The Market Participants Consultative Panel held its third meeting on 12th June 2003 in Paris.

The discussion during the meeting was facilitated by the Chairman of CESR. In his remarks, he thanked the panel for their contribution to the overall process of consultation conducted by CESR. Jacob Kaptein, attended the meeting in his capacity of Chairman of the CESR ISD Expert Group on Markets.

The discussion was mainly focussed on three different subjects: internalisation and pre-trade transparency; quarterly reporting of issuers whose instruments are admitted to trading on regulated markets; future activity of CESR on UCITS.

1. Internalisation and pre-trade transparency.

Following a presentation from Rolf Breuer the members of the Panel discussed one of the most debated issues under the revision of the Investment Services Directive (93/22/EEC): pre-trade transparency and internalisation. The presentation is enclosed. This discussion serves the work that CESR is likely to start on the second half of 2003 in responding to mandates from the EU Commission on implementing measures of the ISD.

The Chairman of CESR reported that the Committee established three different Expert Groups to accomplish the future level 2 work on the revision of the ISD; these Groups will work respectively on: markets, intermediaries and cooperation and enforcement.

The Panel shared the overall objectives of the revision of the ISD, in particular enhancing the level of competition among execution venues, as well as the benefits and advantages of internalisation as alternative means of executing client orders.

Concerning the appropriate regulation of internalisation of client orders (to be understood as orders executed in-house, off-exchange\(^1\) and against the investment firm’s proprietary book), the Panel considered it essential to introduce post-trade transparency requirements, as well as enhancing the role of freedom to contract both from the investment firm’s side (capacity to refuse entering into a transaction because of risk assessment of the counterparty) and the client’s side (choice of execution venue).

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\(^1\) It was pointed out that sometimes it is difficult to ascertain whether a transaction has been executed off-exchange.
Several members of the panel noted that pre-trade transparency in case of internalisation, as requested by Article 25 of the Commission proposal for the revision of the ISD, is inappropriate, since it does not take into consideration the underlying business model, where investment firms put their own capital at risk. On the contrary, some members of the panel considered that pre-trade transparency is essential to enhance the level of competition among different marketplaces; one member stressed the need for a price discovery mechanism at EU level, lacking which the investment firm may be unable to establish that best execution has been attained for the client. Conditions for allowing internalisation were also discussed and, in particular the requirement that transactions should be executed at a price comprised in the spread of available conditions in the reference or benchmark market.

Best-execution rule was considered by the Panel to be essential, even if the text of the Commission proposal needs some adjustments; in particular, due consideration should be given to the different needs of professional and retail clients, as well as the definition of this rule in terms of process instead of mere reference to price.

**2. Quarterly reporting.**

Following a presentation from Salvatore Bragantini, the Panel discussed one of the most debated issues under the revision of the requirements applicable to issuers of financial instruments traded on a regulated market. This is an area in which CESR might respond in the next future to mandates from the EU Commission.

Most members of the panel favoured the introduction of mandatory quarterly reporting in Europe. The discussion mainly focussed on the following points: advantages and disadvantages of such a requirement, content of reports, audit requirements and timing of adoption.

Concerning the content of quarterly reporting, the panel considered it necessary to include, in addition to the requirements set forth in the Commission proposal, net financial positions (liquidity position for banks should be treated according to specific needs) and earnings per share.

Concerning the application of the duty to report, the panel considered it that no distinction should be made on the basis of the size of the issuer and that no exemption should be granted to SMEs. Most members of the Panel favoured the requirement for a form of review by the auditors of quarterly reports, in order to keep European legislation in line with the US; some members felt that an intervention of the auditors would be appropriate, on a voluntary basis at this juncture, to increase the confidence of the markets; one member suggested that IAS 34 should be the rule for quarterly reporting.

Concerning the timing for adoption of quarterly reports, the panel considered it that reports should be approved within 45 days after the expiry of the relevant period.

**3. The role of CESR in the UCITS sector.**

Following presentations from Donald Brydon and Mariano Rabadan (which are both endorsed by FEFSI and EAMA), members of the Panel had an open debate on the possible work by CESR in the areas of UCITS. The Mutual Fund Policy adopted by Eurshareholders in 2002 was presented during the meeting. The two presentations are enclosed.

