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Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
ON INVESTMENT SERVICES AND REGULATED MARKETS, AND AMENDING
COUNCIL DIRECTIVES 85/611/EEC, COUNCIL DIRECTIVE 93/6/EEC AND
EUROPEAN PARLIAMENT AND COUNCIL DIRECTIVE 2000/12/EC

(presented by the Commission)

Table of contents

Explanatory memorandum.....	3
Section I. Background to the proposal.....	3
I.1 What is the Investment Services Directive?	3
I.2 Europe’s fast-changing financial landscape:.....	3
I.3. Why do we need a new Directive?	5
I.4. Broad objectives of the revision:	7
Section II. An efficient, transparent and integrated trading infrastructure:	8
II.1 Competition and fragmentation:	8
II.2. Guiding principles for regulating trade-execution:.....	12
II.3. High level principles for regulated markets (title III):.....	15
II.4. New core service for “Multilateral Trading Facilities” (MTFs):.....	17
II.5. Trade execution by investment firms:	18
II.6. Conclusions on the regulation of trade execution:.....	22
Section III. Investor protection and the investment firm regime (title ii):.....	23
III.1. Capital adequacy (articles 11 & 17):.....	24
III.2. Conflicts of interest (article 16):	24
III.3. Conduct of business rules when providing services to clients (article 18):.....	25
III.4 Best-execution (article 19):	26
III.5. Client order handling rules (article 20):	27
III.6. Dealing with eligible counterparties (article 22):.....	27
III.7. Conclusions on the investment firm regime:.....	28
Section IV. Scope of the Directive:.....	28
IV.1. Investment advice (annex I, section A):.....	28
IV.2. Financial analysis (annex I, section B):	29
IV.3. Commodity derivatives (annex I, section C):.....	29
Section V. Other key features of proposal:	31
V.1. Clearing and settlement:	31
V.2. Competent authorities and supervisory co-operation (title IV):	31
V.3. Use of committee procedures (comitology) to implement provisions:.....	32

EXPLANATORY MEMORANDUM

PROPOSAL FOR A DIRECTIVE ON INVESTMENT SERVICES AND REGULATED MARKETS

SECTION I.: BACKGROUND TO THE PROPOSAL.

I.1 What is the Investment Services Directive?

The Investment Services Directive, adopted in 1993, sought to establish the conditions in which authorised investment firms and banks could provide specified services in other Member States on the basis of home country authorisation and supervision. Services eligible for a passport under the existing ISD include brokerage, dealing, individual portfolio management, reception and transmission of investor orders, and underwriting/placing activities. In addition, the ISD enshrined the right of direct or remote access of any authorised ISD firm to participate in trading on exchanges/regulated markets in other Member States. To support the effective exercise of this right, the ISD introduced elements defining some characteristics for mutually recognised exchanges which imposed some conditions on the operation of those markets.ⁱ The ISD is therefore the legal instrument which seeks to translate Treaty freedoms into practice in respect of investment services and organised trading of financial instruments. (see annex 1 for detailed overview of Directive 93/22/EEC).

I.2 Europe's fast-changing financial landscape:

Market based financing is playing an increased role in the financing of European large and medium sized enterprises and in the allocation of European savings. Orderly, transparent and effectively regulated financial markets can serve as an important motor for wealth-creation.ⁱⁱ In Europe, corporate borrowers have recently turned to financial markets as an alternative source of finance to bank-lending: the number and value of new issues soared in the late 1990s as companies sought access to cheap, dis-intermediated funding to finance ambitious investment projects. Increased supply found a ready demand as investors turned to market-based investments as a means of bolstering risk-adjusted returns on savings and for provisioning for retirement.

Recent reverses suffered by equity markets do not weaken the case for market-based financing. However, they highlight the importance of a robust legal and regulatory framework if investor confidence and liquidity are to be nurtured and financial markets are to thrive. Financial markets can survive periodic bouts of volatility, cyclical corrections or under-performance of individual stocks. They will not survive the erosion of investor confidence if markets are disorderly, opaque and susceptible to market abuse or if intermediaries fail to discharge their fiduciary obligations to the end-investor.ⁱⁱⁱ The present proposal forms part of a coherent programme of legislative measures to facilitate the emergence of integrated and efficient European capital markets, while imposing proportionate checks and balances to avoid market excess and protect investors.

The integration of EU equity and corporate bond markets holds out the prospect of significant reduction in trading costs and the cost of equity/corporate bond finance. New research suggests that the static efficiency benefits of establishing integrated, deep and liquid equity and corporate bond markets alone are likely to be significant – involving a permanent reduction in the cost of equity capital by 0.5%, triggering an increase in investment, employment (0.5%) and GDP (1.1%).^{iv} The benefits of efficient capital markets will be optimised by pooling liquidity, and allowing supply and demand for financial instruments to

interact on a pan-European basis. This will maximise the depth of trading interest, reduce stock-specific volatility and limit adverse price impacts for large trades. Pooling of blue-chip liquidity, and the end to geographical diversification strategies can free up capital for new issues markets and venture capital. The introduction of the euro has already paved the way for full integration of unsecured money markets, and significantly boosted integration of sovereign and financial debt markets. Market participants are now looking to extend the same trading and portfolio management strategies to equity business and other asset markets. All of these factors lie behind the recent strong trend growth in cross-border trading of financial instruments: over the last five years, cross border equities trades have been growing at 20-25% per annum.

In view of the contribution that competitive and flexible market-based financing can make to growth, employment, the Lisbon and Stockholm European Councils have placed integration of European financial markets at the heart of the European economic reform agenda. Harnessing the benefits requires the removal of obstacles to investment transactions together with a comprehensive programme of measures to align national regulatory regimes across all stages of the trading cycle: from disclosure obligations at the time of issue, common guidelines governing trading and the behaviour of market participants, to finalisation and reporting of completed transactions. Building on the FSAP, the Commission has tabled a series of proposals for EU legislative measures which seek to lay the foundations for a coherent regulatory framework for integrated financial markets. This ambitious programme of legislative action holds the key to an important and enduring increase in Europe's employment and wealth-creating potential. The new proposal is an integral part of this programme.

Box: Directive on investment services and regulated markets and related EU legislative measures:

A new ISD will, by harmonising rules for dealing with or on behalf of clients or for own account and promoting the transparent functioning of organised trading systems, facilitate the integration of secondary markets in financial instruments. However, these measures are a necessary but not a sufficient condition for allowing effective cross-border interaction of all potential buy and sell interests in a given instrument. The FSAP identified a number of areas which call for EU-level solutions if a single financial market

Rules harmonising the content and format of disclosure of relevant information by issuers: one of the key roles of financial markets is to reflect all available information relating to a financial instrument in its price. Rules on the information to be disclosed by the issuer at initial offer (prospectus) and on an ongoing basis, are vital if all EU investors and traders are to arrive at an equally informed judgement of the value of a prospective investment (ensure that they are not comparing apples and pears). To this end, the FSAP instigated a comprehensive programme of action in respect of financial information. This encompasses the proposal for Prospectus Directive, emerging work on regular reporting (and ad-hoc disclosure of price-sensitive information) and the (politically agreed) Regulation on International Accounting Standards. The existence of a modernised system for issuer disclosure is also crucial to the ISD objective of allowing regulated markets to compete for liquidity by admitting partner country securities to trading without triggering duplication of disclosure obligations.

Safeguarding market integrity, preventing market abuse: In an integrated financial market, an investor in one Member State will be able to trade securities issued in a second Member State through the systems of a market in a third Member State with a counterparty located in a fourth. Faced with such a scenario, it is crucial that there be a watertight and effective EU regime for detecting and punishing market abuse. Supervisory authorities, market operators and market participants must behave scrupulously, exercise vigilance and cooperate effectively where necessary to prevent cross-jurisdictional abuse from sapping investor confidence. The Market Abuse Directive (now close to

agreement) clearly defines prohibited behaviour and establishes stringent disciplines to police and punish abusive practices throughout the EU.

Allowing collective investment schemes to exploit single market freedoms: Collective investment schemes have emerged as a powerful force for managing and intermediating private savings. UCITS currently have a capitalisation of between 3-4 billion euro. The recently agreed UCITS directives will cement the single market framework for unit trusts and mutual funds by expanding the range of collective savings vehicles which can distribute products EU-wide and provide for mutual recognition of fund manager qualifications.

Promoting efficient and competitive clearing and settlement of cross-border trades: impediments to the finalisation of cross-border securities transactions are coming into sharper focus. A high degree of inter-connectivity between different links in the clearing and settlement chain is crucial if investors undertaking a transaction on a market in another EU member State are to be able to repatriate title to those securities without incurring undue costs, delay or risks of “failed trades”. There is now a growing understanding of the myriad legal, tax and regulatory obstacles which stand in the way of efficient clearing and settlement of cross-border trades. Some parties to the debate have expressed the view that different ownership and organisational structures for these activities may also result in strategic barriers to competitive provision of clearing and settlement. The Commission has recently published a Communication (COM(2002)257) mapping out a number of strategic orientations and inviting interested parties to help identify EU-level policy responses.

I.3. Why do we need a new Directive?

The existing Directive no longer provides an effective framework for undertaking investment business on a cross-border basis in the EU. It does not establish clear ground-rules within which competition and consolidation of trading infrastructures (exchanges and other trading venues) can take place. The principal shortcomings of the existing ISD include the following:

- (1) ISD does not provide sufficient harmonisation to allow effective mutual recognition of investment firm licenses. As a result, the effectiveness of the ISD passport has been heavily mitigated by dual/multiple supervision of cross-border business;
- (2) ISD contains outdated investor protection disciplines: the relevant safeguards must be updated to take account of new business models, market practices and related risks. Investor protection rules also 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. This will ensure that competition between different types of order-execution venue works to the advantage of the end-investor rather than his/her disadvantage;
- (3) ISD does not span the full range of investor-oriented services (e.g. advice, new distribution channels) or financial dealing (e.g. in commodity derivatives). Some of these activities, when undertaken as the main or regular occupation of the firm, may pose material risks to investors or market efficiency/stability which could be addressed through the application of ISD and related disciplines;
- (4) ISD does not address the regulatory and competitive issues that arise when exchanges start competing with each other and with new order-execution platforms. At the time of ISD adoption, competition between exchanges/trading systems was non-existent. Now, competition between different methods of trade-execution (exchanges, new trading systems, in-house order execution by investment firms) is the principal regulatory challenge confronting EU securities supervisors. The few underdeveloped ISD provisions relating to regulated markets do not provide a sound

regulatory framework within which markets and systems can compete for liquidity, and in which investment firms may undertake off-exchange order execution in the context of providing other services to clients;

- (5) ISD provides for an optional approach to the regulation of market structure creating a formidable stumbling-block to the emergence of an integrated and competitive trading infrastructure. Article 14(3) of the existing Directive allows national authorities to stipulate that retail investor orders be executed only on a “regulated market” (“concentration rule”). A number of Member States have availed of this option to favour the interaction of retail investor orders on centralised public order books operated by regulated markets. Other Member States have elected not to use this option and have left responsibility to the investment firm to determine how best it can secure “best execution” for its clients. This has resulted in greater diversity of order-execution methodologies in these countries. Such fundamental divergences as to the regulation of market structure have, in turn, given rise to discrepancies between national trading conventions, rules on market operation, scope for competition between order-execution platforms, and the behaviour of market participants.^v These constitute a significant obstacle to cross-border transactions and fragment liquidity;
- (6) ISD provisions relating to designation of and cooperation between competent authorities are under-developed: the present Directive is insufficiently clear regarding allocation of enforcement responsibilities within Member States, and does not establish a sound basis for cross-border supervisory cooperation. A fully integrated single financial market requires that proscribed behaviour be pursued and punished with equal severity across the EU. A further pre-condition for an integrated and orderly single market is that there be full and immediate co-operation and information flow between national authorities. Current ISD provisions for supervisory cooperation were designed for a context in which linkages between national financial markets were less intensively employed. These mechanisms need to be substantially revamped:
- (7) ISD provisions are inflexible and out-of-date: ISD has to be rewritten because it is unable to respond to pressing regulatory issues caused by evolving market structure and business and supervisory practices. The need to revise ISD testifies to the futility of trying to regulate financial markets by hard-coding provisions in immutable legislation. In the light of the favourable responses of the European Council and EP to the recommendations of the Lamfalussy committee, it is proposed to amend key provisions of the Directive to allow for adoption of legally binding implementing measures through comitology procedure. This procedure will be used in strict conformity with the inter-institutional understanding between the European Parliament, Council and Commission.

