overall economic system.

In view of the numerous issues relating to interpretation and implementation of many ISD provisions which have arisen over the life-time of the ISD, the Commission considers that the ISD should be extensively overhauled if it is to provide an operational passport for investment firms. This is the only means of delivering the requisite legal certainty and clarity.

- In the event that respondents see merit in the elaboration of EU high-level principles for “regulated markets”, they are invited to indicate whether these elements be encompassed in a single extended ISD or whether high level principles on regulated markets be devolved to a self-standing item of EU legislation? What level of urgency should be attached to the adoption of high level principles?

5.1. **The form of revised ISD:**

The pace of change in financial markets, the dangers of codifying detailed implementing provisions in EU law, are overwhelming arguments in favour of an ISD which is confined to a core statement of principles. These principles should reflect clear set of underlying principles, based on Treaty freedoms, and lend themselves to unambiguous interpretation.

An ISD which is confined to a statement of high-level principles must not lead to a proliferation of national interpretations and implementing provisions. Continually updated guidance on the definitions and provisions of the ISD will be needed to ensure that the Directive provides gilt-edged investor protection and effective market access. This will a coherent and structured approach to (1). formulating up-to-date interpretations of concepts; (2). fostering continuous real-time cooperation between national authorities and (3). ensuring common standards of enforcement and implementation at the level of front-line supervisors. Channels are also needed which allow supervisors and enforcement agencies to draw the attention of the legislator to substantive problems called for regulatory action, and devising solutions.

These issues are currently the focus of deliberations by the Committee of Wise Men on Securities markets which is scheduled to issue a final report in the first half of 2001. The conclusions of that Committee will hopefully provide a blueprint for EU legislation which combines legal clarity and certainty with responsiveness to market developments as well as even-handed and rigorous enforcement.
5.2. Guiding principles for revision of the ISD:

Clearly, the prevailing fluidity in market conditions makes the preparation of EU legislative initiatives more complex. The issues which are to the forefront now may not be the predominant concerns once market outcomes have stabilised. On the other hand, change is needed to harness efficiency-enhancing developments which might otherwise be stifled or considerably delayed. Furthermore, in the absence of a collective regulatory or supervisory, market developments in a subset of EU Member States may dictate the shape of market models and regulatory paradigms for years to come. Failure to act now could present EU policy-makers and market practitioners with a solution which is sub-optimal when viewed from a collective or longer-term perspective.

A number of guiding principles will help to ensure that the ISD successfully rises to the challenges of the new securities trading environment:

- **A revised ISD should underpin an effective passport, effective competition between securities trading platforms, which guarantee access on fair and non-discriminatory basis to essential trading infrastructures.** Underpinning and overseeing this open access condition will be critical to ensuring sustainable competitiveness of the trading architecture.

- **The promotion of Treaty freedoms must not come at the expense of investor protection, market integrity and stability.** This will require judicious harmonisation of key regulatory safeguards – particularly for the protection of retail investors. The regulation and supervision of intermediaries is one of the mainstays of investor protection and market integrity.

- **the benefits of deep and liquid securities markets must be available to all issuers – regardless of size:** This objective will best be served by promoting the emergence of deep and liquid markets, which are accessible on the basis of clear and up-to-date rules and streamlined procedures. Reducing the content of disclosure requirements for small issuers could prove counterproductive.

- **the competitiveness of European financial marketplaces should be enhanced.** Vibrant and competitive securities markets, characterised by efficient trading and settlement can be a powerful magnet for international capital inflows.

- **European markets should be well-placed to take advantage of imminent globalisation of securities markets.** Global 24-hour trading is on the horizon. The European regulatory and supervisory framework should ensure that European markets and firms benefit fully from this process and enjoy full access to third country markets – a central theme of the next WTO Trade Round.