The Panel welcomed the decision to bring UCITS sector under CESR and supported its status of observer in the UCITS Contact Committee. This process should be speeded up to keep EU industry in line with US competitors. Members of the Panel advocated for due consideration to be given to
peculiarities of the overall “buy side”. In this respect an appropriate mechanism, internal to CESR, to address “buy-side” issues will be welcome.

The Panel suggested that the following issues should be dealt with by CESR as a matter of priority: simplified prospectus, cross-border depositing business, home country registration; implementation of UCITS directive; cross-border fund mergers.

4. Other issues

4.1. Report on recent events and on future CESR activities.

In the second part of the meeting, the discussion focussed on the organisation of CESR work and its priorities for 2003. The draft half-yearly report did not raise any objections from the members of the Panel.

4.2. The first Report of the Inter-Institutional Monitoring Group

The panel discussed the main findings of the initial report of the Inter-Institutional Monitoring Group. The report did not raise any objections from the members of the Panel.

4.3. The CESR-SEC dialogue.

Following requests of clarification, the Chairman reported on the EU–US dialogue on regulatory issues held at technical level. The Panel felt necessary for CESR the pursuit of this dialogue to enhance the regulatory convergence with the US.

Next meeting

It was agreed to hold the next meetings of the Panel in Paris, on Thursday 11th November 2003 and 11th March 2004.

A series of issues have been raised for discussion during the next meeting and in particular, corporate governance, clearing and settlement, the transatlantic dialogue, UCITS and the “buy side”, a possible mediation mechanism within CESR and the level 2/ level 3 functions, execution-only, the consultation process.

* * *
The members of the CESR Market Participant Consultative Panel are:

- Pr Luis Miguel Beleza, Consultant of the Executive Board, Banco Comercial Português;
- Dott Salvatore Bragantini, CEO, Centrobanca S.p.A.;
- Dr Rolf E Breuer, Chairman of the Supervisory Board, Deutsche Bank AG;
- Mr Donald Brydon, Chair of the Financial Services Practitioner Panel and Chairman of AXA Investment Managers;
- Mr Ignace Combes, Vice-President, Management Committee of the Board of Directors, Euroclear Bank;
- Mr P.P.F. de Vries, Director, Association of Shareholders, Vice-President, Euroshareholders;
- Mr Lars-Erik Forsgardh, Chairman of World Federation of Investors and CEO, Swedish Shareholders Association;
- Mr Dominique Hoenn, Deputy General Manager of BNP Paribas, Vice-Chair of the Supervisory Board of Euronext;
- Ms Sonja Lohse, Group Compliance Officer, Nordea AB;
- Mr Mariano Rabadan, Chairman of the Spanish Association of Investment and Pension Funds (INVERCO);
- Pr Dr Emmanuel D. Xanthakis, Non-Executive President, Marfin Bank and Marfin Portolio Investment Company.
The New ISD - Internalisation and Pre-Trade Transparency

CESR - Paris, June 12, 2003

The Commission proposal for ISD 2
Goals: - investor protection and market integrity
       - fair, transparent, efficient and integrated financial markets

Background:
• crisis on financial markets and loss of investor confidence
• changes in stock exchange landscape
• shortcomings of ISD 1

ISD 2 focus:
• enhanced investor protection rules
• enhanced concept of regulated markets vs. investment firms
• introduction of pre-trade transparency rules

Thesis: Proposed ISD 2 concept is well-balanced, but
        pre-trade transparency regime needs improvement.
What is internalisation?

- not defined in the Directive
- characteristics:
  - inhouse execution of client orders
  - outside regulated markets
  - against the investment firm’s proprietary book
- advantageous for the client:
  - ISD 2 (expl. memorandum): “Investor protection rules need to be reviewed to compel firms acting on behalf of end-investors to make active use of new trading opportunities to get the best deal on the client’s behalf”

*Thesis:* Internalisation offers an alternative execution venue to meet specific demands of the different types of investors.