Given the extensive shortcomings of the existing ISD, and the need to render it more responsive to structural change in EU financial markets, the Commission considers that it is more effective and rational to replace the existing text in its entirety. The new proposal incorporates those provisions of the existing ISD which have proved their worth. It builds on the national supervisory and enforcement structures which give effect to the existing ISD. Proposed changes to its scope represent an organic evolution rather than radical change. By building on the foundations established by the existing Directive, it is hoped to limit the extent of legal, institutional and supervisory adjustment which will be required to implement a new text.

Box:– A new approach to EU financial rule-making.

The Financial Services Action Plan drew attention to the underdeveloped EU legal framework for securities markets, and the significant opportunity costs resulting from the regulatory fragmentation of EU liquidity. It identified a number of initiatives to create a legislative framework to support the emergence of a single deep and liquid financial market. As part of this package, the Commission published a Green Paper in November 2000 exploring a number of themes relating to the operation of the ISD.^{vi} In the light of the 68 responses to the Green Paper, the Commission concluded that a wide-ranging review of the Directive was required.

The recommendations of the Lamfalussy Committee of Wise Men, endorsed by the Stockholm European Council in March 2001, have heavily shaped the preparation of this proposal:

1.Consultation of market practitioners and interested parties: since publication of the original Green Paper, Commission services have twice solicited the reactions of interested parties, in an open and inclusive way, to informal and preliminary thinking on the scope and form of ISD revision. A first consultation, which comprehensively mapped out possible modifications to the Directive, was published in July 2001. These preliminary orientations were discussed in an open hearing, attended by 150 interested parties, in Brussels in September 18-19 2001. 77 submissions were received in response to this consultation. Responses prompted a reconsideration of a number of important facets of the original orientations which were criticised as over-prescriptive and inimical to competition and innovation in the provision of order-execution services. Consequently, the Commission published a substantially revised set of orientations for ISD revision in March 2002. The revised orientations were again subjected to rigorous scrutiny in open forum (22 April 2002) attended by 200+ participants. The present proposal has been drafted on the basis of a careful consideration of the 107 responses to these revised orientations.

2.More effective and market-responsive single market rules: the Lamfalussy committee advocated a systematic and rational distinction between high level principles to be harmonised through EU Directives and the promulgation of uniform, legally binding but adaptable implementing measures under “comitology”. Under this structure, CESR will prepare detailed technical advice, in the light of reactions to open consultation, to mandates issued by the Commission. This two-tier structure for securities law was proposed as a means of reconciling continuity in democratically established core regulatory principles, with detailed harmonisation required to support cross-border organisation of securities trading and services, and the flexibility needed to adapt to rapidly evolving market practice in fast-moving financial markets. The far-sighted EP plenary vote/inter-institutional agreement on implementation of the Lamfalussy proposals, has cleared the way for the present proposal to be drafted in accordance with the Lamfalussy template.

I.4. Broad objectives of the new proposal:

The proposal for a Directive on investment services and regulated markets aims to strengthen the capacity of the EU legislative framework to serve two over-arching regulatory objectives:

1.the protection of investors and market integrity by establishing harmonised requirements governing the activities of authorised intermediaries;

2.the promotion of fair, transparent, efficient and integrated financial markets: this goal will, in particular, be furthered by the development of ground-rules governing the negotiation and execution of transactions in financial instruments on organised trading systems and marketplaces, and by investment firms.

The new Directive is discussed below under the following headings:

- measures to promote an efficient, transparent and integrated financial trading infrastructure;
- provisions governing provision of investment services, with a view to protecting investors and fostering market integrity;
- proposed extensions to the scope of the Directive;
- other issues (clearing and settlement, supervisory cooperation).

SECTION II. AN EFFICIENT, TRANSPARENT AND INTEGRATED TRADING INFRASTRUCTURE:

II.1 Competition and fragmentation:

In Europe, as elsewhere, the functions of market intermediary and marketplace have historically been performed by distinct types of institution. At the time the ISD was adopted, exchanges enjoyed a national franchise for the organised matching of buy/sell interests in locally issued securities. Intermediaries competed with each other in the provision of services to end-investors, issuers and for “over-the-counter” (OTC) dealing.^{vii} This institutional dichotomy allowed a clear distinction between the reach of investor-facing protections – which applied only to intermediaries - and market-facing rules designed to uphold the transparent and efficient functioning of markets – which applied primarily to exchanges. Since the adoption of the ISD, the EU financial marketplace has become more complex and the boundary between marketplaces and intermediaries has become blurred. IT has allowed the core-business of exchanges to be replicated at low-cost by non-exchange systems and for exchanges to reinvent themselves as competitive market players: there are now more players, more trading options.

New developments in EU financial trading:

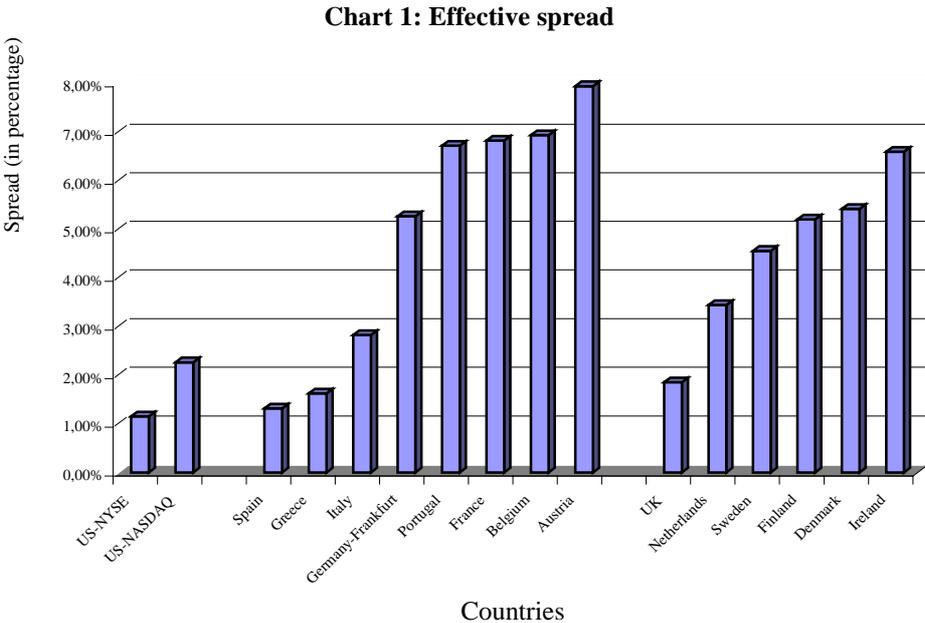
The following technology-driven trends have transformed the financial trading landscape:

1. inter-exchange competition: the era of utility-run stock exchanges, acting as a single uncontested national liquidity-point, is gone. Profit-driven exchanges are now competing directly for order flow and listings, seeking to expand activities through cross-border mergers or vertically integrating along the clearing and settlement chain;
2. competition from alternative trading systems^{viii}: new entrants are providing alternative venues for own-account trading by institutional and professional investors. These systems are now the principal organised trading venues for bond trading. However, they account for only 1% of equity trading volumes in the EU (a much lower share of equity transactions than in US);^{ix}
3. increased internal execution of client orders within investment firms: the concentration of brokerage in the hands of a diminishing number of investment firms and banks is creating a situation in which large volumes of client orders can be executed “in-house” – either by crossing one client order against another or executing against proprietary position of broker-dealers. A diminishing balance of retail investor orders which cannot be executed internally is routed to exchanges for execution. This practice is well established in jurisdictions which have not introduced a “concentration rule”: in these countries, available information suggests that many large institutions are currently internalising between 15-30% of client order flow..

Before examining the regulatory challenges associated with competition in trade-execution arrangements, it is important to note the following:

- 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 (as measured by effective average spreads^x). (Chart 1).

(source: London Economics, 2002).



- To the absence of any static efficiency benefits from directly regulating market structure must be added the dynamic costs to the marketplace as a whole of restricting participant choice, competition between trading systems and innovation. Competition between trade-execution arrangements can deliver dynamic benefits if it brings down transactions costs, brings additional liquidity to the markets, supports sophisticated trading strategies and helps to streamline transaction settlement. Although other factors are also at work, some support for this proposition may be found in the fact that EU regulatory regimes which allow for competition between exchanges and other forms of trading method are characterised by higher stock market capitalisation (170% of GDP) and liquidity (as measured by turnover 407% of GDP) when compared to Member States which favour trading on-exchange (80% and 130% respectively).^{xi} Recent evidence, based on US trading, suggests that this increased turnover and market capitalisation increase should fuel a further reduction in trading costs.^{xii}
- These benefits will not be confined to professional market participants. In-house internalisation of client orders can benefit clients in a number of ways: speedier execution, price improvement, and reduction in costs associated with settlement of trades directly within the system of the investment firm. Competition between intermediaries should result in some of these benefits being passed-through to end-investors. These benefits cannot be taken for granted. One of the objectives of this proposal is to create the

conditions under which off-exchange execution of client orders only occurs where there is a demonstrable advantage for the client. However, the experience with the Retail Service Providers in the UK demonstrates that off-exchange execution can deliver price improvements for retail investors in 7 out of 10 trades.

- Competition between exchanges and other types of trade-execution arrangements is nothing new: exchanges in all Member States have long been confronted with competition from non-exchange execution for at least some types of trade. Even those Member States which require concentration of retail investor orders on a “regulated market”, already allow competition between exchanges and other trading methods for professional and institutional trades. Furthermore, all Member State trading cultures recognise that exchange order-books are not the optimal trading method for all types of transaction. Central order-books exist alongside “over the counter” and upstairs trading for a range of transactions.^{xiii} A number of regulated markets are now seeking to marry the advantages of quote-driven and order-driven trading under one roof.^{xiv} The diversity of trading arrangements in different Member States is tacit recognition that a regulatory framework which favours one type of trade-execution venue will not be able to accommodate the wide variety of trading interests and strategies which make up a competitive marketplace.

If an integrated European financial market is to deliver its full potential, the regulatory environment should allow for the coexistence of different market microstructures, competition between trading systems, and freedom of choice for investors and market participants. Nevertheless, increased competition in trade-execution does present new challenges for the regulatory system in protecting investors and promoting orderly and efficient markets. The new Directive on investment services and regulated markets must provide a coherent and effective framework for managing these challenges. Many of the most complex and contentious issues surrounding ISD revision stem from the blurring of the market-place/intermediary boundary and consequent intensification of competition within and between different types of trade-execution. These challenges can be examined from 3 perspectives:

Fragmentation, and efficient price formation:

The dispersal of trading across a number of order-execution venues can result in the fragmentation of buying and selling interest into shallow and disconnected liquidity pockets. If unchecked, this process could work to the detriment of the two critical attributes of a successful financial market - liquidity and efficient price-formation.^{xv} In particular, fragmentation can result in wider bid-ask spreads, increased adverse price impacts for trades, and reduced opportunities to trade.^{xvi} Both inter-exchange competition, and competition between exchanges and other types of order-execution venue can contribute to fragmentation.

There is a growing consensus amongst financial regulators and commentators that an effective transparency regime can allow the benefits of competition between trade-execution venues to be reaped, while limiting any adverse consequences for overall market efficiency. “Market transparency – in essence the widespread availability of information relating to current opportunities to trade and recently completed trades – is generally regarded as central to both the fairness and efficiency of a market, and in particular to its liquidity and quality of price-formation”.^{xvii}

Efforts to counter the potential adverse effects of fragmentation through appropriate transparency rules should, at the outset, take account of the full range of trade execution arrangements if they are to represent a comprehensive solution. “ It would be desirable to

have a coherent transparency regime for an asset class that applies across all market venues.”^{xviii} A transparency regime which is confined to regulated markets and ignores “off-exchange” trade execution will be partial in reach and sub-optimal in effect. Off-exchange trading which improves on prices prevailing on regulated markets may embody trading information which is relevant for the investment judgements of other market participants in the same way as on-exchange trading. On this basis, it is argued that other market participants should be able to factor information on such trades or trading interests into their investment decisions and thereby maximise the efficiency of price formation.