- **regulatory bias towards particular business models or market structures must be avoided.** Rules which inadvertently favour particular business models or market structures could stifle innovation and damage the competitiveness of EU markets. The design and application of rules must also be neutral in terms of market-model or technology. Finally, regulatory and supervisory arrangements for equity trading are not necessarily appropriate for organised trading in other instruments such as derivatives and fixed income securities. In designing and applying regulatory provisions, a light-touch differentiated approach may be justified for markets
dominated by inter-professional activity. To meet these different needs, ISD provisions should embody a functional approach to regulating risk rather than establish provisions which reflect an existing institutional landscape.

Comments are invited on the scope, presentation, and analysis of this discussion paper and the detailed commentary on individual ISD provisions attached in the working document of the Commission services.
Figure 1a:

Incoming service providers notified under Art. 18 ISD
(free provision of services)

![Bar chart showing the number of notifications from different countries.]


Figure 1b:

Incoming service providers notified under Art. 17
(branches)

![Bar chart showing the number of notifications from different countries.]

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**List of Issues for Comment**

**An effective single passport for investment firms:**

- The effective operation of the single passport for investment firms requires a reconsideration of the exemptions of Article 2(2) and 2(4), and an assessment of whether some or any of the non-core services should be upgraded to core service.

- ISD revision should clearly indicate how individual provisions should be tailored to different core-services so as to avoid pronounced divergences in national supervisory regimes which impede cross-border service provision. Respondents are invited to identify those provisions of the ISD could be applied in a differentiated manners, and how they should be adapted for the different core services.

- Home country supervision should be implemented without pre-condition for services provided to professional counterparties. Apart from conduct of business rules, are there other ISD provisions which could incorporate a clear and operational professional/retail distinction?

- Respondents are invited to comment on regulatory and supervisory issues which call for residual host country role on a transitional basis. What flanking conditions are needed as a precondition before the phasing-out of residual host country responsibilities?

**New forms of service provision:**

- Which of the principles and requirements of Articles 10, 11 will be of most relevance in catering for situations where Alternative Trading Systems (ATSs) provide infrastructure services? Are other elements of the “investment firm” regime potentially relevant?

- In view of functional approach to the regulation of ATSs, which elements of the regulatory framework for “regulated markets” (e.g. for reporting, transparency, monitoring/enforcement) could be of most relevance to different types of ATSs?

**Effective competition between “regulated markets”:**

- The requirements for “regulated markets” in terms of compliance with listing conditions and criteria for admission to trading need to be clarified. This will also require a parallel update of Directive 79/279. What conditions are required for the successful implementation of such an approach so as to preserve disclosure and safeguards the quality of securities trading.

- The concentration rule of Article 14(3) and the right of prohibition of Article 15(5) need to be reviewed with a view to reducing any disproportionate or unnecessary restrictions on the cross-border activity of “regulated markets”

**High level principles for “regulated markets”:**

- The current definition and provisions of the ISD relating to “regulated markets” are inadequate to contend with regulatory and supervisory challenges which result from the intensification of competition and cooperation between exchanges. In which areas could regulatory arbitrage across exchanges compromise the orderly, efficient and transparent functioning of securities trading?
• Should high-level principles for markets be restricted to publicly accessible trading in securities, or extended to organised in all financial instruments. Should high-level principles be tailored to the regulatory and supervisory risks associated with different types of market or trading? Which provisions should be applied in a graduated fashion?

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Promoting transparency:

• How should ISD provisions on transparency can be usefully upgraded? To what extent are common approaches required to ensure that “off-market” trading does not unduly impair efficient pricing of securities for all investors?

• Does the fragmentation of trading across different systems represent a threat to liquid and efficient securities markets? What practical steps could be used to promote effective and efficient price interaction across competing “regulated markets”?

Clearing and settlement:

• Respondents are invited to comment on practical problems relating to access to partner country clearing and settlement systems, and the nature of legal and administrative impediments to cross border securities settlement.

• On which areas should securities supervisors focus their attention when considering possible cross-border ramifications of consolidation of clearing and central counterparty functions? What safeguards might be most effective in managing such risks?
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