



Date: 17 June 2004
Ref.: CESR/04-300

PRESS RELEASE

CESR BEGINS ITS FIRST CONSULTATION ON ITS DRAFT ADVICE TO THE EUROPEAN COMMISSION ON THE NEW INVESTMENT SERVICES DIRECTIVE

CESR publishes its first consultation paper on its draft advice to the European Commission regarding the possible technical measures to implement the proposed Markets in Financial Instruments Directive (MIFID) which revises the existing Investment Services Directive (ISD). CESR requests comments and reactions to its proposal and to the specific questions raised in the document by 17 September from both market participants and, in particular, from retail investors. A public hearing will also be held in Paris at CESR's premises on 8 and 9 July.

CESR's draft advice published today is structured into three sections relating to the regulation of intermediaries, markets and co-operation and enforcement issues.

- **CESR's advice on Intermediaries** covers the provisional mandates regarding organisational requirements for intermediaries, including internal compliance and control, internal procedures and systems for the provision of services, outsourcing of services, record keeping, safeguarding of clients' assets and funds; identification and management of conflicts of interest; conduct of business obligations, including fair, clear and not misleading information, information to clients, clients' agreement, best execution obligations and order handling rules.

In particular, CESR advice includes:

- **A common approach to compliance and systems of internal control (Article 13):** CESR proposes, for example, that investment firms be required to establish permanent and effective compliance policies, procedures and functions. In particular, the compliance function has to monitor, on an ongoing basis, the adequacy and effectiveness of the internal policies and procedures and report results at least to senior management. In addition, investment firms will have to set up, where appropriate, internal audit control systems and independent and internal audit risk control functions. This approach should enhance and strengthen the effectiveness of initial measures to check compliance with applicable rules and should therefore help regulators to detect any misbehaviour and by so doing protect investors;
- **An initial proposal to achieve a common approach on best execution (Article 21):** The Directive establishes a key rule to ensure that best execution is achieved despite the fragmentation of trading venues, which is a new scenario. At this stage, CESR's draft advice indicates its first orientations on this subject in the format of a concept paper which includes a summary of factors that investment firms have to take into account when achieving the best possible results for their clients. It also puts forward a proposal on how the 'order execution' policy should be designed and reviewed by investment firms. These measures are intended to increase investor protection and market efficiency.
- **Key proposals on conflicts of interest, including inducements and specific proposals on investment research (Articles 13 and 18):** CESR draft advice is intended to enhance the regulatory response to the emergence of conflicts between investment firms and or between the clients of investment firms. The proposed advice highlights criteria for the identification of conflicts; it also requires investment firms to pay special attention to proprietary trading, portfolio management and corporate finance business. The key proposal is that investment firms have to establish, maintain and enforce a written policy for identifying, preventing and managing conflicts.

- **CESR's advice on Markets** covers the mandates on pre and post trade transparency information with the exception of the so called quote disclosure for systematic internalisers (which is expected to be included in the next set of Commission mandates anticipated shortly). Additionally, it covers the requirements that different instruments have to fulfil in order to be traded on regulated markets. For example, CESR's advice in relation to three key (markets) issues is as follows:
 - ***The method and timing of disclosing the pre and post-trade information:***
In order to protect investor confidence, markets must function transparently and to achieve this, it is important that market users can access consolidated information from all the different trading venues so that prices can be compared. The Directive requires certain minimum information requirements to be met. CESR's draft advice proposes that the information should include the following (minimum) elements: Type of quote/order i.e. bids or offer; Security identifier (the code of the financial instrument); the number of shares the market participant is ready to buy (or sell), and the price at which the market participant is willing to buy (or sell). In addition, it proposes that information must be readily available and provided in a format that will enable a third party, such as a data disseminator to consolidate this information. Furthermore, this information should be released in real time during trading hours.
 - ***Exemptions from transparency:***
In some cases, there are justified reasons to make exemptions from the pre-trade transparency or allow delays in post-trade transparency. CESR'S draft advice proposes that these exemptions should apply not only to block trades waivers but also to certain market models such as "crossing systems" and certain types of orders such as iceberg orders. Consultees are invited to analyse whether there are other cases where exemptions should be allowed.

The transparency requirements described in the two bullet points above fall within Articles 28, 29, 30, 44 and 45.