However, transparency may come at a price in terms of reduced liquidity provision to market participants. Forcing dealers and broker-dealers to display the terms at which they are willing to buy or sell instruments may reduce their ability to trade at a profit, and expose them to strategic trading by other market participants.^{xix} In this way, rules which are designed to promote an absolute level of transparency – where all market participants possess all information on all current opportunities to trade, all of the time – would oblige dealers and broker-dealers to expose their trading positions to such an extent that they would no longer be willing to provide liquidity support to the market. This would complicate trading for market participants and investors, particularly in respect of block trades, trades in illiquid stocks, programme trading, and could add to price volatility. Therefore, caution is needed before extrapolating exchange-type regulation and transparency rules to off-exchange trading where market participants place their own capital at risk.

Investor protection:

The structural changes in financial trading and order-execution can also give rise to particular investor protection concerns. One particular concern in this regard concerns the scope for conflicts of interest within broker-dealers which may execute client orders internally against proprietary trading positions – a process widely referred to as “internalisation”. The integrated broker-dealer has an incentive to place the interests of its trading desks before the interests of the client. The existence of this conflict of interest raises the question of whether investors/clients can be confident that broker-dealers will comply with their over-riding duty to act in the best interests of the client. These conflicts of interest are already commonplace under the existing ISD and under those national regimes which allow broker-dealers to execute client orders outside the rules of a “regulated market”. However, these conflicts of interest may be exacerbated where the investment firm has an active strategy of internalising client order flow and minimising the orders that have to be finalised on-exchange.

A related issue is that market fragmentation may undermine the representativeness of on-exchange prices which have traditionally served as an anchor for “best execution” policies. “Best execution” rules generally provide that investment firms are considered to have discharged their duties to a client when its orders are executed on a “regulated market” or at a price equal to or better than that prevailing on the “regulated market”. Widespread order-execution away from the “regulated market” could drain liquidity away from exchanges and undermine the representativeness of reference prices established on regulated markets. Under this scenario, “best execution” policies which benchmark broker performance against the price obtaining on regulated markets lose their relevance as a base-line of protection for clients. Furthermore, faced with fragmentation of trading across disconnected systems and markets, investors or their brokers may not be aware of or have access to the best available trading opportunities. It is important to note that the experience of markets which allow off-exchange order-execution does not lend much empirical support to these claims: bid-ask spreads in shares traded on the LSE SETS order-book have continued to narrow despite the conclusion of a large volume of retail investor orders outside the SETS order-book.^{xx}

Regulatory arbitrage:

Trading through multilateral trading facilities (MTFs) and off-exchange order execution by investment firms can reduce the volume of transactions finalised through the order-book of an exchange. Inevitably, this has prompted the question of whether new trading entities should be able to compete with exchanges for order-flow without incurring comparable regulatory overheads. In particular, should broker-dealers which internalise large volumes of client orders – and which on this basis are sometimes portrayed as assuming the role of “market-places”^{xxi} - be asked to comply with exchange-type regulation? The answer to this question requires an objective assessment of whether it is correct to assimilate in-house execution with the operation of a marketplace. It further requires an understanding of how different regulatory requirements need to be adapted to the mechanics and risks of different methods of trade-execution.

II.2. Guiding principles for regulating trade-execution:

ISD revision represents a unique opportunity to define the rules of the game so that order-execution – whether conducted on regulated markets, through MTFs or via off-exchange transactions by investment firms – is undertaken in a way which serves investor interests and the overall efficiency of the financial system. The way in which these issues are resolved will also have an important and direct bearing on the competitive relationship between different sets of market participants. In developing its response to the above issues, and deciding a balanced approach to the different regulatory trade-offs, the Commission has been guided by the following principles:

1). ISD revision should create the foundations for an integrated and competitive trading infrastructure. A fully integrated financial market is one in which buy and sell interests in a given financial instrument can interact seamlessly and instantaneously across EU-borders irrespective of the location of the market participants or the systems/means through which trading interests are expressed.^{xxii} In this regard, national “options” concerning the handling and execution of retail investor orders – which account for some 90% of the number of transactions, but only 10% of value - are fundamentally at odds with the objective of a single financial market. They create a fault-line not only in terms of the regulatory and competitive situation of trading platforms in different Member States, but also in terms of the regulation of intermediaries, and protection to be offered to investors. If a revised ISD is to pave the way for an integrated and efficient financial market, it must – above all else – resist the siren call of an opt-in/opt-out approach to market regulation. In view of its potential to hinder the alignment of market regulation on a common model the proposal does not envisage the renewal of the “concentration rule” option.

2). ISD should respond effectively to demonstrable risks to investor protection and market efficiency. The emergence of a more heterogeneous and complex trading environment calls for a proportionate response from regulators if investor interests and overall market efficiency are to be safeguarded. Investors must have confidence that brokers actively exploit new trading opportunities in order to obtain the “best deal” on client’s behalf. Client interests must not be adversely affected by the existence of conflicts of interest when they rely on broker-dealers to execute their orders. Market professionals, issuers and regulators have a shared interest in ensuring that liquidity is not fragmented into shallow and disconnected pockets.

These concerns require the introduction of a package of measures to ensure that the dispersal of trading across multiple marketplaces and through diverse trading channels does not

fragment liquidity and prevent market participants from identifying mutually advantageous potential trades. At the heart of this package is an effective transparency regime which seeks to ensure that appropriate information regarding the terms of recent trades and current opportunities to trade at all marketplaces, trading facilities and other trade-execution points is made available to market participants on an EU wide-basis. The proposal will also introduce enhanced obligations to ensure that intermediaries make active use of this information so as to get the best deal for their clients.^{xxiii}

The proposal also recognises that brokerage clients should be allowed to express any preference that they may have as regards the channels through which their order may be executed. Information which may be relevant to the choice of broker or perception of quality of execution-service should be provided up-front so as to allow the client to make an informed judgement. To this end, it is proposed that the retail investor should give its prior consent, either on a general or on a trade by trade basis (see 3.5), before its orders are executed elsewhere other than on a “regulated market” or Multilateral Trading Facility.

3). ISD rules should be proportionate and work with the grain of the market:

Market efficiency and investor protection objectives should be pursued through regulatory interventions which constitute a proportionate response to demonstrable risk. They should take account of technology and market-based remedies, and impose as little restriction on competition and innovation as possible. This philosophy has informed the proposal in the following ways:

- “No prohibition” - ISD revision should not prohibit or otherwise impede, through application of unjustified or inappropriate regulatory requirements, order-execution outside traditional marketplaces/exchanges. Competition from new trading places^{xxiv} has spurred exchanges to innovate and develop new sources of competitive advantage. There is no reason to believe that these benefits have now been exhausted or that regulatory road-blocks should be erected to create captive order-flow for a certain category of marketplace.
- No compulsion: The proposal will not require an entity to be licensed as a “regulated market” in order to undertake order execution on an organised basis. “Multilateral trading facilities”, which operate trading interest display and execution systems, will be allowed to operate these systems on the basis of an investment firm licence subject to compliance with customised regulatory requirements (see below).
- No-one size fits all framework: Differences in regulatory treatment should not undermine the ability of institutions/exchanges, operating subject to a particular regulatory regime, to attract liquidity. However, limiting regulatory arbitrage does not amount to a case for blanket application of exchange-type regulation to other systems of methods of executing investor orders. Instead, ISD revision should establish comparable regulatory requirements for comparable order-execution methodologies. On this basis, multilateral trading facilities, which mimic exchange functionality for display and interaction of trading interests, will be subject to a variation on exchange-type rules for trading functions.^{xxv} However, trade execution by investment firms when dealing or providing services to clients should not be equated with the operation of an organised market/order-book. The business, mechanics and regulation of multilateral trading systems and markets is fundamentally different from that of trade-execution by investment firms – even when the latter are internalising client orders. In particular, internal execution of client orders does not allow clients to trade at their discretion with other clients through systems operated by the investment firm. Furthermore, any transparency rules for quote-based dealing should not make it impossible

for dealers to placing proprietary capital at risk in a manner that may improve market liquidity and smooth market functioning. ISD revision must, therefore, strike a careful balance between concerns relating to regulatory arbitrage and the need to allow liquid providers sufficient margin to operate. It is not a question of opting in favour of one type of one market structure at the expense of the other (order-driven versus quote-driven). The proposal seeks to create a regulatory framework which supports the co-existence of different trading channels, subject to the necessary safeguards for overall market efficiency and the interests of end-investors.

In the light of the above considerations, this proposal seeks to establish a coherent and risk-sensitive framework for regulating the main types of order-execution arrangement currently active in the European financial marketplace. It proposes proportionate regulatory interventions to contend with the specific investor protection and market efficiency risks associated with each of the different trading methodologies. It addresses the competitive and regulatory interactions that arise when different trading platforms and methods exist alongside each other but subject to different permutations of market and investor-facing regulation. It aims to create a situation in which trading interests, regardless of the medium through which they are expressed or where they are located in the EU, are able to interact with each other on a cross-border basis in real-time so that liquidity is fully responsive to price-differentials.

Central to realisation of these goals is a comprehensive set of rules requiring transparency of trading information. This regime encompasses all main categories of execution method for equities transactions – regulated markets, MTFs, and off-exchange execution by investment firms. These transparency obligations aim to allow the effective, real-time, cross-border interaction of trading interests without which a single financial market cannot be said to exist. This regime will also permit competition and innovation in trade-execution, or services which include trade-execution, without jeopardising efficient price-formation. It will do so in a manner that promotes the disclosure of as much trade information as is possible, taking account of the fact the same degree of transparency is not suitable for all business models. This transparency regime will be an important guarantor of the fairness and efficiency of EU financial markets, and of investor access to the best deal for the size and type of trade that they are considering. It is not the only guarantor.

The proposal also envisages a range of other actions to ensure that off-exchange execution of client orders takes place only where it can be demonstrated to be in the best interests of the client. A particularly important feature of the proposal is the emphasis placed on enforcement of a more active and dynamic form of “best execution” obligation to ensure that investment firms consider a wide range of trading opportunities when trading on behalf of their clients. The proposal envisages a reinforced “best execution” obligation which will force investment firms to undertake a regular assessment of which execution venues represent offer the most favourable terms for transactions, and to be able to demonstrate that it is making use of those venues on behalf of its clients. This “best execution” obligation is the mechanism which will ensure that trading information made available under transparency obligations results in changes to the order-routing decisions of investment firms. In this way, it will ensure that competition between trading venues translates into price-improvement for the end-investor. It will also help to ensure that liquidity flows to the most efficient trading points. At present, liquidity in Europe tends to be very sticky and continues to be concentrated on the market of first listing^{xxvi} – even where there are reasons to believe that alternative trading venues may offer better prices. Whilst there is no directly comparable experience of using “best execution” to inter-link the range of competing trading venues that co-exist in Europe, new “smart order routing” applications are now available in the market place which will enable

investment firms to monitor prices and depth across all EU exchanges and other principal trading venues.

Taken together, these proposals constitute an important step towards a regulatory regime for an integrated, efficient and investor-friendly EU financial market. The key elements of the concrete proposals as they relate to the 3 main categories of trade-execution format currently active in the EU marketplace will be briefly presented.

II.3. High level principles for regulated markets (title III):

The proposal preserves the particular status and authorisation regime for regulated markets which is at the heart of the existing ISD, and is now firmly entrenched in all Member States securities rule-books. A “regulated market” comprises not only a trading venue where the negotiation and exchange of financial instruments is organised under a set of rules which embody different kinds of trading features. It is more than that: it encompasses a broad set of functions, represents a distinct organisational form, and embodies particular trading features.^{xxvii} Admission of an instrument to trading on a “regulated market” also serves as trigger for the application of provisions of a number of related legislative measures. In recognition of these considerations, the ISD treats the operation of a “regulated market” as an activity warranting a separate regulatory regime.

The existing ISD establishes a limited number of legal features that should be respected by all EU regulated markets. These embryonic elements are not sufficient to represent a common basis for the regulation/supervision of the principal EU financial trading venues. regulated markets are now becoming increasingly European in terms of the investor base, membership and range of instruments admitted to trading. Market conditions on one “regulated market” will henceforth have instantaneous and important repercussions for trading and market participants in other markets.^{xxviii} Against this backdrop, the absence of a common regulatory template risks presenting a significant impediment to the objective of an integrated, efficient and orderly trading infrastructure.

