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Revision of the ISD

Eddy WYMEERSCH

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Abstract

The ISD of 1992 has had a considerable influence on the development and structuring, as well as on the integration of the securities markets in Europe. Over the last ten years, markets have developed considerably and some have integrated. Time has come to update the rules of the game, taking into account the need for a stronger integration of the securities markets in Europe, the considerable increase of cross-border transactions due to the introduction of the Euro and the phenomenal developments in the information technology that increasingly determine the structure of securities trading.

Comments to the Author:

eddy.wymeersch@rug.ac.be

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Revision of the ISD
Discussion of the Second Consultation Document

Eddy Wymeersch
Chairman of the Belgian Banking and Finance Commission.

1. The ISD of 1992 has had a considerable influence on the development and structuring, as well as on the integration of the securities markets in Europe. Over the last ten years, markets have developed considerably and some have integrated. Time has come to update the rules of the game, taking into account the need for a stronger integration of the securities markets in Europe, the considerable increase of cross-border transactions due to the introduction of the Euro and the phenomenal developments in the information technology that increasingly determine the structure of securities trading.

New markets organisations and trading forms have developed. Competition and technological innovation have shaped the present markets into a structure that is considerably different from the one that existed in the late 1980s, at the moment the 1992 ISD was framed. The need for a truly integrated European securities market has accelerated significantly under the pressure of the Euro, removing pre-existing monetary protection. In the meantime, European markets have become more open, more investor-friendly and therefore more attractive. In the world-wide competition, European markets have been able to attract a considerable part of world savings, to the detriment of the far eastern markets, but markedly less in comparison to the US markets. Apart from this low degree of integration, leading to a lack of transparency, the often decried unfavourable cost structure and the difficulties to gain easy access to all of the markets can be cited among the market related factors explaining the lower attractiveness of present European securities markets.

2. The role of regulation of securities markets is a complex one. The ultimate objective of the regulation of securities markets is to safeguard the interest of investors and to allow markets to function as an efficient source of financing for business firms and public authorities. At the same time, regulation may exercise a stifling influence on market developments: it is therefore essential that, while offering sufficient guarantees in terms of the protection of investors and of the general interest, regulation does not prevent market structures to develop unhampered by regulatory restrictions. Competition between markets is a fundamental safeguard for ensuring markets to remain competitive, innovative and keeping pace with international developments.

Competitive forces have considerably contributed to innovation in market organisation and constructively challenged the traditional systems for order execution. Several features that were initially tested within more or less experimental ATS have been incorporated in the existing trading facilities that are currently on offer at the largest regulated markets (automatic order execution is one example). Therefore the existence of competing forms of order execution is an essential safeguard for the evolution towards more efficient and more flexible systems of order execution.

Competition between these different types of order execution have undoubtedly been beneficial to investors and hence lowered the cost of capital. Therefore these multiple developments towards a multiplicity of order execution types should not be curbed, and rather be enhanced by identifying the basic rules that are in play. The future ISD should avoid that new developments in order execution systems be hampered by conferring privileges to certain systems, or put these at a competitive disadvantages; on the other hand the same guarantees in terms of market transparency and integrity should be required from each of them.

Functionally there is no difference between an order execution system that is run by a stock exchange - or by a regulated market - and the alternative systems of order execution. Therefore the same set of fundamental rules and obligations should apply to both. It would be left to the forces of competition to allow each of the competing entities to develope its own rules and facilities and compete on the basis of these differences. So e.g. if some systems would prefer a quote-driven system, while another would be based on an order-driven system, or on an intermediate form - as is now being tested in the US - , regulation should avoid making any express or implicit choice between the different types of execution.

As in the past, the revised Investor Services Directive is likely to exercise a significant influence on these developments and ultimately on the organisation and structure of the future markets for European securities. The following developments will focus on the equity markets. Bonds markets and markets for derivatives may be subject to somewhat different rules.

3. The new ISD should be based on a number of essential policy lines:

- functional approach, whereby not the legal status of the parties engaged in a transaction is determinant, but the activity exercised, the same activity giving rise to the application of the same regulation; therefore the playing field among all market participants should be as level as possible and should not be affected by differences of a mere regulatory nature;
- the need to safeguard open, competitive markets, easily accessible to investors from all over the world;
- transparency remains the main instrument for the protection of investors; here especially pre- and post-trade information is addressed;

- in order to enhance integration of the markets, a more radical application of home country rule and supervision, the host state intervention being limited to the utmost.