- ***Requirements for admission to trading (Art 40):***
CESR's draft proposals highlight the responsibility of regulated markets in making sure that fair and orderly trading is possible. CESR's draft advice indicates what regulated markets should consider when accepting a financial instrument to trading. In particular, it identifies the following elements that should be taken into account: the free float (in case of equity), the expected trading activity of the instrument and the appropriateness of the planned trading mechanism for the instrument together with some additional requirements for derivatives. The proposals are formulated in an open way and do not contain exact thresholds.
- **CESR's advice on co-operation and enforcement** covers the provisional mandates regarding: transaction reporting, co-operation between competent authorities and exchange of information. It mainly addresses the following:
 - **Transaction reporting (Art. 25 par. 4 and 5):** CESR's advice aims at proposing a common minimum content for transactions reports that competent authorities would request from investment firms and that they would be able to exchange on the basis of a common format. In this exercise, CESR has, to the fullest extent possible, taken into account the characteristics of existing reporting systems. In addition, the Directive establishes the channels to report financial transactions to the competent authority by investment firms, either directly or via regulated markets, multilateral trading facilities and trade-matching or reporting systems. CESR's draft advice sets out some minimum standards that these reporting channels must meet. From a prudential standpoint this will improve the quality of information reported, the timeliness of these reports, and the security and efficiency of the reporting process generally. In addition, the harmonisation of these requirements will make it easier for the transaction reports to be exchanged between competent authorities.
 - **Criteria for determining the most relevant market in terms of liquidity (Article 25 par. 3):** To ensure market integrity is maintained and competent authorities can identify any potential cases of market abuse, the competent authority of the most liquid market for each particular financial instrument is entrusted with the responsibility of developing a complete overview of the activity



regarding a financial instrument across Europe. In order to be in a position to prepare this, the Directive states that this authority should receive transaction reports for this instrument from fellow competent authorities. CESR's advice seeks to identify how supervisors will establish which competent authority is the most appropriate to take on this role. CESR proposes a "proxy approach", which means for example, that in case of shares, the competent authority of the most liquid market would be established by identifying where the share was first admitted to trading. In cases where the proxy approach does not provide a reliable result in the view of a supervisor, CESR proposes a revision procedure where more detailed statistics on liquidity are gathered from the various potential competent authorities; on the basis of this the potential supervisors would reach agreement on who should take on this role. Whilst these arrangements will not alter to whom firms or markets report, efficiency in how this is carried out could potentially have indirect cost implications for firms and markets.

- **Co-operation and exchange of information (Art. 58):** CESR proposes a general framework for co-operation between competent authorities. CESR's draft advice sets out, in particular, how requests from fellow regulators should be handled for different categories of confidential information and to whom requests for information should be made. The framework aims at striking a balance between greater clarity and legal certainty in this area, but also tries to be adaptable enough to cater for the many potential scenarios that may arise. Although co-operation among regulators is not of primary interest to market participants, effective arrangements for exchange of information are of importance for maintaining integrity of increasingly integrated markets and can reduce costs of competent authorities by increasing the efficiency of exchange of information.

Background

The EU Commission's provisional mandates, published by CESR on 22 January (Ref. CESR/04-021), requested CESR to submit its advice on the appropriate measures to implement the Directive by 31 January 2005. The implementing measures upon which CESR is giving technical advice will complement the high level political objectives (known as level 1 measures of the Lamfalussy Directive) which were adopted by the European Council on 21 April 2004, following a second reading in the European Parliament in March 2004. Additionally, CESR published with the Commission mandates in January 2004, the key milestones in CESR's work programme for this Directive (Ref. CESR/04-021) which includes an indicative consultative timetable. A second set of mandates from the European Commission is likely to follow shortly.

CESR's draft advice published today follows a call for evidence on 20 January (Ref. CESR/04-021) and approximately 40 responses were received. In addition, CESR published a concept paper on co-operation and enforcement on 1 March (Ref. CESR/04-073b) on which approximately 25 responses were received. The responses received can be found on CESR's website under the section consultations and past consultations.

The European Commission published on 22 January 2004, the first set of provisional mandates and requested CESR's technical advice to develop what is known under the Lamfalussy legislative process as the Level 2 technical implementing measures.

The decision to revise the ISD, originally adopted in 1993, reflects common agreement that structural changes in EU financial markets requires legislation to be adapted in order to advance integration of the single market in financial services. MIFID will form one of the the cornerstones of the EU's securities regulatory regime, and is intended to deliver an effective 'single passport' allowing investment firms and regulated markets to operate across Europe.

The new Directive will, for example, broaden the range of investment services for which authorisation is required under the existing ISD Directive; clarify and expand the list of financial instruments that may be traded on regulated markets and between investment firms; it will also introduce rules on the provision of investment advice and conflicts of interest. Standards for regulated markets and multilateral trading facilities will be included, as well as new rules on handling client orders.