The proposal requires Member States to impose certain specified obligations on the “regulated market”, which it shall fulfil under the supervision of a designated competent authority. The latitude given to the “regulated market” to design its trading rules, access conditions and reliance on it as a first line of defence for surveillance of trading on its systems is in recognition of the proximity to trading and self-interest of the latter in maintaining the quality of business performed under its systems.

The ISD proposal therefore seeks to establish a common set of high level principles authorisation, regulation and supervision of regulated markets so as to:

- identify the competent authority and applicable law (article 33): the proposal seeks to eliminate uncertainty as regards the relevant competent authority under whose exclusive jurisdiction the activity of the “regulated market” will fall. This will prevent scope for jurisdictional conflict or legal uncertainty which could have deeply damaging consequences for the legal finality of business done on the market;
- introduce requirements relating to the operator of the market (article 34): This provision requires the management personnel to be fit and proper, and to be endowed with financial resources needed to ensure the orderly functioning of the financial market. Once recognised as being in compliance with this provision, the market operator will be entitled to operate an MTF”, without having to obtain an additional authorisation to operate such a

facility. The fitness and properness of the market operator and the resources at its disposal should also be taken into account if the market operator of an already established Regulated Market wishes to establish a “regulated market” in another Member State;

- define organisational requirements for the “regulated market” so as to ensure its fair, orderly and transparent operation. Relevant provisions in this regard include article 36 (trading rules) and article 39 (access of participants to market);
- establish comprehensive pre and post-trade transparency obligations to apply to orders/quotes displayed in the market and details of completed trades in equity transactions;
 - pre-trade transparency (article 41): order-driven systems will be required to make public a part of their order-book. In quote-driven markets, designated market-makers will be required to publish an indication of bid/offer prices for some specified quotation size(s). The range of orders/quotes to be disclosed will be defined under comitology. In view of the fact that requiring display of orders/quotes of large sizes or in illiquid securities may deter market participants from bringing trades to the regulated market, these obligations shall not be applicable to such trades;
 - post-trade transparency (article 42): regulated markets will have to make public the price, volume and time for all trades in equity instruments concluded under the rules and systems of the market on a reasonable commercial basis. Deferred reporting of trade details will be permitted for trades of large size and in illiquid securities.
- Admission of instruments to trading (article 37): this provision sets the high level principles under which a “regulated market” can admit instruments to trading on its systems, while allowed the detailed implementing measures to give effect to these principles to be developed at level 2. In brief, the “regulated market” should implement generic admission requirements, which have received prior public approval and which aim to ensure the free negotiability and effective settlement of instruments. The minimum conditions which instruments should fulfil in order to meet these requirements will be clarified at level 2. This clarification allows for differentiation between products admitted to trading on different market segments and is not intended to prevent regulated markets from applying more demanding admission requirements to its market segments. Article 37 also seeks to create a legal context in which regulated markets are able to admit to trading instruments which have been constituted and issued in another jurisdiction and where the market has taken steps to verify that the issuer is in compliance with its initial and other ongoing disclosure obligations.
- Suspension and removal of an instrument from trading (article 38): this provision foresees circumstances and conditions under which the competent authority or the Regulated Market can to suspend or remove an instrument from trading. It also establishes the framework for dealing with suspension or removal on a fragmented marketplace. When a competent authority decides to suspend or prohibit trading on an instrument, its decision shall be immediately applicable to all the trading under its jurisdiction (either on RMs, MTFs or OTC/internalisation). The competent authority will also have to inform about the suspension or removal to competent authorities in other Member States.

II.4. New core service for “Multilateral Trading Facilities” (MTFs):

The proposal envisages the introduction of a new core ISD service relating to the operation of an MTF. This will allow entities operating such systems to be authorised as an investment firm subject to a customised regulatory regime. There is a sizeable and growing population of these systems.^{xxix} Their functionality does not correspond directly with the existing ISD services, and this has led to some uncertainty as to the appropriate basis on which to license and supervise these entities. The recognition of MTFs as a new category of investment firm is intended to clarify the nature of this business for the purposes of EU law, and to allow for the application of a common set of customised regulatory disciplines to deal with (market-facing) risks.^{xxx} On this basis, MTFs will be able to make their facilities and services available to users throughout the EU on the basis of home country authorisation.

The proposed definition of MTF draws on the extensive analysis and 2 rounds of open market consultation undertaken by the Committee of European Securities Regulators (CESR). The proposed definition captures systems which support the multilateral disclosure of firm orders/indications of interest between the system users and the execution of orders resulting from the interaction of buy/sell interests expressed through the system. It also includes “auction-crossing” systems where user orders are executed against a reference price imported from outside the system. The common feature of these systems is that they support autonomous trading decisions by the system users, without there being any intercession of the system operator to facilitate trades or participate itself (against a proprietary trading book) in transactions with system users. There is no active or discretionary role of the system operator in pre-selecting, recommending or otherwise bringing together of trading interests. The system supports and facilitates direct user interaction with other system users. This form of functionality means that MTF possess many of the exchange-kind features and give rise to some of the same regulatory issues as regulated markets. For this reason, the proposed regulatory treatment under revised ISD focuses on the fair, orderly and transparent organisation of trading through the system.

The proposed MTF obligations are modelled on the market-facing principles which apply to the trading system functionality of regulated markets. These obligations are also heavily informed by the recently published CESR standards for “Alternative Trading Systems”. The key provisions of the proposal concern:

- Organisational requirements for MTF (article 13): MTF will be required to apply transparent and objective commercial criteria in admitting its users. The potential user base for MTFs comprises market participants who are willing to trade at own risk and without the benefit of agency protections. In addition, the provision lays down obligations to ensure the objective, fair and expeditious handling of trading interests expressed through the MTF;
- pre and post-trade transparency obligations in respect of equity transactions concluded on MTFs (articles 27 and 28): the basic obligations are aligned with the level of transparency foreseen for trading interests in equity transactions when concluded or displayed through a “regulated market”. Possibilities for deferral of trade reporting, and the range/depth of pre-trade disclosure will be similar to those required of regulated markets. Auction-crossing systems and other types of MTF which do not involve prior disclosure of firm indication for prices may be exempted from the scope of the pre-trade transparency obligation;
- waiver from agency obligations for transactions concluded on the MTF (article 22): Users of the MTF are professional or active market participants trading on their own account and

at their own risk and capable of assuming responsibility for their investment decisions. They do not expect the operator of the MTF to offer them agency protections. Consequently, conduct of business and other investor protections will not be relevant to the type of trading conducted through an MTF. In view of this, the proposal foresees that MTF will be required to limit participation to “eligible counterparties”. The proposal does not envisage forcing MTF to admit freely non-system users for the purposes of trading against a bid or offer which is publicly displayed pursuant to article 27.

- Right for MTF to place screens in other Member States (article 29): In parallel with the provision allowing regulated markets to place trading screens or operate other arrangements to enable remote members located in other Member States to have access to and trade on the “regulated market”, it is proposed to recognise a similar right for investment firms operating MTFs under the free provision of services.

In order to ensure that this new category of investment firms has provisioned for relevant risks arising from its activities, they will be required to hold initial capital and an additional amount of own funds in accordance with Directive 93/6/EEC (CAD). Capital requirements and endowment shall take account of relevant regulatory developments in the EU and other international for a, particularly those pertaining to capital charges on operational risk.

The proposal does not consider adequate to establish mandatory admission requirements for the instruments traded at the MTF. The MTF is a pure trading functionality where its participants may decide what specific financial instrument to trade. However, when in the systems of an MTF is traded on a regular basis an instrument that is also traded in a “regulated market”, the MTF should take the necessary steps to verify the compliance of the instrument/issuer with the relevant provisions of Community law (i.e. disclosure).

II.5. Trade execution by investment firms:

The proposal envisages a systematic modernisation of the obligations incumbent on investment firms when they execute transactions outside the rules and systems of a “regulated market” or MTF. This review has been prompted by two distinct considerations:

- to contend with particular concerns relating to the possible conflicts of interest which arise when integrated houses (broker-dealers) execute client orders internally;
- to provide an effective and proportionate response to concerns that off-exchange order execution by dealers and broker-dealers may undermine efficient price-formation, and in doing so, potentially weaken “best execution” policies.

Conflicts of interest in (internalising) broker-dealers:

The debate surrounding “internalisation” has thrown into sharper relief the already commonplace conflict of interest that arises when investment firms cumulate the functions of broker and dealer.^{xxxix} Execution of client orders against the firms’ proprietary positions begs the question of whether investors can be confident that their interests are paramount when the broker-dealer acts on their behalf.^{xxxix} These concerns are exacerbated where an investment firm implements systems and procedures to maximise the number of client orders executed against proprietary positions or other client orders.

The assessment of the need for additional checks and balances on investment firm trade execution must take account of the range of investor-facing obligations with which investment firms must already comply, and which circumscribe the manner in which an

investment firm can execute client orders. “Best execution” requirements, in particular, mean that the investment firm does not have unlimited discretion about how it executes orders on behalf of clients. However, the Commission considers that existing disciplines for investor protection must be significantly tightened in order to contend with the possibility that conflicts of interest in integrated broker-dealers operate to the detriment of their clients. The ISD proposal seeks to place proportionate and effective safeguards on a definitive and firm legal footing. In particular, it is proposed to:

- introduce a new self-standing provision on conflict of interests covering, inter alia, those that arise in integrated broker-dealer houses (article 16). This provision seeks to ensure that the investment firm is organised so that client interests are not adversely affected by conflicts of interest between the brokerage and dealing business of the firm. Broker-dealers will be required to identify, prevent or otherwise manage conflicts of interest so that they do not adversely affect clients interests. Legally binding implementing measures which specify the types of administrative and organisational arrangements that broker-dealers need to introduce will be developed at level 2;
- reinforce “best execution” obligations (article 19): the investment firm will be obliged to be able to demonstrate that it has made best endeavours to obtain the best deal for the client. This obligation limits the possibilities for internal execution to situations where this matches or betters the terms at which the client order could be finalised on a “regulated market” or in the wider market.
- establish client order-handling rules (article 20): these rules will ensure that client orders are processed expeditiously and according to objective rules of precedence and priority. These stipulations seek to ensure that the investment firm takes active steps to facilitate execution of the client order, and that the client’s interests are not adversely affected by self-interested or negligent handling by the firm. In addition, it is proposed that client limit orders, which the firm is not in a position to execute itself at the specified terms, be traded into the wider market.

Off-exchange trade execution and efficient price formation:^{xxiii}

Transparency rules are the principal means through which it is proposed to safeguard the efficiency of price formation and sustain “best execution” in an environment where trade-execution is being performed on a range of markets and systems throughout the EU. Quotes offered and details of off-exchange trades completed by investment firms may also embody information which is relevant for the valuation of instruments by other market participants. A critical issue is therefore to what extent and in what form should transparency obligations be imposed on off-exchange trade-execution by investment firms. The basic presumption is that pre and post-trade transparency rules should apply to off-exchange trade execution by investment firms unless other considerations – trade-off with liquidity provision, compliance costs – outweigh any benefits. The following sections set out the conclusions of the Commission on whether and/or how ISD should impose transparency obligations on investment firms.

(a). Post-trade transparency obligations (article 26):

Against the backdrop of global competition between markets and trading systems and the growing preponderance of parallel trading in blue-chip securities, post-trade transparency obligations can play an important role in reconstituting liquidity and inter-linking different trading venues. Swift publication of price and volume details in respect of completed trades

will allow professional market arbitrageurs to shift liquidity in response to observed bid/offer prices at different trading venues. Transparency rules which overlook the sizeable and growing volume of off-exchange/MTF trading will, by definition, be partial in scope and sub-optimal in effect.

It is therefore proposed to introduce an obligation for all investment firms concluding trades in equity instruments (once these are admitted to trading on a “regulated market”) to disclose publicly, as close to real-time as possible, the price and volume of completed trades. Possibility of deferred reporting for large trades or trades in illiquid equities is foreseen in order to allow traders to unwind large positions before the existence of their exposure is made known to other market participants. By allowing for deferred reporting of large trades, the proposed post-trade transparency rule avoids exposing proprietary trading positions and limits any conflict with liquidity provision.