The proposed revision of the ISD by and large reflects these policy guidelines and constitutes a welcome and useful answer to several of the dysfunctions that can be observed or feared in today's market structure.

The central issue discussed in the revised proposal relates to the relative position of regulated markets, Alternative Trading Systems and Internalisation of order execution. In addition, attention is drawn to the regulatory function in regulated markets. Finally some comments will be made on the new categories qualifying for the investment services regime.

Section 1. Regulatory classification.

4. The present market structure, mainly based on the presence of a shrinking - although still too numerous- number of predominant national stock exchanges, is increasingly being challenged by mainly two developments: different types of ATS are offering alternative execution facilities, while the much feared internalisation of order flows may lead to putting into doubt the role of a central market place. Fragmentation of order flows is reported to have a negative impact on the reliability of price formation, leading to price differences depending on the system in which orders have been executed, while ultimately preventing intermediaries to guarantee best execution to their clients.

-A- Centralisation v. segmentation

5. In fact two philosophies confront each other: on the one hand, those believing that centralisation of order flow will insure the deepest market, with the highest liquidity, and therefore offering best execution, as all buy orders are supposed to interact with all sell orders. In this scheme there would be competition between orders, but no competition between order execution schemes.

On the other hand, there are those allowing for competition between execution techniques, whereby the schemes that offer the most favourable conditions will attract the largest part of the overall order flow. Under unchanged conditions, fragmentation of trading will necessarily result, which according to the critics of this system cannot be alleviated by present arbitrage techniques.

6. Both views are characterised by a certain form of dogmatism. On the one hand, even in centralised systems, there have always been alternative trading mechanisms functioning alongside the main market, whether for block transaction, for OTC trading, or for other purposes.

Moreover, if trading takes place on several markets, especially at different trading hours, parallel trading and hence price distortion will be inevitable. Globalisation of transactions leads to more differentiation in price formation. It seems likely that these developments - globalisation of trading along with the increasingly prominent position of competing trading platforms - will become part of the overall structure of the market. Centralisation can only be achieved by artificial, regulatory means.

The question therefore is not whether one trading system is good, the other not, but how to integrate these different trading schemes to an overall system, likely to efficiently serve investors and issuers. Therefore, competition between orders should go along with competition between order execution systems.

On the other hand in decentralised trading schemes, no single trading system can persist for a long time if it underperforms other systems. If one trading platform would offer more favourable conditions, the question arises why investors are excluded from taking part in that trading platform. Normally there would be no valid business reasons why investors should be prevented from obtaining access to more favourable conditions, provided these investors finds themselves in the same conditions (e.g. as to volume, type of participants- wholesale v. retail- , currency etc.).

7. However, in both cases, the ultimate objective is the same, viz. how to ensure that investors obtain best execution for their orders. Best execution should include not only price elements, but also costs linked to execution, and services especially requested by clients, such as immediacy. Therefore it is essential to identify systems that can effectively insure best execution throughout the market place. At present, regulations in several national markets have deemed that best execution is achieved if the order has been executed on the main market. This presumption should be further refined.

8. The notion of "regulated market" deserves some further analysis. Under present market conditions, more and more regulated markets are being privatised. As a consequence regulation is imposed by private contract, being enforced by techniques and remedies of private law. Being private organisations, there are clear reasons to require that these market operators should be submitted to the same type of regulation as any other operator, while avoiding regulation to include a bias in favour of any type of market operator. The Treaty principles of competition should be plainly observed here.

As the market operators have changed from the status of an official body to that of a private service provider, the regulatory and supervisory function have to be readjusted: more supervisory powers should be allotted to the public supervisor, while the markets should limit

themselves to ensure the enforcement of their trading rules, that are part of the contracts with the market participants.

9. The subject matters for which "regulated markets" have enacted regulation have changed over time: originally company disclosure and conduct, including market manipulation[1] belonged to their field of activity. At present regulation concerns essentially access of market participants to the trading system, including financial reliability, and "fit and proper character", market behaviour (no manipulation), pre- and post trading disclosure and transparency rules, and finally, rules on listing of securities on the market. With respect to last-mentioned subject, reference is to be made to developments infra.

