



Directive on markets in financial instruments (ISD2)

Sabino Forniés Martínez
European Commission



Institutional context

- Based on the 4 level "Lamfalussy approach": distinction between level 1 framework principles and level 2 "implementing measures"
- Framework Directive: Commission proposal/adoption by Council + European Parliament (codecision)
- Level 2 legislation: adoption by the Commission via "comitology procedure" – agreement of a regulatory committee: European Securities Committee (ESC)
- Technical Advice: Committee of European Securities Regulators (CESR)
- Level 3 guidance: CESR non compulsory guidelines



Background

Transparent approach – extensive consultation

- Two Commission Communications on the ISD: November 2000.
- Two rounds of Public Consultation: July 2001 and March 2002.
- Adoption Proposal: November 2002
- Council Political agreement: October 2003
- Adoption of the Directive (after Second reading) – April 2004



Objectives of new proposal:

- **Regulatory Objectives:**
 - **Create a true Single Market in which services can be provided freely and instruments traded across borders;**
 - **Establish a high level of investor confidence in financial markets and credentials of cross-border suppliers;**
 - **Promote the emergence of an efficient, transparent and integrated financial trading infrastructure;**
 - **Strengthen enforcement and supervisory cooperation.**



European Code for Investment Services



Guiding principles

- Home country authorisation and supervision;
- Sufficient harmonisation to allow mutual recognition of partner country authorisation and supervision;
- Open competition in the provision of services and marketplace functions;
- Proportionate response to demonstrable risks to investor protection and orderly functioning of markets;

What investment services are covered?

- **Persons providing following services on regular/professional basis must have ISD licence (cumulative):**
 - reception and transmission of orders;
 - execution of orders on behalf of clients;
 - dealing on own account;
 - underwriting and placing of financial instruments;
 - investment advice (personalised investment recommendations);
 - operation of a Multilateral Trading Facility (=ATS/ECN).
 - portfolio management
- **Investment firms so authorised may also be allowed to provide the following ancillary services:**
 - custodianship;
 - credit directly linked to provision of investment services;
 - management consultancy;
 - FX services linked to provision of investment services;
 - investment research & financial analysis.
 - services related to underwriting
 - Services and activities related to commodities.

What investment services are covered?

- Transactions in following financial instruments are covered by Directive:
 - transferable securities (shares, bonds, DRs);
 - money market instruments (short-term securities);
 - UCITS;
 - financial derivatives
 - commodity derivatives;
 - Non-financial; non-commodity derivatives (level 2).
 - financial contracts for differences & credit derivatives.



The Passport

- What's?
 - The possibility for Investment Firms duly authorised in one MS
 - To provide investment services in another MS on a cross-border basis or to establish through a branch in another MS.
 - Applying the regulation of their home country and being supervised by the authorities of their home country.
- Specificities for Branches: Host country regulation in some cases (Conduct of business rules, best execution, etc.).



Main areas regulated by the Directive:

- Issues related to the execution of orders (Marketplace Regulation).
- Investor protection
- Conflicts of Interest
- Regulated Markets



Marketplace regulation - I

- **Market:** Includes the different order execution venues (Exchanges, MTFs and Internalisation). Abandons the concentration rule.
- **New regulatory challenge:** Fragmentation.
- Based on three principles:
 - Primacy of the interests of the client.
 - Protection of market efficiency – sound price formation process.
 - Promote competition between the different order execution systems but guaranteeing the existence of a level playing field.



Marketplace regulation - II

- Regulatory Interventions:
 - Pre and post trade transparency.
 - Best Execution.
 - Order Handling rules.

Marketplace regulation – III - Transparency

- All order execution systems are subject to a comparable pre and post trade transparency regime.

	Regulated Market	MTF	Internalised
Pre-trade (non-block size)	Make public current (some) part of order-book during normal trading hours.	Make public current (some) part of order book during normal trading hours.	Immediate display of unfilled client limit orders to wider market. Quote disclosure rule.
Post-Trade (non-block size)	Make public price, volume and time or trades executed under their rules and systems. As close to real time as possible.	Make public price, volume and time or trades executed under their rules and systems. As close to real time as possible.	Make public price, volume and time or trades executed. Immediately and in a manner that is easily accessible to other market participants.



Quote disclosure by investment firms

- **What does it require?**
 - Make public a bid/offer price (or prices) at which the firm is committed to buy/sell a share. Price must reflect prevailing market conditions and be regularly updated.
- **Which transactions are concerned?**
 - Transactions in shares in a size up to a standard market size (arithmetic average value of the orders executed in the market). Applies only to shares for which there is a liquid market.
- **Who does it apply to?**
 - Only applicable to systematic internalisers - organised, frequent and systematic basis (precise definition at level 2).
- **Protections for internalisers?**
 - Updating, Withdrawal, Multiple hits.
- **Price Improvement?**
 - Possibility to improve quotes in certain cases (transactions from professional investors, of a size bigger than the one customarily done by a retail investor, and provided that the improvement fall within a certain public range).
- **How can the obligation be discharged (compliance)?**
 - through a RM that has admitted that instrument to trading;
 - through a third party (data vendor).
 - through proprietary arrangements;



Marketplace regulation – IV – Best Execution

- Brokers are obliged to search the best conditions (price, cost, etc.) for their clients.
- Establishment of a transparent order execution policy – Includes the venues where best conditions are offered.
- Regular updating of the order execution policy.
- Consolidation of information: No direct public information (No National Market System). Only regulatory intervention to eliminate barriers to consolidation.