Investment firms are afforded considerable flexibility as to the arrangements through which they comply with this obligation. A base-line obligation is that they report the details of completed off-exchange trades to any “regulated market” of which they are a member (and with which they will already have established 2-way data feeds). Such links, once established, can allow investment firms to report trades at low cost.^{xxxiv}

(b). Pre-trade transparency obligations:

In preparing the proposal for revision of the ISD, the Commission services have given careful consideration to the imposition of pre-trade transparency obligations on off-exchange transactions of investment firms. The reason for contemplating such an obligation stems from the basic presumption that maximising the flow of trading information to market participants will enhance the price-formation process. Judged from the perspective of “best execution” or efficient price-formation, it is not enough to know the conditions under which the last trade was concluded. The fact that a particular execution-point represented the best deal for the last trade provides no guarantee to market participants and investors that it will also offer the best terms for the next deal. Judged against the benchmark of an absolute “best execution” obligation, market participants and investors could benefit from access to information on all current trading opportunities – not only those available on regulated markets and MTFs. Investment firms, in processing of investor orders or by publishing quotes to other market participants, may possess or generate information which could also influence the overall market valuation of given instrument.

However, given the fundamental differences between bilateral dealing or order-execution by investment firms and exchanges, pre-trade transparency obligations designed for regulated markets and MTFs cannot be directly extrapolated to dealers and broker-dealers. Trading interests expressed through a public order-book are knowingly disclosed to other market participants. This allows wider disclosure of those trading interests to be mandated without undue concern about any potential consequences for proprietary positions of market participants. The same is not true of dealers whose ability to undertake their business is inextricably bound up with their ability to make quotes on a selective or discretionary basis. It would be counterproductive from the perspective of liquidity provision, to compel investment firms to disclose extensive details of their trading book to the wider marketplace.

In view of these considerations, the Commission proposes to introduce pre-trade transparency requirements for investment firms in the form of a client limit order display rule (article 20(4)) and a quote disclosure rule for retail size orders in shares (article 25).

The client limit order display rule will require the investment firm immediately to make public client limit orders which it is unable or unwilling to execute itself at the specified price. Limit orders are a particularly powerful price-signal because they specify clearly the precise value which that investor attaches to the transaction. In certain marketplaces limit orders are becoming a normal or even the predominant form in which investor orders are expressed. Some 62.9% of orders for small transactions of less than 5000 shares in CAC 40 stocks on Euronext Paris (in September 2001) were expressed in the form of limit orders. This proportion increases as the size of the transaction increases.^{xxxv}

The client limit order display rule will ensure that investment firms do not withhold price-relevant information – embodied in the terms of a non-executed client limit order – from other market participants. The rule seeks to ensure that this information is made public in a way that the relevant information is immediately and easily visible to other market participants and the marketplace as a whole. The rule allows the possibility for non-disclosure of limit orders in respect of large transactions or where requested by the client. The rule would also not prevent the investment firm from concluding the transaction in-house as long as this is done immediately so as to offer the benefits of fastest and most expedient execution to the client, and subject to the express prior consent of the client. Given the growing preponderance of limit orders, and their importance as a source of price-relevant information, the client order display rule represents an important safeguard for overall market efficiency.

In addition, the Commission proposes to introduce an obligation for investment firms which operate a trading book to make public a bid and offer price for a specified transaction size for the most liquid shares (a “quote disclosure” rule). This provision reflects the basic presumption in favour of maximising the volume of trading information. The overall price formation process and the effective enforcement of “best execution” will be enhanced if (large) dealers and broker-dealers are required to advertise the terms at which they are willing to conclude transactions.

Such a rule will provide other market participants with some indication of the terms on which the investment firm stands ready to conclude transactions for the specified transaction size in the share in question. This will expand information on current opportunities to trade, and allow even greater number of execution possibilities to be considered for “best execution”. In the case of broker-dealers which internalise client orders, it will require those firms to disclose some prior indication of the terms and conditions at which they are able to match client “market orders” (orders for execution at the best available price).

As explained previously, a quote disclosure rule should avoid over-exposing the positions of dealers to the extent that they are unable to trade positions at a profit, and lose the incentive to act as a permanent point of liquidity in the market place. However, a review of theoretical and empirical material of the US experience suggests that the concern that pre-trade transparency will impede liquidity provision seems only to be borne out for transactions which are large in size or in illiquid securities. An appropriately calibrated pre-trade transparency rule does not seem to hinder dealers and market-makers from continuing to provide liquidity support to the market on a profitable basis. The SOES (“small order execution system”) rules operated by the NASD provide a working example of how quotation rules can be designed which stipulate specified quotation sizes to be displayed, and which take account of different levels of liquidity in the stocks concerned^{xxxvi}. Moreover, US experience suggests that quote disclosure may enhance trading volumes and overall market liquidity at the displayed bid/offer and quote sizes. In the light of US experience with quote disclosure rule, it is proposed that mandatory quote disclosure should be confined to retail-size transactions in highly liquid

equities. In this way, it should not constitute a significant impediment to proprietary dealing by banks.

The introduction of a quote disclosure rule will impose some compliance costs on investment firms as regards the publication of quotes. In particular, they will have to ensure that the mandated bid and offers are visible and accessible to market participants on a continuous and real-time basis – preferably through systems which consolidate quotes from as many investment firms as possible. These costs will be minimised through appropriate specification of the scope of the obligation and the reporting methods. The proposed quote disclosure rule also allows for small dealers, which are unlikely to be significant contributors to liquidity or price-formation for shares, to be exempted from the scope of the obligation.

II.6. Conclusions on the regulation of trade execution:

The proposed Directive for revision of the ISD seeks to create a regulatory framework in which obligations are tailored to the specific risk-profile of different market participants, and which takes account of competitive and regulatory interactions between different trading formats so as to maintain overall market efficiency. The following table summarises the salient features of this regulatory regime.

Table: Synopsis of regulatory framework for different methods of trade-execution.

	<i>Market integrity</i>	<i>Trading processes</i>	<i>Conflict of interest vs. client orders</i>	<i>Best execution</i>	<i>Post-trade</i>	<i>Pre-trade</i>
Regulated Market	Market monitoring	Prior supervisory approval	N/A	N/A	Full reporting of all trades on mkt. Deferral for large trades	Depth/range to be specified – not for large illiquid trades
MTF	Capacity to detect and report atypical trades	Prior supervisory approval	N/A	N/A	As for reg. Market	As per regulated market.
Dealer	Comply with market Abuse Directive	N/A	N/A	N/A	Same as per trades on Reg. Market	Quote disclosure for large dealers
Broker-dealer	Comply with Market Abuse Directive	Client order handling rules	Admin and organisational arrangements.	Reinforced obligation	Same as per trades on Reg. Market	Client order handling & quote disclosure for large B/Ds
Broker	Comply with market abuse Directive	(some) client order handling rules	N/A	Reinforced obligation	Same as per trades on reg. market	N/A

SECTION III. INVESTOR PROTECTION AND THE INVESTMENT FIRM REGIME (TITLE II):

The proposed Directive will harmonise the initial authorisation and operating conditions for investment firms established in the EU. The relevant provisions embody a high level of protection for investors/clients which rely on investment firms for advice, to intervene in the market on their behalf, or to manage their personal investment portfolios. Clients of such firms should be confident that duly authorised firms, wherever authorised in the EU, will act diligently and in their best interests. To the extent that these conditions are established, duly authorised investment firms should be able to provide services to clients in other Member States on the basis of their home country authorisation and ongoing supervision by their domestic competent authority.

The provisions of the existing ISD are not sufficient to serve these twin objectives:

- the investor protection disciplines of the existing ISD are outdated. They do not provide sufficient leverage over the manifold conflicts of interest that arise when investment firms perform a wider range of client-oriented and own-account activities under one roof. They do not create effective obligations for investment firms to make use of the increased array of order-execution facilities for their clients. The current proposal envisages a systematic overhaul of the provisions relating to authorisation and ongoing supervision of investment firms so as to rectify these deficiencies;
- the existing Directive does not establish the bed-rock of harmonised investor protection obligations needed to support mutual recognition of authorisation and operational requirements. A combination of overly generic principles, unsupported by operational guidance and undermined by ample provision for “general good” derogations, has limited the ability of investment firms to exercise their Treaty freedoms on the basis of home country supervision. In revamping the ISD, it is proposed to enshrine a high level of investor protection and on this basis to clarify that investment firms providing services freely in other Member States shall operate subject to control only of their home country supervisor.^{xxxvii}

To remedy these deficiencies, the proposal envisages a far-reaching modernisation and reinforcement of the obligations that investment firms must comply with when providing services to clients or acting in the marketplace, as well the rights to which investment firms are entitled by virtue of ISD authorisation. The relevant provisions encompass:

- conditions for initial authorisation, including organisational requirements (articles 4-14);
- general operating conditions including conflict of interest identification and management (articles 15-17);
- obligations of investment firms when providing services to clients, including conduct of business rules, best execution obligations and client order handling rules (articles 18-22);
- requirements to uphold market efficiency and integrity including transparency obligations (articles 23-28);
- provisions governing the rights of investment firms (articles 29-32).

The most substantive adjustments to the content of key investor protections are presented in this section. The obligation for investment firms to comply with transparency obligations for

off-exchange transactions has been discussed extensively in the previous section and will not be presented again.

III.1. Capital adequacy (articles 11 & 17):

As under the existing Directive, compliance with the initial and ongoing capital requirements, as laid down by Directive 93/6/EEC, is a pre-condition for authorisation and operation as an investment firm.

The proposal for ISD revision envisages modification of the Capital Adequacy Directive to clarify that investment firms which provide only the service of investment advice shall be exempted from obligation under the Capital Adequacy Directive. This clarification is achieved through art. 62 which proposes to add a 4th indent to Article 2(2) of 93/6/EEC which clarifies that investment firms which are authorised to provide only the service of investment advice are not to be regarded as investment firms for the purposes of CAD. This special treatment of investment advisors for the purposes of the capital adequacy Directive is in addition to the existing exemption for investment firms which receive and transmit client orders without holding money or assets on their behalf.

A special treatment with respect to capital requirements can be justified by the fact that these entities do not represent a source of counterparty or systemic risk to other market participants, and that clients are not exposed to the risk of direct loss of funds and assets when dealing with advisors. The main regulatory risk associated with this activity is the legal/operational risk that could arise from failure to respect “due diligence” when providing investment recommendations to individual clients. The proposal envisages the introduction of obligation to hold professional indemnity insurance to contend with these risks and to allow the firm to meet any damages owed to clients awarded compensation resulting from inadequate performance of these activities. This obligation, and the amounts of professional indemnity insurance cover to be held are based on the corresponding provisions of the Directive on insurance Mediation.

In the context of the ongoing review of capital requirements, the Commission is developing proposals which will change the current regime. In so doing, the Commission will have full regard to the situation of low risk investment firms, including investment advisors.

III.2. Conflicts of interest (article 16):

It has become imperative to create a self-standing provision of the ISD to govern the expanding range of circumstances in which the various interests of the investment firm, its managers and employees may conflict with those of its clients. The expanding range of activities that many investment firms and banks undertake under one roof by has increased potential for conflicts of interests between these different activities and those of clients. This is allied to the greater prevalence of inducements, and well-established concerns relating to conflicts between clients. The patchy treatment of conflict of interests under the existing ISD does not allow for a coherent or effective response to these matters which are critical for the defence of clients.

The introduction of a separate provision which allows for the elaboration of detailed implementing measures through comitology, will allow regulators to react in a concerted and tailored way to types of conflict of interest which warrant particular attention. This would for example allow for targeted interventions in respect of conflicts arising from, for example, the

accumulation of financial analysis/research and brokerage or underwriting/placing activities, or client order execution by broker-dealers.

The proposed provision establishes an obligation for investment firms to, first, identify conflicts of interest that arise in their business activities which might prejudice the interests of their clients. Investment firms would then be required to either:

- Prevent those conflicts of interest from adversely affecting the interests of clients; or
- establish organisational and administrative arrangements which allow them to manage these conflicts of interest in such a way that the interests of clients are not adversely affected.

The provision does not prescribe the nature of organisational or administrative arrangements that shall be considered appropriate for management of different forms of conflict of interest, or way in which conflicts of interest must be disclosed where relevant. The provision foresees that detailed implementing measures be adopted at level 2 to provide guidance on these points.

Where the firm has sought to manage conflicts of interest through the establishment of organisational arrangements but it cannot be ascertained with reasonable confidence that these conflicts of interests no longer potentially prejudice the interests of clients, the firm shall disclose the existence of these residual conflicts of interest to the client. Disclosure may, where appropriate or necessary, be generic.