Most of these subjects are not proper to "regulated markets" but should be applied by any market operator. ATS also introduce and maintain - contractual - rules on access, on market behaviour, on price and trade reporting or on any subject necessary for structuring the order execution mechanism. There is no reason not to apply the principle of equal functional regulation by not requiring compliance with the same rules by both regulated markets and ATS that essentially engage in the same activity.

From the regulatory point of view, a future directive should establish the minimal criteria to be respected by all market operators (including so-called "regulated" markets and by ATS), in fact by anyone who organises largely accessible systems for execution of securities orders. These criteria should be sufficiently general to allow for effective competition between order execution systems.

10. Overall market efficiency is to a large extent a function of transparency, especially with respect to pre- and post- trade information. Therefore, it is essential that information flows generated by the different market operators - whether regulated markets or ATS - circulate among all interested participants. At present the situation in Europe is far from perfect: some market operators consider this type of information as proprietary, leading to suboptimal integration of markets.

It is useful to distinguish post-trade information from pre-trade information.

There should be a regulatory requirement for the authorisation of a market operator - under whatever regime - to make the post-trade information available to the market at a reasonable cost. Information vendors or other specialised firms will then be able to process this information and make it available to all market participants, all over Europe, and even world-wide. There is no need for the regulation to mandate the formation of a consolidated type-like instrument: this can more efficiently be left to the existing interconnection systems, managed by information vendors. However, there might be arguments for requiring information vendors to adhere to certain requirements contributing to better disclosure, e.g. to avoid anti-competitive conduct. (see infra)

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[1] Insider dealing, but also rules on transfer of controlling blocks and mandatory take-overs.

11. Ideally, pre-trading information should be made available to all market participants, and automatically classified so that the three or four best bid or ask quotes are displayed. The technological developments already allow for these selection programmes to be installed.

As a consequence, the best execution rule could be fully operative. Brokers would have no difficulty to prove to their clients that they have picked one of the orders that were best classified in the list, and hence that best execution has been achieved. Because it is doubtful that such a system could be mandated by the authorities, it could be considered a condition for recognition of market operators to adhere to an existing interlinkage system.

12. The mere availability of pre- or post trade information is not sufficient to allow effective interaction of bid and ask quotes, if in addition investors have no access to the different trading systems. A general obligation to allow all participants to obtain access to all systems is excessive, if not impracticable as some operators may be serving only a specific set of clients, such as institutionals.

This feature should better be left to the market itself. There is no reason why market operators would be refusing client orders, provided these correspond with the characteristics of their order execution system. Also, if some operators would refuse too many participants, indirect participation would allow other parties to execute. Furthermore, market transparency would reduce price differentials making participation in numerous systems for all market participation marginally less interesting.

Some market segments would remain excluded: this would be based on market criteria, not on regulatory or operational differences. There is no need e.g. to allow the general public to access the block transaction section of the market. But post trade information on block transactions should be made available to all investors, at conditions to be further specified..

- B - Internalisation

13. Internalisation of securities orders is a more controversial but also conceptually a more difficult subject. The issue should clearly be distinguished from the previous one, i.e. the integration of ATS in the overall market structure.

The starting point in the analysis should be: why would banks and investment firms internalise their order flows? The answer is simple: because they can earn more money by internalising. Margins flowing from transactions between the bid and ask quotes, lower execution costs, immediacy if trading from the bank's own portfolio. However, if the bank is not trading from its own portfolio, but has to cover its position, the margin will exclusively, if not mainly result from the differences between the bid and ask quote. Therefore, the markets will in that case

benefit from internalisation, as it will urge parties intervening in the market to pursue lower margins. Best execution will be met.

14. From the regulatory side, there are several concerns.

The first regulatory criterion should be: what is in the interest of the investors? If they get a better price, there should be no outright prohibition of internalisation. In case of internalisation, the evident fear of conflict of interest - it is the conflict between any buyer and any seller - will usually be alleviated by making reference to the prevailing market price. If no such price exists, investors should be clearly informed about the nature of the intervention.

15. However internalisation has also a systemic aspect: if most of the transactions would be internalised, there would be no reliable, no representative criterion against which the price for internalised transactions could be measured. The validity of the price mechanism would be put into jeopardy, and the role of the internalising banks could be identified to constitute free riding, as none of the burdens imposed on other market participants would apply to the internalising bank.