Marketplace regulation – V – Order handling

- Primacy of the client's instructions.
- Information to the client if his orders are to be executed outside a RM or an MTF – Client consent (general basis – not necessary trade by trade).
- Principles for order handling:
 - implement procedures and arrangements which provide for the prompt, fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm.
 - execution of otherwise comparable client orders in accordance with the time of their reception by the investment firm



Investor protection – I

- Obligation to act honestly, fairly and professionally in accordance with the best interests of its clients .
- Active role of the client – Importance of information.
- Conduct of business rules (principles):
 - All information, including marketing communications, addressed by the investment firm to clients or potential clients shall be fair, clear and not misleading .
 - Appropriate information shall be provided in a comprehensible form to clients or potential clients about a) the investment firm and its services, b) financial instruments and proposed investment strategies; this should include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies; c) execution venues, and d) costs and associated charges.
 - Suitability test: Obligation to determine whether the service or product provided is suitable for the client. – Advice vs Service provided at the initiative of the client (execution only)
 - establish a record that includes the document or documents agreed between the firm and the client that set out the rights and obligations of the parties, and the other terms on which the firm will provide services to the client. The rights and duties of the parties to the contract may be incorporated by reference to other documents or legal texts .
 - The client must receive from the investment firm adequate reports on the service provided to its clients. These reports shall include, where applicable, the costs associated with the transactions and services undertaken on behalf of the client .



Investor Protection – II – Professional investors – Eligible Counterparties

- Possibility to have a differentiated approach on Investor protection: Professional/Retail but not lack of protection.
- List of Professionals:
 - a) Credit Institutions
 - b) Investment Firms
 - c) Other authorised or regulated financial institutions
 - d) Insurance companies
 - e) Collective investment schemes and management companies of such schemes
 - f) Pension funds and management companies of such funds
 - g) Commodity and commodity derivatives dealers
 - h) Locals
 - i) Other institutional investors
 - j) Large undertakings meeting two of the following size requirements on a company basis:
 - balance sheet total: EUR 20 000 000,
 - net turnover: EUR 40 000 000,
 - own funds: EUR 2 000 000.
- In general, a) to i) if they act in a principal to principal basis could be considered as eligible counterparties in which case there will not be any client protection unless requested by them.



Conflicts of interest - I

- The Directive includes an article that deals with conflicts of interest when providing investment services (covers also Investment research and analysis) between:
 - themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or
 - between one client and another



Conflicts of interest II

- Basic obligation: prevent any conflict of interest within firm or between clients from adversely affecting client.
 - Step 1: identify all conflicts of interest
 - Step 2: implement organisational and administrative arrangements (e.g. Chinese walls) to prevent or manage conflicts;
 - Step 3: where risk of adverse client affect remains, generic disclosure of nature/sources of conflicts of interest.
- Detailed implementing measures will specify the measures that shall be implemented:
 - particularly by “multi-functional” houses where conflicts of interest are more present.

Regulated markets

- **Definition**
- **Applicable law is that of Member State where RM is registered.**
- **Requirements relating to the RM:**
 - sufficiently good reputation and sufficiently experienced,
 - sufficient capital
- **Authorised market operator should be recognised as such when seeking authorisation to run a RM in other MS.**
- RM can place facilities in other MS to serve remote members.
- Market operator of RM can run MTF (“unregulated segment”)

A regulated market is a multilateral system, operated and/or managed by a market operator, which brings together or facilitates the bringing together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and systems, and which is authorised and functions regularly

Regulated markets

- **Organisational requirements and trading rules**
 - to ensure the efficient execution of orders;
 - to manage conflicts of interest.
- **Transparent and non-discriminatory criteria for access/membership -.**
- **Market Integrity - monitor transactions undertaken under rules and systems of the RM.**
- **Pre and post trade transparency.**

Regulated markets

- RM to set up clear rules on admission of financial instruments to trading - should be freely negotiable and “proper market” should exist.
- RM to verify that securities comply with EU disclosure obligations:
 - a valid Prospectus lodged with relevant competent authority
 - Disclosure of information on an on-going basis (Regular Reporting)
 - Ad-Hoc disclosure of price sensitive information(Market abuse).
- Once admitted to trading in RM, security can be parallel-listed without the consent of the issuer. RM should inform the issuer.
- Competent authority may demand suspension (temporary) or removal (definitive) of instrument from trading. Any such decision shall be communicated to other MS authorities.

MTF - legal concept and rules:

- New investment (core) service: Operation of Multilateral Trading Facilities. Definition
- **Licensed as Investment Firm subject to tailor-made IF regime:**
- **Authorisation and operating conditions equivalent to RM:**
 - organisational requirements and trading rules;
 - access to the facilities;
 - market surveillance;
 - pre and post-trade transparency.
- **No rules on admission of instrument to trading - pure trading facility (must inform issuer).**
- **Can cumulate MTF operation with other core/ancillary services.**

MTF is a multilateral system which brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract

Procedures/conditions for authorisation

- Authorisation by home competent authority
- Organisational requirements
- Capital adequacy:
 - firms providing only investment advice



Powers and obligations of authorities

- Maintenance of internal structures and competences
- One single contact point
- New cooperation and exchange of information obligations
- Joint investigations



What happens next? Level 2 measures

- First set of mandates for level 2 (advice received from CESR in January 2005). Includes: Transparency, conduct of business rules, order handling, best execution, organisational requirements, competent authorities, admission to trading, conflicts of interest.
- Second set of mandates (advice to be received from CESR by April 2005. Includes: Quote disclosure, eligible counterparties, execution only and commodity derivatives.
- 2nd semester 2005: Adoption of Level 2 measures (Directives or regulations).
- May 2006 or 2007– all Level 1 and Level 2 measures transposed by MSs and applicable.