III.3. Conduct of business rules when providing services to clients (article 18):

Conduct of business rules are one of the mainstays of investor protection. Implementation of the present provision has been hampered by a lack of clarity as to interpretation of the main operational concepts (professional/retail investor), ambiguity as regards the role of home and host authorities in enforcing these obligations, overlap with market integrity issues, and inclusion of unworkable tests (“look through”). The provision has been extensively reworked to update the rudimentary and ambiguous principles laid down in the existing Directive. conduct of business regimes. This revamping of underlying principles takes full account of the standards for investor protection which have recently been adopted by CESR.

A key objective of this overhaul has been to allow the provision of clear and legally binding guidance on the implementation of the broad principles. To this end, the provision provides for the adoption of common conduct of business rules through comitology. It is provided that these detailed rules will differentiate in their application between investment services and between professional and retail clients who require different forms and intensity of agency protection. Annex 2 to the proposal sets out criteria and procedures for determining when a client can be categorised as a “professional client” for the purposes of applying the relevant light-touch conduct of business rules. This classification mechanism is based on the work developed by CESR in consultation with market practitioners. Detailed implementing rules will also be applied in a differentiated manner to investment or ancillary investment services and/or to different service formats (e.g. portfolio management and “execution-only” brokerage) or instruments.

In the event of branch operations, it is proposed that the host authority assume responsibility for enforcing conduct of business. The host authority is in greatest proximity to the branch and is better placed to detect and intervene infringements of firm-client transactional

obligations. The management of firm-client business at branch level means that investment firms do not see any difficulty in cooperating with host authorities in this domain.

III.4 Best-execution (article 19):

An effective “best execution” obligation for investment firms can help to ensure that fragmentation of trading across diverse execution venues works to the advantage of clients rather than to their disadvantage. An active “best execution” policy will ensure that investment firms consider trading conditions on a range of trading venues, and make use of “smart” order-routing techniques in order to seek out the best bargains for their clients. In doing so, it will allow competition between brokers to drive improvements in execution quality to the benefit of the investor. This should result in improved brokerage services for clients compared to current practice whereby firms are only required to match the prevailing price on the local regulated market.

“Best execution” rules are also important from a broader market efficiency perspective. The operation of an integrated financial market requires that orders to buy and sell financial instruments interact effectively, freely and instantaneously with each other on a cross-border basis. Requiring investment firms to consider trading conditions on a reasonable range of execution venues, and to route orders to the venues offering the best prices, will ensure that liquidity responds quickly to price differentials. In this way, an effective “best execution” policy helps to ensure that liquidity flows to the most efficient and competitive trade-execution venues and serves as a guarantor of overall market efficiency.

Given these important considerations, a key feature of ISD revision is to establish a separate provision governing the “best execution” obligations of brokers/broker-dealers. The first element of the provision establishes the obligation for all investment firms acting on behalf of clients to exercise due diligence to ensure that the order is executed in the conditions that are most favourable to the client. It establishes a general benchmark against which the execution of client orders may be judged in a context where transactions in the instrument in question are potentially being concluded on a variety of marketplaces. This benchmark emphasises, in the first instance, the best net price to the client. However, allowance is made for other factors which may influence the optimal handling of the order such as the time and size of order. These considerations may be particularly relevant for professional clients with larger orders which may require more sophisticated handling.

The competent authority is required not to verify that the investment firm obtains the best price in respect of all transactions that it undertakes on behalf of clients: instead, the competent authority should verify that the investment firm operates procedures which maximise the probability of its clients obtaining “best execution” having regard to the best terms that are available at the different execution-points that make up the marketplace. An important aspect of a successful provision will be to provide an indication of the conditions under which an investment firm can be considered to have undertaken reasonable endeavours to obtain best execution on behalf of its client – notably by ensuring that it has access to a sufficient range of the venues which consistently deliver “best execution”.

A third element of the provision is the requirement that the investment firm regularly review the procedures that it operates so as to obtain “best execution” on behalf of its clients. In this regard, it should continually assess and update the arrangements which it employs to execute client orders to ensure that these are delivering the best possible result for client orders.

The key elements of the “best execution” obligation are derived from the CESR conduct of business rule-book. The provision foresees the adoption of detailed measures, through comitology, to clarify how critical elements of this new test are to be interpreted and implemented.

III.5. Client order handling rules (article 20):

Rules regarding the way in which client orders are processed and executed can enhance confidence in the impartiality and quality of execution services. The proposal therefore requires that investment firms establish processes which provide for the fair and expeditious handling of client orders. Fairness and expediency for the purposes of this provision are to be understood not by reference to the quality of execution of a given client order relative to conditions in the wider marketplace (“best execution”), but relative to the handling of other client orders or proprietary transactions of the investment firm.

This provision recognises that investor should be fully aware of different channels through which his order may be executed. Information provided up-front to the investor should allow him to make an informed judgement as to which are the potential risks and benefits attached to each of the different channels available. By default, the Directive establishes that when the investor does not express his preference his orders are to be routed to those channels, such as regulated markets or MTF, that do not give rise to potential concerns as regards the protection of the interests of the investor (notably conflicts of interest). To this end, the client should give its express consent before its orders are executed elsewhere other than on a “regulated market” or MTF (this is through OTC dealing or against proprietary positions/internalisation). The investment firm will have the right to decide whether this prior consent will be obtained on a general (e.g. at the outset of the relationship) or on a trade-by-trade basis. This consent, when obtained on a general basis, will have to be renewed annually.

In the case of limit orders, where the client specifies conditions that prevent the prompt execution of the order, the firm shall take steps to facilitate prompt execution – either by routing it to a “regulated market” or MTF, or disclosing the limit order to the market in some other way so as to allow other market participants the opportunity to trade at the specified terms.

III.6. Dealing with eligible counterparties (article 22):

OTC trades between financial institutions and specialised trading entities, such as commodity dealers, are generally undertaken on a principal-to-principal basis. These transactions do not involve the application of conduct of business/agency protections. However, the existing Directive does not clarify what obligations, if any, are owed to counterparties in the event of a transaction that does not involve provision of a “service to a client”. It is therefore proposed to provide explicit treatment this type of inter-counterparty trading relationship in the ISD.

The provision clarifies that, in the event of a transaction involving an investment firm and an “eligible counterparty”, the obligations that would be owed to a client under “conduct of business rules” do not hold. It therefore creates a safe harbour for investment firms authorised to deal with a population of “eligible counterparties” without triggering the application of agency obligations. Investment firms should simply confirm with the counterparty, at any stage prior to or during (but not after) the conclusion of the transaction, that the latter accepts to trade without the benefit of agency protections for one or more transactions. The scope of the “eligible counterparty” category is heavily informed by the corresponding definition

adopted by CESR for the purposes of the counterparty regime. For the purposes of ISD, eligible counterparty includes the following entities:

- Authorised credit institutions, investment firms and insurance companies;
- Member States have the option of authorising additional categories of locally domiciled entity as an eligible counterparty.^{xxxviii}

The fact that an entity falls within the category of “eligible counterparties” is without prejudice to its right to request the investment firm to treat it as a “client” benefiting from conduct of business protections.

III.7. Conclusions on the investment firm regime:

The proposed modifications to the investment firm regime will:

- strengthen key investor protections which are contained in embryonic form in the existing Directive;
- allow them to be developed and enforced in respect of an ever-changing kaleidoscope of investment services;
- ensure that investment firms conduct their business in a manner that sustains overall market integrity and efficiency;
- provide for the uniform interpretation and enforcement of these disciplines across the EU.

These modifications to the ISD investment firm regime therefore lay the foundations for a modern investment firm regime which is capable of responding to the main investor protection and market efficiency challenges that are set to arise in an integrating and constantly evolving financial marketplace.

SECTION IV: SCOPE OF THE DIRECTIVE:

It is proposed to expand the scope of the Directive to integrate some investor-facing activities or dealing activities that are financial in character, are widely offered to investors, clients, or financial market participants, and/or which give rise to investor or market-facing risks which could usefully be addressed through the application of core ISD disciplines. The most notable changes (apart from the inclusion of MTF operation which is extensively dealt with in section 2) relate to the inclusion of investment advice, financial analysis, and commodity derivatives.

IV.1 Investment advice (annex I, section A):

It is proposed to recognise investment advice as an autonomous and increasingly important financial business in its own right. Its inclusion as a core ISD service should help to provide a regulatory framework which addresses the investor-facing risks specific to this business in a proportionate and flexible manner. The principal implications of inclusion in ISD will be that:

- investment advisors become subject to initial authorisation and ongoing obligations established by the ISD. Proportionate and appropriate supervisory disciplines are warranted to deal with the risk to investors of unsuitable or unprofessional/unethical conduct by advisors. Inclusion in ISD would, in particular, offer basic “conduct of

business” protections to investors when dealing with advisors authorised or located in another Member State (via remote communication technologies);

- entities (including natural persons) providing investment advice as their principal/exclusive activity, will be required to be licensed as an “investment firm” within the meaning of the ISD as opposed to being subject to specialised national regimes, as at present;
- firms providing investment advice on a “stand-alone” basis will be able to conduct business, on a cross-border/remote basis, with clients throughout the EU under the sole control of their home country authority. At present, the benefit of an ISD passport for advice is reserved to banks and investment firms providing existing core services. However, most investment advisors operate only in small geographical markets and see limited interest in an ISD passport.

The proposal seeks to establish a situation in which inclusion in this regulatory framework should not impose unjustified or over-onerous regulatory demands on investment advisors. To this end, the proposal provides for customised capital adequacy treatment for firms providing only investment advice (cf. section 3.1).

In view of the large population of investment advisors - 4’000 IFAs in UK, 7’000 advisors in Italy, even larger numbers in Germany - and the currently limited cross-border dimension of this business, the inclusion of this service has been challenged on the grounds that it will entail significant investment in authorisation and supervision in return for limited benefit in terms of functioning of the single financial market. In recognition of these concerns, it is proposed to allow competent authorities to delegate the functions of authorisation and monitoring of these entities to duly constituted and resourced self-regulatory bodies.

ISD revision will allow multi-functional investment firms to cumulate investment advice with other services. In this case, the revised ISD will entail stringent conflict of interest management and disclosure by such entities in order to ensure that the interests of the investor are paramount when advice is provided.

IV.2. Financial analysis (annex I, section B):

The provision of general investment recommendations in respect of transactions in financial instruments to clients or the public at large, in the form of financial analysis or research or other forms, must be undertaken to high professional and ethical standards in order to avoid adversely affecting the interests of the recipients of this information. The inclusion of financial analysis and research as a non-core service will avoid bringing specialised and independent research within the scope of the Directive and focus regulatory attention on those entities which combine research/analysis with other investment business in a way that may give rise to conflicts of interest.

IV.3. Commodity derivatives (annex I, section C):

It is proposed to include commodity derivatives within the scope of the new Directive so as to bring the organised trading and intermediation in these instruments within the scope of the ISD. The exclusion of commodity derivatives from the existing ISD definition of financial instruments has the following implications:

- investment firms cannot benefit from the ISD passport for the cross-border provision of investment services in commodity derivatives – even though, the capital Adequacy

Directive requires them to hold capital reserves against any trading book exposures in commodity derivatives;

- specialised commodity dealers are not covered by ISD rights or obligations;
- exchanges and other trading arrangements which provide for, inter alia, organised trading in commodity derivative instruments cannot rely on ISD provision for admission of remote members or provision of trading screens.

Having considered the many aspects of this complex issue, the Commission proposes that commodity derivatives be included within the scope of ISD. The absence of single market framework for this business is anachronistic, particularly when one considers parallel steps taken to liberalise underlying commodity and energy markets. This will allow disciplines for preventing market abuse and maintaining orderly markets to be placed on a common EU-wide footing.

The extension of the ISD to commodity derivatives business must take account of certain features specific to trading in these instruments, as well as the predominantly “wholesale/professional” nature of the market participants. In particular, the proposal recognises the widespread presence of experienced traders active in the market for hedging/commercial reasons or acting exclusively on behalf of their parent companies or affiliated subsidiaries. These are not holding themselves out as market-makers/dealers and should not be required to hold an ISD licence to deal on own account. Art. 2(2) and 2(8) make clear that such entities are not investment firms. Given their experience in trading in these instruments, Member States could classify some or all commodity traders as “eligible counterparties” which are able to trade in the marketplace without requiring “conduct of business” protections.

