

31 January 2011

To: European Securities and Markets Authority

By email only at: www.esma.europa.eu/index.php?page=to_respond&id=178

Re: Request for technical advice on possible delegated acts concerning the Prospectus Directive (2003/71/EC) as amended by the Directive 2010/73/EU ("Call for evidence")

In response to the publication for comment of the above, we are pleased to provide some comments in our capacity as a leading research facility focusing on optimal securities market design. We welcome the opportunity to present ESMA with a framework to carry out the assessment of the equivalence of third-country¹ financial markets (Article 4(1)) requested by the European Commission.

The activities of the Capital Markets Cooperative Research Centre ("CMCRC" or "the Centre") are founded on a combination of academic research and industry expertise that fosters innovative research and products designed to assist regulators in their mandates to protect the integrity and efficiency of financial markets. We understand that ESMA is being asked to provide advice to the European Commission, notably on the basis for making an assessment about "...the ability of a third-country regulatory framework to ensure a similar integrity of its financial markets". The CMCRC has developed a framework designed to assess the efficiency and integrity of financial markets and we wish to briefly explain this framework and offer our assistance to ESMA in providing the technical advice about the relevant assessments to the European Commission.

Equivalence of third-country financial markets (Article 4(1))

In its request for technical advice, the European Commission states that it seeks to define equivalence to the requirements resulting from the Market Abuse Directive, the Transparency Directive and the MiFID "by reference respectively to the ability of a third-country regulatory framework to ensure a similar integrity of its financial markets, to the ability of investors to make similar informed assessment of the financial situation of issuers with securities admitted to trading on those financial markets, and to the ability of that third-country regulatory framework to ensure that those markets are subject to similar authorization, supervision and enforcement on an ongoing basis." It further states that "the priority should lie in assuring that investors would benefit from similar protections in terms of market integrity and transparency", with an assessment focused on technical criteria as opposed to "considerations of a political nature" and on "differences between the regulatory regime established at the EU level and the third-country regulatory framework." Finally, we note that one of the elements of the equivalence assessment includes that "securities are capable of being traded in a fair, orderly and efficient manner".

¹ Third country is defined as any country that is not a member of the European Union, such as the USA, Canada, Australia. See <http://www.eurofound.europa.eu/areas/industrialrelations/dictionary/definition> and <http://europa.eu/abc/eurojargon/>.

We conclude that the framework for assessing the equivalence of a third-country's market must revolve around the twin notions of market integrity and market efficiency, and that the assessment must provide regulators with means to establish differences in integrity and efficiency between markets, and to compare them. This is exactly what the CMCRC framework can provide, and we explain it in the sections below.

The CMCRC Market Quality Framework

We begin by noting that virtually every major securities regulator in the world, including the umbrella International Organization of Securities Commissions (IOSCO), define their mandate in terms of fairness (or "integrity") and efficiency², together constituting "market quality". Surprisingly, however, market efficiency and market integrity are not defined, and this lack of definition results in a lack of measures for the efficiency and integrity of a market. Likewise, the regulator is left unable to measure the impact of its regulatory framework and policy-making on market quality. We believe that regulators need to define market fairness and market efficiency and seek operational measures of both. Market quality would then be defined as maximizing market fairness without detriment to market efficiency, and vice versa. In our opinion, these measures would fulfill the requirements of the European Commission for the criteria to be used in the assessment of a third-country's financial markets, as they are set out in the Call for evidence.

The CMCRC has spent the last 10 years building infrastructure (which includes an underlying theoretical framework, applications and data) designed to measure the impact on market quality of the choices made by regulators about the market design they implement or propose. The framework is described in the exhibits 1 and 2 below. Exhibit 1 characterizes the overall Market Quality framework. Under this framework, market design changes consisting of changes in five broad areas, namely, technology, regulation, information, participants and instruments are required to pass tests of market quality. Market Quality in turn is divided into the two core concepts of market efficiency and market integrity, and to pass the tests one must provide empirical evidence that the changes (actual or proposed) will enhance both market efficiency and market integrity, or enhance one without detrimentally affecting the other. Exhibit 2 further develops the framework by defining the two key concepts and identifying empirical proxies to assist in measurement. Through this framework, we contend that a regulator is able to measure a market's efficiency and its integrity and to report changes in the measures pre and post important market design changes. These measurements can also be used to compare how well one market fares against other markets at a point and/or over time with the implication being that markets that have higher quality have more optimal designs.