Responses to the Consultation can be submitted online by 17 September 2004 through CESR's website (www.cesr-eu.org) under the section 'Consultations'. Similarly to register for the hearing please visit the section 'Hearings'.



Notes for Editors:

1. CESR is an independent Committee of European Securities Regulators. The role of the Committee is to:
 - Improve co-ordination among securities regulators;
 - Act as an advisory group to assist the EU Commission, in particular in its preparation of draft implementing measures in the field of securities;
 - Work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States;
 - The Committee was established under the terms of the European Commission's decision of 6 June 2001 (2001/1501/EC). It is one of the two committees envisaged in the Final Report of the group of Wise Men on the regulation of European securities markets, chaired by Baron Alexandre Lamfalussy. The report itself was endorsed by the European Council and the European Parliament. The relevant documents are available on CESR's website.

Each Member State of the European Union has one member on the Committee. The members are nominated by the Member States and are the Heads of the national public authorities competent in the field of securities. The European Commission has nominated the Director General of the DG Market, as its representative. Furthermore, the securities authorities of Norway and Iceland are also represented at a senior level.

2. The development of CESR's advice takes place within three Expert Groups:
 - **Expert Group on intermediaries' issues:** The expert group is chaired by Mr Callum McCarthy (Chairman of the UK's Financial Regulator, The Financial Services Authority [FSA]). This expert group covers the provisional mandates related to: organisational requirements; conflicts of interest; conduct of business obligations when providing investment services to clients; best execution; client order handling rules, with particular regard to prompt, fair and expeditious execution of client orders.
 - **Expert Group on markets:** This expert group is chaired by Mr Jacob Kaptein (Commissioner at the Dutch securities regulator, the Netherlands Authority for Financial Markets [Autoriteit Financiële Markten]). This expert group covers the provisional mandates relating to: the admission of financial instruments to trading; pre-trade transparency requirements for multilateral trading facilities (MTFs) and regulated markets; post-trade transparency requirements for MTFs and regulated markets; post-trade disclosure by investment firms.
 - **Expert Group on co-operation and enforcement:** This expert group is chaired by Mr Michel Prada (President of the French Securities Regulator, the Autorité des Marchés Financiers [AMF]). This covers the provisional mandates related to: transaction reporting, co-operation between competent authorities and exchange of information.

A steering group has also been established to consider horizontal issues and to ensure overall consistency in the advice prepared by each expert group. This will be composed of the three chairs of the experts groups and chaired by CESR's Chairman, Arthur Docters van Leeuwen.

3. **The ISD Consultative Working Group:** A consultative group of 23 market participants has also been appointed to provide technical advice to the expert groups. The market participants are experts drawn from across the European Markets. They are not intended to represent national or a specific firms' interest and do not replace the important process of full consultation with all market participants. A full list of the participants can be found under the page of the MIFID Directive under Consultative Working Group.
4. **Progress to date of the proposal to revise the Investment Services Directive is as follows:** The Council adopted a common position on 8 December 2003. The European Parliament's first reading was concluded on 25 September 2003. The Parliament completed its second



reading of the text in March 2004. The Directive was adopted on 21 April 2004 and published in the official journal on 30 April 2004.

5. The European Commission's proposals in the MIFID Directive can be summarised broadly as seeking to:
 - clarify and expand the list of financial instruments that may be traded on regulated markets and between investment firms;
 - broaden the range of investment services for which authorisation is required under the Directive, notably to include the provision of investment advice, clarification of ancillary services investment firms can provide.
 - reinforce the requirement that investment firms execute orders in a way that provides best result for the client (often referred to as 'best execution obligations');
 - set in place new rules for handling clients' orders;
 - set requirements for managing conflicts of interest
 - clarify standards for regulated markets and MTFs;
 - enhance the principles for co-operation between competent authorities.
6. The provisional mandates submitted to CESR assist the Commission to prepare its 'Implementing Measures' which form part of the four level approach to European legislation for financial services. The four level approach was proposed in the report by the working group chaired by Baron Lamfalussy (available on the CESR website as described in para. 5). The approach can be summarised very briefly as follows: Level one measures set out the high level objectives that the legislation must achieve. Level two measures set out some of the technical requirements necessary to achieve these objectives. Level three measures are intended to ensure common and uniform implementation by the use (amongst others) of common interpretative guidance and standards agreed amongst regulators in CESR. Level four measures relate to the enforcement of the legislation.

Page 8 of the Lamfalussy report illustrates diagrammatically how these four levels of legislation fit together and the procedure to adopt these measures. The Level 2 'implementing measures' including the conditions for their adoption are described in more detail on page 31 of the report.

7. For further information please contact:

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