Transparency

Transparency
- pre: assessment of terms of a transaction at any time
- post: subsequent verification of conditions of trade

Problem
- ‘the’ best price does not exist
- price formation is an ongoing process

Requirement of ISD 2:

**Article 25:**
Member States shall require that any investment firm authorised to deal on own account to make public a *firm bid and offer price* for transactions of a size customarily undertaken by a retail investor in respect of shares in which it is dealing, and where those shares are admitted to trading in a regulated market and for which there is a liquid market.
Member States shall require that the investment firms referred to in the first subparagraph trade *with other investment firms and eligible counterparties* at the advertised prices, except where justified by legitimate commercial considerations related to the final settlement of the transaction.
Pre-trade transparency (Art. 25)

Concerns regarding Art. 25:
- Transparency requirement does not reflect trading structures
- Obligation to accept contracts
- Price change risk for investment firm
- Unequal publication methods
- Discrepancy between use and costs
- Disadvantage for active market participants
- Investor protection already achieved through other measures

Thesis: The proposed pre-trade transparency regime harms both
- investment firms, offering internalisation and
- clients, seeking off-exchange execution.

Market efficiency

'As far as overall market efficiency is concerned, regulatory measures that directly restrict competition between trade execution arrangements do not seem to deliver improvements in price-formation which would justify an intrusive intervention in market structure to favour exchange execution. Recent analysis of prices of transactions in almost all equities traded on leading European exchanges does not provide any support for the proposition that concentrating transactions on exchanges improves market efficiency.' (source: London Economics, 2002)

Thesis: Market efficiency cannot be improved by forcing a concentration of liquidity, since disregarding client needs would decrease trading activity.
Conclusion

ISD 2 - goals

Integrated European financial market based on
• innovation
• competition
• adequate regulation
• client’s choice
CESR – Market Participants Panel

Mariano Rabada

European discussion on transfer of competency on UCITS to CESR

CESR
Paris, 12 June 2003

The Product UCITS

- All product related issues in Dir. 2001/108/EC which sets out investment regime, except for...
- Simplified prospectus (in Dir. 2001/107/EC)

- Member States must
  - implement before 13 Aug. 2003
  - apply before 13 Feb. 2004

- UCITS Contact Committee interpretative body
The « classical » UCITS issues

- Wider investment opportunities
  - Money market instruments
  - Deposits with credit institutions
  - Wider use of financial derivative instruments
  - Investment in units of investment funds
  - Replication of indexes

- Strengthened investor protection
  - Risk management process
  - More complex risk spreading rules
  - Extended disclosure duties
  - Simplified prospectus

Consistent implementation is crucial
- Simplified prospectus
- The use of derivatives
- In the context of investment in non-UCITS funds: « Equivalent level of investor protection »
- In the context of index funds: « Sufficiently diversified » - « adequate benchmark » - « published in an appropriate manner »
The Regulatory Environment

Three different cases:

- « Classical » UCITS issues
- New UCITS issues
- Other issues from outside UCITS

The Regulatory Environment

- « Classical » UCITS issues
  - Traditionally remit of Contact Committee
  - 2 main functions:
    - Advisory (Art. 53)
    - Regulatory (Art. 53a), limited to:
      - Clarification of definitions
      - Alignment of terminology
      - Under pre-Lamfalussy comitology procedure
        (Council Decision 1999/468)
The Regulatory Environment

Necessities for change:

- Extension of Lamfalussy approach requires a legal measure (directive)
- Currently EP reluctant to agree on extension
- Waiting for IGC 2004 (modification of Article 202)
- For the time being the UCITS Contact Committee is the regulatory committee

The Regulatory environment

New UCITS issues:

- Non-core activities (<i>indiv. portfolio & pension fund management, advice, administration, safekeeping, ...</i>)

- Regulated under ISD & falls within CESR competence ⇒ no need for legislative change

- Creation of dedicated working sphere for investment management
The Regulatory Environment

- Benefits of dedicated working sphere:
  - Take account of investment management specificities
  - Clear separation of the « buy-side » issues from the « sell-side » emphasis
  - Independence preserves investment management’s fiduciary duty
  - Avoid rule-setting delays for investment management by keeping the issues distinct from sell-side
  - Preserving specific & upgraded role of Contact Committee functions