² Objectives and Principles of Securities Regulation, IOSCO, June 2010. One of IOSCO's three objectives is "ensuring that markets are fair, efficient and transparent;"

Exhibit 1

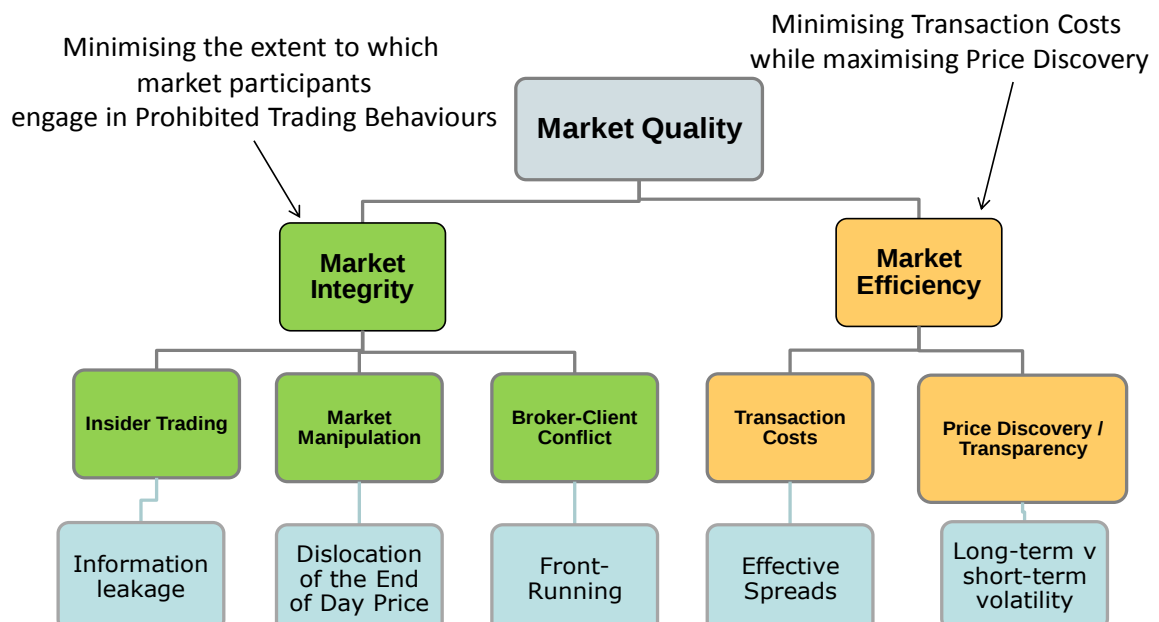
Market Quality Framework



In the Context of accepted Regulatory Mandates a market design change must enhance (and certainly not detract from) either Efficiency or Integrity

Exhibit 2

COMPONENTS OF MARKET QUALITY





Notwithstanding the difficulties associated with measurement, we contend that the proxies for fairness and efficiency make it possible to compare and contrast markets at a point in time, and therefore fulfill the requirements of the equivalence assessment required by the European Commission. They could also assist regulators in Europe to assess the impact of the changes they make to their own markets' design on the quality of their markets through time. Markets which have higher efficiency and fairness measures are markets which by definition have more optimal market designs and better quality, and vice versa.

We trust you will find our framework useful and look forward to further assisting ESMA in providing its advice to the European Commission.

Thanking you for the opportunity to comment, we remain,

Yours faithfully.

CAPITAL MARKETS CRC LIMITED

A handwritten signature in black ink, appearing to read 'MJ Aitken', with a long horizontal stroke extending to the right.

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