Specialised dealers in commodity derivatives have been active on national marketplaces, without being subject to harmonised capital adequacy requirements, without occasioning prudential or systemic problems. Nevertheless, it cannot be excluded that such entities incur and themselves become a source of counterparty risk to other market participants. However, at this juncture, there is no consensus on the prudential arrangements that should be imposed on entities engaged in dealing in commodities derivatives as their main business. The proposal therefore provides that specialised dealers in commodity derivatives shall not be considered as investment firms for the purposes of the ISD. In determining whether the main business of the firm is dealing in commodity derivatives, the activities of the firm shall be considered at a group/consolidated level. Given that traders see the advantage that a passport will bring when doing business in other Member States, and that financial regulators see benefits in being able to supervise and police financial arbitraging undertaken by entities whose sole function is to run a trading book, albeit in a specific class of financial instruments, it is proposed to review this exemption 2 years after the entry into force of this Directive. That review shall take account of any need to adapt the prudential framework to take account of any specificities of this business.

The definition of commodity derivatives to be used for the purposes of this Directive has been carefully considered so as to limit its reach to instruments which are constituted and traded in such a way as to give rise to regulatory issues comparable to traditional financial instruments. The definition of commodity derivatives employed for the purposes includes certain futures contracts traded on regulated markets (or MTF) which are physically settled where those contracts possess the characteristics of financial instruments. In this respect, regard may be had to whether, inter alia, they are cleared and settled through a recognised clearing houses,

give rise to daily margin calls, are priced in reference to regularly published prices, standard lots, delivery dates or standard terms as opposed to the price being specified in individual contracts. The definition also includes other contracts for differences such as swaps which are settled only in cash and where the amounts to be settled are calculated by reference to values of a full range of underlying prices, rates, indices and other measures. The definition does not include physically-settled spot or forward exchange or commodities

SECTION V: OTHER KEY FEATURES OF PROPOSAL:

V.1. Clearing and settlement:

The proposal does not seek to establish a harmonised framework for the authorisation, ongoing supervision and mutual recognition of entities engaged in the provision of clearing and settlement activities. The Commission recognises that robust and efficient linkages between competitive providers of post-trading services are needed to bring about a situation in which a cross-border transaction can be undertaken on comparable terms to a purely domestic trade. The efficient clearing and settlement of securities transactions is also crucial to the orderly functioning of securities markets, the smooth conduct of monetary policy operations, and the stability of the financial system as a whole. The Commission also acknowledges that the blurring of the distinction between “custodianship” – a non-core ISD service – and CSDs is giving rise to concerns relating to regulatory arbitrage between entities licensed under the two regimes. However, it is precisely because of their systemic importance and the complex technical and public policy considerations that require a considered response, that the Commission does not believe that these distinct types of market function should be addressed by ISD.

Merely adding clearing and settlement functions to the list of ISD services, without harmonising the risk-management practices to be implemented or creating an effective supervisory framework will not only fail to deliver an effective single market environment for the organisation of these activities: it could prove counterproductive from the perspective of sound prudential supervision of these entities. Simply labelling these activities as ISD services is no panacea. A considered view of the regulatory framework required to support a sound and integrated post-trading infrastructure must first be established. On this basis, the actions needed to create the legal, administrative, technical and fiscal environment in which clearing and settlement can be reorganised can be identified and implemented. Discussions on the content of this programme of action have recently been launched at European level.

In view of the preceding considerations, the proposal for ISD revision confines its treatment of clearing and settlement to clarification of the rights of the investment firm and regulated market populations in terms of access to/choice of clearing and settlement facilities located in other Member States (article 32). These rights are not absolute: demonstrable prudential concerns on the part of the supervisor, or commercial interests of clearing and settlement providers may prevail over the access demands of investment firms or market operators.

V.2. Competent authorities and supervisory co-operation (title IV):

The proposal comprehensively revamps existing provisions on competent authorities and supervisory cooperation. There are three important strands to this work:

- to clarify the attribution of responsibilities for enforcement of provisions of the Directive (article 45). Given that ISD is an omnibus Directive, it may require the involvement of a

number of competent authorities to enforce its wide-ranging provisions - particularly so in Member States which have not grouped financial supervisory responsibilities under one roof. ISD revision is without prejudice to the configuration of supervisory structures within Member States. It requires that Member States clearly identify the competent authority which is responsible for enforcement of the individual provisions, so as to allow this information to be communicated to other Member States. The chapter also establishes the conditions under which competent authorities can delegate responsibility to other entities including self-regulatory bodies. Where such delegation is permitted in the individual provisions of the proposal (e.g. provisions relating to investment advisors, tied agents, regulated markets), it must be undertaken in accordance with the conditions specified in article 46(2).

- to provide for some convergence in the powers at the disposal of competent authorities so as to pave the way towards equivalent intensity of enforcement across the integrated financial market. The list of powers (article 46), and provision for administrative sanctions (article 47) are modelled on similar provisions which have been introduced in the Prospectus and Market Abuse Directives;
- to upgrade existing provisions on exchange of information between national competent authorities and strengthen the duties of assistance and cooperation which they owe to each other (articles 51-55). Existing ISD provisions on supervisory cooperation were designed for a context in which links between segmented national markets were underdeveloped and infrequently used. The greater intensity and immediacy of transmission mechanisms between national markets calls for a corresponding intensification of cooperation between supervisors. Collaboration of this nature will be all the more necessary if the confidence needed to support systematic reliance on home country supervision is to be sustained.

V.3. Use of committee procedures (comitology) to implement provisions:

Member States' securities markets are facing dramatic changes and increasing consolidation, driven by new technologies, globalisation and the effect of the euro. Standard setting is also evolving rapidly. Competition between securities markets calls for best practice taking new financial techniques and new products into account. On the other hand, investor protection and confidence has to be maintained at Community level.

To meet the challenge of regulating modern financial markets, new legislative techniques have to be introduced. On 17 July 2000, the Council set up the Committee of Wise Men on the Regulation of European Securities Markets. In its final report, the Committee called for each Directive to be a split between framework principles and "non-essential" technical implementing measures to be adopted by the Commission under the Union's committee procedures. In its resolution on more effective securities markets regulation in the European Union, the Stockholm European Council welcomed the Commission's intention to establish a Securities Committee. The Securities Committee, acting in its advisory capacity, should be consulted on policy issues, in particular for the kind of measures the Commission might propose at the level of framework principles. In its resolution, the European Council added that, subject to specific legislative acts proposed by the Commission and adopted by the European Parliament and the Council, the Securities Committee should function as a regulatory committee in accordance with the 1999 Decision on comitology to assist the Commission when it takes decisions on implementing measures under Article 202 of the EC Treaty. This Directive follows the guidelines laid down by the Stockholm European Council and the European Parliament.

The provisions of the proposed Directive seek to confine themselves to a high level statement of the principal obligations incumbent on national authorities or authorised entities. The statement of high level principles is supplemented, where appropriate, by the specification of the principal matters to be harmonised through detailed implementing measures to be adopted through comitology, and the main legal and technical concepts which detailed implementing measures should take into account.

The amended proposal identifies the second-tier implementing arrangements that will have to be decided by the Commission by the committee procedure - for example, adaptation and clarification of certain definitions or adoption of detailed implementing measures to give effect to the obligations set out in the Directive. The proposal seeks to limit the use of comitology to those operational provisions where detailed harmonisation will be crucial to the uniform application of ISD provisions and the smooth development of the single financial market. Account must also be taken of the heavy investment that must be made in the promulgation of detailed implementing measures by EU institutions, national competent authorities and securities supervisors and market practitioners (via their involvement in consultation procedures).

Despite this restrictive approach, the scale of the Directive and the introduction of important new disciplines at EU level (e.g. transparency rules, “best execution”) call for extensive use of comitology powers to give effect to core provisions of the proposal. 20 of the 67 articles provide for some use of comitology.

Annex 1: Overview of Directive 93/22.

(a). single passport for investment firms:

The primary objective of the ISD was “to effect only the essential harmonisation necessary and sufficient to secure the mutual recognition of authorisation and of prudential supervision systems making possible the grant of a single authorisation valid throughout the Community and the application of the principle of home Member State supervision; whereas, by virtue of mutual recognition, investment firms authorised in their home Member States may carry on or all of the services covered by this Directive for which they have received authorisation throughout the Community by establishing branches or under the freedom to provide services”.

Entities (natural and legal persons) which provide, as their regular occupation, investment services listed in annex to the ISD are required to be licensed and supervised as investment firms in accordance with the provisions of the Directive. Credit institutions are entitled to provide investment services on the basis of their 2BCD licence as long as they comply with specified provisions of the ISD (e.g. conduct of business rules). Article 2(2) of the Directive excludes a number of categories of operator, which would otherwise be categorised as investment firms, from the scope of the Directive.

Core services for which an ISD license is compulsory include reception and transmission of orders, execution of orders (brokerage), dealing, individual portfolio management and underwriting. Firms can provide a combination of core and non-core services as long as they are explicitly authorised to do so and this is specified in their license. In addition, licensed investment firms may also provide a range of non-core services on a cross-border basis on the basis of their ISD licence. The main non-core services include safekeeping and administration of assets (custodianship), and investment advice. Firms may be licensed at national level to provide one or more non-core services without being licensed to provide any of the core services. In such cases, the firm cannot rely on this authorisation when trying to provide those non-core services in other Member States.

The principal start-up and ongoing obligations imposed on investment firms include:

- Possession of initial and ongoing capital reserves in accordance with the requirements resulting from CAD (93/6);
- Organisational requirements designed to uphold the orderly conduct of the firms operations (art. 10);
- Conduct of business rules governing the way in which acts in its dealings with and on behalf of its clients, and when participating in the market (art. 11);
- membership of an Investor Compensation Scheme Directive (art. 12 and Dir. 97/9).
- Reporting of transactions in specified instruments conducted on/off exchange (art. 20).

On the basis of compliance with the minimal harmonisation embodied in these provisions, the investment firm benefits from the right to:

- Freely provide investment services to clients in other Member States on the basis of home country supervision, except where otherwise provided for in the provision of the Directive (e.g. Articles 11, 13);
- Establish branches in other Member States for the provision of investment services;

- Benefit from a right of access, on a direct, indirect or remote basis, to the trading systems of exchanges/regulated markets in other Member States. This right also extends to membership of clearing and settlement arrangements which are used to finalise transactions concluded on the “regulated market” in question.

(b). conditions for recognition as a “regulated market”.

The ISD also introduced the first elements for a common regime for national authorisation and supervision of regulated markets. Trading venues organised on a permanent basis, operating in accordance with publicly approved trading rules, and imposing strict controls on the securities admitted to trading so as to sustain effective dealing in that instrument, are eligible for authorisation as regulated markets. A “regulated market” is also required make available information “to enable investors to assess at any time the terms of a transaction they are considering and to verify afterwards the conditions in which it has been carried out” (cf. Article 21 defining broad pre and post-trade transparency requirements). Conferral of “regulated market” status requires the market to admit any duly authorised bank or investment firm from another Member States as a market participant. The “regulated market” benefits from the right to place trading screens and terminals on the desks of remote/overseas members so as to allow the latter to participate fully in trading on the market. Under Article 16 of the Directive, the Commission is required to publish a list of regulated markets on an annual basis.

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL
ON INVESTMENT SERVICES AND REGULATED MARKETS, AND AMENDING
COUNCIL DIRECTIVES 85/611/EEC AND EUROPEAN PARLIAMENT AND
COUNCIL DIRECTIVE 2000/12/EC

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 47(2) thereof,

Having regard to the proposal from the Commission¹,

Having regard to the opinion of the Economic and Social Committee²,

Having regard to the opinion of the European Central Bank³,

Acting in accordance with the procedure laid down in Article 251 of the Treaty⁴,

Whereas:

- (1) Council Directive of 10 May 1993 on investment services in the securities field 93/22/EEC⁵ sought to establish the conditions under which authorised investment firms and banks could provide specified services or establish branches in other Member States on the basis of home country authorisation and supervision. To this end, that Directive aimed to harmonise the initial authorisation and operating requirements for investment firms including conduct of business rules. It also provided for the harmonisation of some conditions governing the operation of regulated markets. In this respect, it granted Member States the option of allowing retail investors to request execution of their transactions on a regulated market.
- (2) In recent years more investors have become active in the financial markets and are offered an even more complex wide-ranging set of services and instruments. In view of these developments the legal framework of the Community should encompass the full range of investor oriented activities. To this end, is necessary to provide for the degree of harmonisation needed to offer investors a high level of protection and to allow investment firms to provide services throughout the Community, being a Single

¹ OJ C , , p. .