The Regulatory Environment

Other issues from outside UCITS:

1. Buy-side concerns in other market regulation
   - If EC Directives with CESR competence ⇒ no need for legislative change
   - Here too: Creation of dedicated working sphere for investment management

2. Industry concerns in other regulation (e.g. consumer protection, taxation, ...)
   - Increased CESR awareness & closer coordination helpful

CESR – Advisory Committee 12 June 2003
Conclusions

• Fulfill existing expectations on Single Market:
  – Common interpretation of Directive & harmonised supervisory practices
  – Coherent fiscal policy & abolition of tax discrimination
  – Abolition of administrative constraints with respect to cross-border distribution
  – A passport for fund managers allowing real cross-border management of UCITS

• Create mechanism to accommodate investment management issues in CESR

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THE ASSET MANAGEMENT INDUSTRY AND EUROPE

Donald H. Brydon
Chairman
AXA Investment Managers

ASSET MANAGEMENT IN EUROPE

- The European Asset Management Industry is responsible for over €10 trillion of consumer savings.
- Between 1995 and 2000 investment fund assets grew by over €2 trillion and pension fund assets by over €1 trillion.
- Asset managers play a crucial intermediary role between consumers and suppliers of capital.
- Asset Management is an industry in its own right, NOT just part of insurance, banking or securities.

The Asset Management Industry welcomes the decision to bring UCITS III under CESR.
STRUCTURAL SUGGESTIONS FOR CESR

- Set up mechanism to include buy-side views on buy-side, as well as sell-side issues.
- Separate UCITS III from wider asset management issues.
- Establish Asset Management Committee to liaise with/ partially replace (?) UCITS Contact Committee, but also take on broader remit.
- Set up industry expert groups to advise Asset Management Committee.
- Ensure CESR has the power to adapt UCITS regulation quickly to market changes, if necessary.

GENERAL: BARRIERS TO PAN EUROPEAN ASSET MANAGEMENT

- PROTECTIVE TAXATION - All Member States practice some form of fiscal discrimination against foreign funds

- DISTRIBUTION & INFRASTRUCTURE - Distribution channels must be open and unbiased; market infrastructures must be efficient

- LEGAL & REGULATORY RESTRICTIONS - Member States often interpret and implement EU legislation in a protectionist manner
ASSET MANAGEMENT AND ECONOMIES OF SCALE: U.S. vs. EUROPE

European managers are unable to enjoy economies of scale because small local markets restrict the size of funds.

- The US fund market is twice as big as the European ($7.5 trillion vs. $3.4 trillion)...
- ...but the European market has three times as many funds as the US (25,559 vs. 8,172)...
- ...therefore, the average US fund is six times larger than that in Europe ($887 million vs. $136 million).
- In most countries, over 90% of investment funds are still supplied domestically.

REGULATORY BARRIERS: UCITS III - MANAGEMENT COMPANIES

UCITS firms will be able pursue non-core activities, such as discretionary portfolio management and investment advice. The problems:

- Conflict with Investment Services Directive (ISD)
- Vague definitions and open questions
- Contact Committee focus on Product Directive
UCITS III - MANAGEMENT COMPANIES: OVERLAPS WITH ISD

Most overlaps are rooted in a lack of distinction between buy-side (management companies) and sell-side (brokerages):

- Suitability requirements and non-advisory services
- Best execution for investment managers
- Client order handling rules for investment managers
- Eligible counterparties (excludes UCITS, pension funds, and their respective management companies)
- Conflicting capital adequacy requirements

UCITS III - MANAGEMENT COMPANIES: OPEN QUESTIONS

- What is a management company?
- What is a core function?
- What is allowed under non-core activities?
- What does “13 weeks fixed overheads” mean in the context of new capital requirements?
- What can a branch in a host country do and not do?
UCITS III - OTHER ISSUES

- Host country registration
- Cross-border fund mergers
- Cross-border depositing business
- Too restrictive on UCITS investments
- Excludes many newer products
- Can it keep pace with the market?