

CESR CALL FOR EVIDENCE
IMPLEMENTING MEASURES FOR THE DIRECTIVE
ON FINANCIAL INSTRUMENTS MARKETS
RESPONSE OF AFEI

1. In July 2001 the European Union started work on modernising the current Investment Services Directive, which dates from 1993. Although the new directive, now named the Directive on Financial Instruments Markets (FIM), has not yet been finally adopted, work on its implementing measures began officially on 20 January 2004. In accordance with the Lamfalussy process, the European Commission on that date published a set of provisional mandates given to the Committee of European Securities Regulators (CESR). These mandates are based on the text of the common position adopted by the Council on 8 December 2003 following the political agreement reached on 7 October 2003. They set forth the initial areas in which, subject to any modifications that might emerge from discussions currently under way at the European Parliament, CESR is asked to propose implementing measures.

2. The French Association of Investment Firms (*Association Française des Entreprises d'Investissement* - AFEI) has been following these efforts closely. AFEI comprises nearly 130 investment service providers, mainly investment firms but also credit institutions authorised to provide investment services. The majority of AFEI members operate in the fields of equities and derivatives. For AFEI members, the FIM directive is a key piece of legislation that will have a strong impact on the way they do business.

For this reason, following CESR's call for evidence on 20 January, AFEI wishes to submit a number of observations on both the practical aspects of the method (Part A) and the concepts at issue (Part B).

A. – PRACTICAL OBSERVATIONS

➤ The indicative timetable is welcome

3. AFEI first wishes to thank CESR for having provided an indicative timetable for its work on the FIM directive. This initiative, which is consistent with what we have advocated in the past, gives participants a clear and precise view of the different phases of the reflection process. In a context where everyone is trying to allocate the available resources as best they can, this timetable enables interested parties to organise themselves in order to contribute as constructively as possible to CESR's reflection.

➤ **The timetable should be reorganised to provide for an initial round of consultation on a document setting forth general orientations**

4. The indicative timetable established by CESR for work on implementing measures for the FIM directive is as follows.

- 20 January 2004: Publication of the first provisional mandates.
- 19 February 2004: Deadline for comments in the Call for Evidence.
- March 2004: Possible consultation on a Concept Paper.
- June 2004: Begin first Open Consultation (3 months).
- Early July 2004: Open hearing.
- September 2004: Deadline for comments in the Open Consultation.
- End October 2004: Possible second consultation.
- November 2004: Possible second open hearing.
- 31 January 2005: Submission of CESR's technical advice to the European Commission.

AFEI believes that this timetable is unsuitable, given the issues at stake in the FIM directive. To envisage discussion of a concept paper as a mere possibility, and then to call for a formal consultation phase ending in early September, strikes us as unreasonable.

5. What chance is there that, come September, CESR will actually take market participants' comments into account in the remaining four-and-a-half months?

AFEI fears that, even if those comments were to evince a need for a major shift of orientation, such a shift would no longer be possible in practice. It will be impossible not only for reasons of time, but also and more importantly because after nine months of work – which in fact began in November 2003 – CESR will have formed a judgment which, at that stage, will leave little room for a truly "open and transparent" discussion with market participants. And openness and transparency are key to the Lamfalussy process.

6. AFEI therefore believes that consultation on a concept paper is an extremely important phase of the work to be done. It is at this stage that orientations will emerge for the more detailed consultation document or documents that CESR will subsequently send out to market participants. These orientations need to be known by all, and any differences of opinion that arise between CESR and market participants need to be clearly identified.

Identifying any divergences in orientation at an early stage is particularly crucial for market participants, who will then need to adjust their proposals if they are to participate constructively in the work that CESR is doing. Furthermore, a consultation phase on a concept paper that is clear and concise will undoubtedly result in a substantial reduction in the time needed for the subsequent phases of discussions with market participants.

7. AFEI therefore expressly requests that CESR schedule a consultation phase on a concept paper in March or April. This phase could be fairly short – four to six weeks or so – since the discussion will concern broad general orientations only.

- **The timetable should make allowance for the fact that the summer months are not a good time for consultation among industry professionals**

8. We notice that CESR is not planning to provide a consultation document or documents to market participants until early June 2004. Thus, whereas CESR will have had effectively seven months to work up its proposals, industry professionals will have only three months in which to respond. Moreover, these three months fall during the summer – an unfortunate time of year for organising consultation among professionals. Under these circumstances, the likelihood that they will be able to make a constructive contribution to CESR's reflection is lessened substantially, a consequence that AFEI sincerely regrets.

In making this remark, we are well aware that the time constraint is not CESR's doing alone; rather, it stems largely from the desire of the European Commission to have implementing measures for the FIM directive by 31 January 2005. We have several times expressed our views to the Commission and the Inter-Institutional Monitoring Group¹ regarding the time constraints imposed on CESR, and we shall continue to do so forcefully.