The resulting lack of liquidity and greater volatility due to a diminishing order flow may lead to the widening of the spreads in the principal markets. Ultimately, the price discovery function of the main market could be undermined.

Internalisation functioning along normal order execution systems also has undeniable advantages: especially for the investors, it will often offer better conditions than on the main market, especially as the "internalised" facility will offer a price in between the quotes offered on the market. Costs of execution may also be lower. The main reason for internalising order seems to be some form of inefficiency of markets: if the spread on the market, including the cost of executing the order is wider than the margin the bank can realise, there is a tendency to move the order away from the market. One may even argue that according to the principle of best execution, the bank or investment firm is bound to offer the best terms, whether resulting or not from an internalised trade. These arguments plead for maintaining a certain, limited form of internalisation.

16. The discussion paper makes a clear distinction between occasional internalisation and systematic internalisation. In the first case, one is mainly dealing with a conflict of interest issue, to be solved by making allowances for sufficient disclosure to the client of the reference price at which the security was traded on the market at that time. Other techniques aimed at avoiding the same conflict may be envisaged.

The dividing line between occasional en systematic internalisation is very difficult to establish. As there are good reasons - as explained supra - to maintain a certain form of

internalisation, one could imagine techniques that would limit internalisation to cases in which the competitiveness of the main market would be enhanced. So e.g. could orders be matched internally only if the execution price would remain between the bid and ask quotes. It could also be limited to a certain percentage of block orders that are being off-loaded in the market. More quantitative techniques seem more difficult to handle, such as limiting this activity to a percentage of total orders flow.

In order to safeguard the interests of investors, one could imagine that orders to be matched by the internaliser should first be checked with the market itself. At least the internaliser should be able to demonstrate that internalised execution took place at better, or at least equal prices as the ones available on the market.

17. Internalisation for securities that are not actively traded create a more difficult issue as is evidenced in the secondary eurobond market where spreads are wider than in the regular equity markets, while traders, acting for their own behalf, have a tendency to calculate considerable margins. However, in the overall absence of a sufficiently liquid market, restrictions on internalisation will not enhance the present pricing techniques.

18. By way of conclusion, there are good arguments for allowing a limited or specific form of internalisation, also as it puts a certain pressure on the price structure of the main market, and hence contributes to overall competition. However, outside the boundaries of these conditions, internalisation should be avoided, essentially for systemic reasons.

Section 3 Investment activities covered by ISD.

19. In general, and subject to the few observations formulated hereafter, the undersigned agrees with the proposals made in the revised consultation document.

As far as "arranging and facilitation" activities are concerned, there may be a need for reserving certain powers with respect to information processing and facilitation firms, in order to safeguard equal access, both from suppliers and from users of information, in terms of access conditions, financial conditions, and other elements that may result in less than fully competitive conditions.

Therefore supervisors should be entitled to subject to authorisation the conditions at which information vendors, and other arranging and facilitating firms interconnect with the existing market operators. At the European level harmonised minimum conditions should apply, ensuring also a free flow of information, not only across the European internal borders, but also outside the Union.

20. We also agree with the proposed regime for reception and transmission of orders and for investment advice, provided that adequate safeguards are provided that are proportionate to the risks involved. More particularly attention is to be paid, in both cases, to operational risks, due to the insufficient organisation of these firms and to their liability flowing for negligent acts This to clarify that these risks should be dealt with not necessarily on the basis of own fund requirements only (Basel II), but also by other regulatory requirements, such as insurance, deposit insurance etc.

21. With respect to "execution only" orders, and the regime for counterparties, we can refer to the CESR rules that are being prepared.

Special attention should be paid to the rules applicable to "locals": these are persons active on certain markets and acting exclusively for their own portfolio. These parties may contribute to the liquidity of the market and therefore exercise a useful function. The mere fact that these firms are not held to any fiduciary obligation does not prevent that certain safeguards have to be provided for in order to secure efficient market functioning. Provided that their solvency is being taken care of, e.g. by a central counterparty, adequate regulation is to be put into place insuring that some form of supervision is applicable, e.g. with respect to " fit and proper" character and the screening with respect to money laundering. These persons could be subject to a light regime of supervision. Moreover, by bringing them within the ambit of the ISD, these parties would benefit from the European passport.