9. We stress that this remark should be seen in the light of the observations offered previously about the need for a consultation phase based on a concept paper (point 4 *et seq*), for two reasons. First, because implementing such a phase must lead to rescheduling of the planned work programme – unless CESR expects not to draw any serious input from it, thereby making it a pointless exercise in any case. Second, because, as already noted, AFEI believes this first phase ought largely to facilitate the subsequent phases, reducing the need for lengthy consultation periods.

- **Encourage the staggered release of CESR working documents to market participants**

10. The European Commission has given CESR a whole series of provisional mandates, and CESR has arranged to deal with them in three distinct groups. It therefore seems relatively obvious that the reflection is likely to progress quickly on some points but prove slower and more difficult on others.

AFEI would clearly prefer CESR to send out each of the consultation documents as soon as it has been finalised, without waiting until all of them are ready to be sent to market participants in a single package. Staggered release will enable market participants to do a better job of organising and managing their time during the comment period. The effectiveness and, hence, the usefulness of the consultation procedure will be significantly enhanced.

11. We stress, however, that staggered release of documents ought not to entail any change in the general length of the consultation period. Although it is important for market participants to have documents – even partial ones – as early as possible, they also need to have a complete picture of the measures envisaged by CESR in order to appreciate the scope of the observations that they

¹ See in particular two AFEI memos available on its website (www.afei.com): "Lamfalussy Process – Interim Report of the Inter-Institutional Monitoring Group – Response of AFEI". (AFEI 03-33, 25 September 2002); "Lamfalussy Process – Second Report of the Inter-Institutional Monitoring Group – Response of AFEI" (AFEI 04-04, 6 February 2004).

make. Consequently, the sending of the last document should be the starting point for the consultation on the implementing measures envisaged by CESR for the first series of mandates.

➤ **Specify how the open hearings are to be organised**

12. In its indicative timetable, CESR provides for the holding of one or two open hearings. Because open hearings are such fundamental steps in the consultation process, AFEI believes it essential to specify precisely how they are to be organised.

First and foremost, it is important to specify dates and locations. Almost all participants will have to travel to another country, and the large number of subjects on the table will probably make it necessary to hold the meeting over several days or even to split it up around different topics.

Next, in terms of participation, it is probable that a great many people will wish to take part in these hearings, and this could pose real difficulties of physical organisation. From this standpoint, AFEI believes that any restrictions on participation that might be imposed must take two imperatives into account. Firstly, in conjunction with the concern expressed below (point 14 et seq.), a distinction must be made between participants speaking on their own behalf and those representing a collective body; and priority should naturally be given to the latter. Secondly, given the broad range of topics addressed, it is important that the open hearings be organised in such a way that the experts in charge of each question can participate in all the different major topics under discussion. This means that, if need be, substitutions of participants must be permitted.

13. Although CESR's timetable does not clearly provide for a second open hearing, AFEI believes a second hearing is indispensable, if only to provide feedback to industry professionals on the choices CESR has made.

➤ **Give due regard to the representativeness of professional organisations**

14. AFEI has already expressed its views on this issue several times. That we have so far received no clear assurances in this matter only heightens our concern. Is it even imaginable that CESR could give the same weight to all the responses to its consultations, without considering how representative the respondent might or might not be?

Obviously, we object strenuously to such a possibility. First, because it would deny the special role of representative professional organisations, which, when they provide comments to CESR, present a position that expresses the consensus view of their members. Second, because it would be totally unproductive from CESR's standpoint. In AFEI's case, for example, it would mean that we would have every interest in asking each of our 130 members to forward AFEI's comments to CESR under separate cover. CESR would then have 131 response documents to deal with rather than just one.

We therefore request once again that CESR take a clear position on this question.

B. – CONCEPTUAL OBSERVATIONS

- **Find the right balance between the need to regulate and the desire for the greatest possible harmonisation, on the one hand, and the danger of introducing inappropriate over-regulation on the other**

15. Much of the debate about the Lamfalussy process hinges on differentiating between measures that ought to belong to level 2 and those that should belong to level 3. That issue is all the more critical in the present case.

AFEI believes it useful to restate its position in this matter. Naturally, we are not in favour of over-regulation, which would hinder the development of investment service providers and make it harder for them to bring out new services or products in response to demand from issuers and investors. We nevertheless observe that an inadequately defined level 2 may prompt a national regulator to introduce particular provisions into its own legal framework in order to fill the identified gaps.

Barring a case-by-case analysis by the Court of Justice of the enforceability of such provisions on service providers using a European passport, a situation of this kind would induce a high degree of legal uncertainty. That uncertainty would tend to preserve the fragmentation that stands in the way of achieving a true single market.

To head off such a situation, AFEI considers it necessary that level 2 should have real content which, without leading to harmful over-regulation, sets precise limits on the ability of national regulators to add additional requirements at the domestic level.

- **Avoid over-regulation by allowing latitude in permitted responses to the implementing measures**

16. In drawing up implementing measures for the FIM directive, CESR may legitimately be tempted to establish a legal framework that is as precise and detailed as possible, to prevent a situation in which a market practitioner takes advantage of any loopholes. The risk is that the regulations will then be excessively burdensome, with all the attendant drawbacks (see point 15).

In this regard, AFEI believes that regulations should not be based on a presumption in principle that the practitioners subject to them will almost systematically seek to circumvent them. The great majority of market practitioners take pains to conduct their business in accordance with the rules.

17. For this reason, we would like CESR to take an approach in which regulatory constraints are imposed only to meet duly identified needs for regulation, not to bar the door to possible circumvention.

In AFEI's view, following such an approach is made all the easier by the fact that, with the mechanism of implementing measures, EU-wide regulation has a genuine capacity to react swiftly to any weaknesses in the existing legal framework.

➤ **Set regulatory requirements in a way that still makes room for new entrants of modest size**

18. The requirements that investment firms have to meet today are more numerous than before. So much so, it must be recognised, that new entrants are finding it increasingly difficult to get into the investment services business unless they are already of relatively significant size.

AFEI believes that, unless care is taken, this situation is likely to lead to a relatively swift decline of diversity in the supply of investment services. Loss of diversity on the supply side carries a significant risk in terms of keeping the market competitive and maintaining its capacity for innovation.

➤ **Spell out the notion of risk assessment procedures (point 3.1.2)**

19. We believe that the notion of risk assessment procedures needs to be clarified.

➤ **Allow investment firms to derive the full benefits of outsourcing (point 3.1.3)**

20. The outsourcing issue is an important one. Outsourcing can generate substantial economies of scale in different functions. To get results of this kind, however, the firm that subcontracts some of its functions must not be required to oversee every single detail of the conditions in which the subcontractor assumes its obligations. Obviously, a firm cannot totally wash its hands of the functions it outsources. But the rules governing the aspects it is still required to supervise must take account of why the functions were outsourced in the first place.

AFEI also believes that, in general, the degree of control expected from the outsourcer should certainly vary according to whether the subcontractor is an enterprise subject to the same regulatory requirements as its principal.

➤ **Conflicts of interest (point 3.2): adopting measures based on the IOSCO standards raises a major difficulty**

21. Regarding conflicts of interest, AFEI observes that the European Commission has asked CESR to take account of work done in other forums, such as IOSCO's on financial analysts or the Forum Group on Financial Analysts set up by the Commission.

On this point, we certainly cannot accept that CESR's reflections should be guided by work carried out by others, with no real involvement by industry professionals. This is clearly the case with the work of IOSCO, which published its standards without consulting the industry. Accepting any other solution is tantamount to emptying the content of the Lamfalussy process of its basic principle, which is that implementing measures are to be drawn up as part of a process that involves industry professionals.

This is also the case, although to a lesser degree, with the Forum Group, which has published a report and asked for comments from the industry but has yet to follow up on that consultation.

While it is to be expected that CESR will make use of the findings of IOSCO and the Forum Group, CESR must not consider that these forums have established sacrosanct, unassailable principles for European regulators. It is absolutely necessary that CESR consult industry professionals regarding any of the IOSCO standards or observations of the Forum Group report that it intends to take up in the implementing measures.

➤ **Define the conduct of business obligations (point 3.3) by drawing on the work done previously by CESR on this question**

22. Drafting conduct-of-business rules is a major undertaking for CESR. In general, AFEI believes that this work should be based on the document published by CESR in April 2002, "A European regime of investor protection – Harmonisation of conduct of business rules" (CESR/01-014d). This document has already been the subject of numerous discussions with industry professionals.

➤ **Reporting of transactions (point 3.6)**

23. AFEI stresses that transaction reporting requirements must be determined in such a way that, at least in the short to medium term, the obligation to standardise reportable data falls on the competent authorities rather than on investment firms.

It is simpler and less costly to have the authorities transform the data they receive from market participants and put it into a standard format for exchange, than to oblige all market participants to standardise the data they send to the authorities. Standardisation at the latter level could have a heavy impact on all participants' information systems.

24. That said, general standardisation of data is an objective to which AFEI fully subscribes, provided the timetable is realistic.

➤ **Do not prejudge the ongoing debate on the pre-trade transparency question (point 3.7.1)**

25. The European Commission has directed CESR to provide advice on the pre-trade transparency standards that ought to be imposed on multi-lateral trading facilities and regulated markets. We are surprised that this question is broached here. It absolutely cannot be separated from the ongoing discussions regarding the pre-trade transparency obligations of systematic internalisers.

In particular, the very fact that CESR is conducting a reflection on the notion of orders "that are large in scale compared with normal market size" is, in AFEI's view, liable to pre-empt the debate currently under way.