22. As to mixed intermediaries, whose business is only partly related to securities business (whether or this relates to derivatives), the consultation document invites comments as to whether these firms should be submitted to the ISD obligation. There may be good arguments for imposing similar requirements as to any other securities firm. Apart form the difficulty to determine the dividing lines between main and ancillary business, the risks these firms may represent should be adequately taken care of. If the solvency risk has been covered by one of the devices mentioned for the "locals", there seems to be no need to impose additional requirements: the activities within CESR are dealing with these issues in an adequate manner. Here again a light regime of supervision would be indicated, involving also adequate supervision on the "fit and proper" character of the directors and shareholder, and application of the money laundering and similar rules. A home country supervisory system would be welcome.

23. Although the subject is to be dealt with on the basis of the Commission's consultation document on Clearing and Settlement, it is useful to mention that cross border offering of services for clearing and settlement deserves full recognition as an activity that qualifies for a European passport.

Section 4. High-level principles applicable to regulated markets

24. A preliminary question relates to whether the notion of "regulated markets" should be maintained in light of the developments above: in order to insure a level playing field, all market operators i.e. all parties that systematically organise the execution of transactions in securities should be subject to the same rules and regulations. These rules would apply to price and quote disclosure, free access to the market for all those meeting the conditions fixed in an objective way; interlinkage with other trading systems; surveillance of the rules for order execution (e.g. are price and time priority rules adequately implemented, are order routing systems efficiently functioning)? The market organiser would have no other supervisory tasks than those relating to his own rules; these would essentially be private law rules and be sanctioned according to the rules of private law. Serious violations could also involve violation of public law rules, e.g. on market manipulation. In this case both regulatory systems - public and private - would be applicable.

25. With respect to the position of the securities to be traded on the markets, the scheme to be developed should be based on the assumption that securities are vetted by the public authorities before being allowed for public trading. These authorities will ensure that the necessary disclosures are being made, not only upon admission, but on a continuous basis. Once the decision has been made that the security is eligible for public trading, and is satisfying the applicable criteria for such trading, the decision to effectively trade the security is up to the market operators.

Market operators - be it exchanges or ATS - should be free to trade in all securities that the authorities have considered fit for public trading. It is a decision, based on pure market reasons, to organise the trade in a certain security. Most market organisers would prefer to trade in the most liquid securities, capturing the main markets. Others, as niche players, will prefer to specialize in medium sized issuers, in bonds, in infrequently traded securities, or even merely put their trading and price discovery system at the disposal of certain securities.

26. The present paper therefore subscribes to the idea that the competent public authorities should have transparent "admission" requirements in place, especially rules on disclosure. It would further be up to these authorities - to be designated according to the usual criteria e.g. place of incorporation - to follow up whether the issuer continues to meet the requirement laid down for companies e.g. with widely dispersed ownership. The market operator would not have to intervene in these matters, except for insuring that the necessary information is effectively put at the disposal of his market client. This can easily be done by installing a hyperlink to the company's disclosure documents.

As has been rightly mentioned in the consultation document, market operators could establish different trading segments according to the types of securities in which they want to organise trading. The notion of "official" segment should be omitted, but quality standards

should be introduced, indicating the rules that are being met for a specific market segment. As a consequence, the notions of "regulated" or "organised" market" would disappear: it is up to the public authorities overseeing the different market operators to ensure that the labels used for identifying the different market segment confer the necessary, differentiating message.

This approach would increase and clarify the competition in the market for listings (the so-called "market for markets"); it would also do away with the differences between "listed" and "traded" securities, as all market operators would be allowed to trade any instruments that have been approved by the public authorities. Integration of the European securities markets would benefit.

27. An issue to be dealt with separately relates to the possibility to trade publicly securities that do no meet the standards established by the authorities, e.g. securities of strictly private companies, or securities that have lost their status of being fit for public trading. Here specific measures could be taken, to be further defined after a comparative analysis of existing practices within the member states. At present e.g. in Belgium, these securities are traded on an monthly basis, according to the rules of a public auction, whereby only buyers can intervene and bid for securities that have been posted a certain number of days in a advance. The directive should not deal with this subject, as it is of too marginal importance. However, it should not prevent Member States to allow such markets to function.