² OJ C , , p. .

³ OJ C , , p. .

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⁵ OJ L 141, 11.6.93, p.27 Directive as last amended by European Parliament and Council Directive 2000/64/EC (OJ L 290, 17.11.2000, p.27)

Market, on the basis of home country supervision. In view of the preceding, Directive 93/22/EEC should be replaced by a new Directive.

- (3) Due to the increasing dependence of investors on personal recommendations, it is appropriate to include the provision of investment advice as an investment service requiring authorisation. Therefore proportionate and relevant requirements should be imposed on investment advisors to ensure that the content of personal recommendations is not influenced by factors other than the financial situation, investment objectives, knowledge, risk profile and expertise of the client. Those requirements should not apply to the mere provision of information of a general nature on financial instruments, provided that the purpose of that activity is not to help the client conclude or fulfil a contract for an investment service or financial instrument. In granting authorisation to provide investment advice, the competent authority or body to whom it delegates this responsibility, should be able to take into account any authorisation conditions required for registration as an insurance intermediary which overlap with the requirements laid down in this Directive.
- (4) It is appropriate to include in the list of financial instruments commodity derivatives which are constituted and traded in such a way as to give rise to regulatory issues comparable to traditional financial instruments such as certain futures or options contracts traded on regulated markets, which might be physically settled, where those contracts possess the characteristics of financial instruments, and swaps which are settled only in cash and where the amounts to be settled are calculated by reference to values of a full range of underlying prices, rates, indices and other measures. In this respect, regard may be had to whether, inter alia, they are cleared and settled through a recognised clearing houses, give rise to daily margin calls, are priced in reference to regularly published prices, standard lots, standard delivery dates or standard terms as opposed to the terms of settlement being specified in individual contracts.
- (5) It is necessary to establish a comprehensive regulatory regime governing the execution of transactions on financial instruments irrespective of the trading methods used to conclude those transactions so as to ensure a high quality of execution of investor transactions and to uphold the integrity and overall efficiency of the financial system. A coherent and risk-sensitive framework for regulating the main types of order-execution arrangement currently active in the European financial marketplace should be provided for. It is necessary to recognise the emergence of a new generation of organised trading systems alongside regulated markets which should be subjected to obligations designed to preserve the efficient and orderly functioning of financial markets. With a view to establishing a proportionate regulatory framework provision should be made for the inclusion of a new investment service which relates to the operation of Multilateral Trading Facilities (MTFs).
- (6) Definitions of regulated market and MTF should be introduced and closely aligned with each other to reflect the fact that they represent the same organised trading functionality. The definitions should exclude bilateral systems where the investment firm enters into every trade on own account and not as a riskless counterparty interposed between the buyer and seller. The term “buying and selling interests” is to be understood in a broad sense and includes orders, quotes and indications of interest. The requirement that the interests be “brought together ... in the system by means of non-discretionary rules set by the system operator” means that they are brought together under the system’s rules or by means of the system’s protocols or internal operating procedures (including procedures embodied in computer software). These

rules should be approved by the competent authority. The expression “non-discretionary rules” means that these rules leave the investment firm operating an MTF with no discretion as to how interests may interact. The definitions require that interests are brought together in such a way as to result in a contract, meaning that execution take place under the system’s rules or by means of the system’s protocols or internal operating procedures.

- (7) The purpose of this Directive is to cover undertakings the normal business of which is to provide third parties with investment services on a professional basis. Its scope should not therefore cover any person with a different professional activity.
- (8) Insurance undertakings the activities of which are subject to appropriate monitoring by the competent prudential-supervision authorities and which are subject of Council Directive 64/225/EEC of 25 February 1964 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of reinsurance and retrocession⁶, First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of direct insurance other than life assurance⁷ and First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of direct life assurance⁸ should be excluded.
- (9) Undertakings which do not provide services for third parties but the business of which consists in providing investment services solely for their parent undertakings, for their subsidiaries, or for other subsidiaries of their parent undertakings should not be covered by this Directive.
- (10) Persons who provide investment services only on an incidental basis in the course of professional activity should also be excluded from the scope of this Directive, provided that activity is regulated and the relevant rules do not prohibit the provision, on an incidental basis, of investment services.
- (11) Firms which provide investment services consisting exclusively in the administration of employee-participation schemes and which therefore do not provide investment services for third parties should not be covered by this Directive.
- (12) It is necessary to exclude from the scope of this Directive central banks and other bodies performing similar functions as well as public bodies charged with or intervening in the management of the public debt, which concept covers the investment thereof, with the exception of bodies that are partly or wholly State-owned the role of which is commercial or linked to the acquisition of holdings.
- (13) It is also necessary to exclude from the scope of this Directive collective investment undertakings whether or not coordinated at Community level, and the depositaries or

⁶ OJ 56, 4.4. 1964, p. 878/64; Directive as amended by the Act of Accession of Denmark, Ireland and the United Kingdom.

⁷ OJ L 228, 16.8.1973, p.3; Directive as last amended by European Parliament and Council Directive 2002/13/EC (OJ L 77, 20.3. 2002, p. 17).

⁸ OJ L 63, 13.3.1979, p. 1; Directive as last amended by European Parliament Directive 2002/12/EC (OJ L 77, 20.3.2002, p.11).

managers of such undertakings, since they are subject to specific rules directly adapted to their activities.

- (14) Firms that provide the investment services covered by this Directive should be subject to authorization by their home Member States in order to protect investors and the stability of the financial system.
- (15) The principles of mutual recognition and of home Member State supervision require that the Member States' competent authorities should not grant or should withdraw authorization where factors such as the content of programmes of operations, the geographical distribution or the activities actually carried on indicate clearly that an investment firm has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State within the territory of which it intends to carry on or does carry on the greater part of its activities. An investment firm which is a legal person should be authorized in the Member State in which it has its registered office. An investment firm which is not a legal person should be authorized in the Member State in which it has its head office. In addition, Member States should require that an investment firm's head office must always be situated in its home Member State and that it actually operates there.
- (16) An investment firm authorized in its home Member State should be able to carry on business throughout the Community by whatever means it deems appropriate.
- (17) In the interest of the sound and prudent management of the investment firm, special obligations should be imposed on persons who effectively direct the business and persons exercising effective control. Since certain investment firms are exempted from the obligation imposed by Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions⁹, they should be obliged to hold professional indemnity insurance. The adjustments of the amounts of that insurance should take account adjustments made in the framework of European Parliament and Council Directive 2002/.../EC of ...2002 on insurance Mediation¹⁰. This particular treatment for the purposes of capital adequacy should be without prejudice to any decisions regarding the appropriate treatment of these firms under future changes to Community legislation on capital adequacy. No later than the 31.December2006, the Commission should present a report to the European Parliament and the Council on the application of these provisions accompanied where appropriate by proposals for their revision. These proposals should take account of developments within the Community and other international fora , particularly those pertaining to capital charges on operational risk.
- (18) Since the scope of prudential regulation should be limited to those entities which, by virtue of running a trading book on a professional basis, represent a source of counterparty risk to other market participants, entities which deal for their own account in financial instruments, including those commodity derivatives covered by this Directive, on an ancillary basis to their main business, should be excluded from the scope of this Directive.

⁹ OJ L 141, 11.6.1993, P. 1; Directive as last amended by European Parliament and Council Directive 98/33/EC (OJ L 204, 21.7.1998, p.29).

¹⁰ OJ L

- (19) Since the prudential framework established by Community law is not currently adapted to the specific situation of undertakings whose main business, when considered on a consolidated basis, consists of dealing on own account in commodity derivatives it is appropriate to exclude them from the scope of this Directive.
- (20) In order to protect an investor's ownership and other similar rights in respect of securities and his rights in respect of funds entrusted to a firm those rights should in particular be protected by being kept distinct from those of the firm. This principle should not, however, prevent a firm from doing business in its name but on behalf of the investor, where that is required by the very nature of the transaction and the investor is in agreement, for example stock lending.
- (21) For the purposes of ensuring that retail investors do not enter into unsuitable transactions, access to the systems operated by an MTF should be restricted to investment firms and credit institutions for the purposes of trading on own account or on behalf of their customers and other eligible counterparties.
- (22) The procedures for the authorisation , within the Community, of branches of investment firms authorized in third countries should continue to apply to such firms. Those branches should not enjoy the freedom to provide services under the second paragraph of Article 49 of the Treaty or the right of establishment in Member States other than those in which they are established. In view of cases where the Community is not bound by any bilateral or multilateral obligations it is appropriate to provide for a procedure intended to ensure that Community investment firms receive reciprocal treatment in the third countries concerned.
- (23) The expanding range of activities that many investment firms and credit institutions undertake simultaneously has increased potential for conflicts of interests between these different activities and the interest of their clients. It is therefore necessary to provide for rules to ensure that such conflicts do not adversely affect client interest.
- (24) It is necessary to strengthen the Community's legislative framework to protect investors by enhancing obligations of investment firms when providing services with or on behalf of clients. In particular, it is indispensable for an investment firm acting on behalf of a client, in order to properly fulfil its agency obligations to its clients, to obtain information on the client's financial position, experience and investment objectives and to assess the suitability, for that client, of services or transactions in financial instruments which are being considered in the light of this information. The performance of this assessment should not require a separate authorisation to provide investment advice.
- (25) By way of derogation from the principle of home country authorisation, supervision and enforcement of obligations in respect of the operation of branches, it is appropriate that the competent authority of the host Member State assumes responsibility for enforcing conduct of business rules in relation to business conducted with clients through a branch, since that authority is in greatest proximity to the branch, and is better placed to detect and intervene in respect of infringements of rules governing firm-client transactions.
- (26) It is necessary to impose an effective "best execution" obligation to ensure that investment firms execute client orders on terms that are most favourable to the client. This obligation should apply to the firm which owes contractual or agency obligations

to the client – irrespective of whether that firm executes the order itself or relies on another intermediary to do so.

- (27) In order to enhance confidence in the impartiality and quality of execution services and to improve the overall price-formation process, it is essential that the investment firm which receives a limit order and is unable to execute such an order on specified terms immediately, routes it to a "regulated market" or MTF, or discloses the terms of the trading interest to the market in some other way.
- (28) This Directive recognises that investors should be fully aware of the potential risks and benefits associated with particular order handling arrangements. To this end, the clients should give their express consent before their orders are executed, in particular against the proprietary positions of the firm. The investment firm should have the right to decide whether to obtain this prior consent on a general basis (e.g. at the outset of the relationship) or on a trade-by-trade basis.
- (29) It is appropriate to determine the conditions under which investment firms can rely on the offices of tied agents. As it performs limited range of functions on behalf of one investment firm, the tied-agent should not be considered an investment firm itself and should not be eligible to undertake its activities in other Member States. Member States should be able to delegate responsibility as regards the authorisation, registration and supervision of tied agents to appropriately resourced and independent self-regulatory bodies. This Directive should be without prejudice to the right of tied agents to undertake related activities in respect of financial services or products not covered by this Directive, including on behalf of parts of the same financial group. The conditions for conducting activities outside the premises of the investment firm (door-to-door selling) should not be covered by this Directive.
- (30) For the purposes of ensuring that conduct of business rules are enforced in respect of those investors most in need of these protections, and in reflection of well-established market practice throughout the Community, it is appropriate to clarify that conduct of business rules may be waived in the case of transactions between eligible counterparties.
- (31) The mere fact, however, that an entity which is neither a credit institution nor an investment firm may be recognised as "eligible counterparty" should not deprive it of the right to be treated as a client to whom conduct of business or other agency protections are owed.
- (32) With the two-fold aim of protecting investors and ensuring the smooth operation of securities markets, it is necessary to ensure that transparency of transactions is achieved and that the rules laid down for that purpose apply both to investment firms and to credit institutions when they operate on the markets. In order to enable investors or market participants to assess at any time the terms of a transaction on shares that they are considering and to verify afterwards the conditions in which it has been carried out, common rules should be established for the publication of details of completed transactions in shares and disclosure of details of current opportunities to trade in shares. These rules are needed to ensure the effective integration of Member State equity markets, to promote the efficiency of the overall price formation process for equity instruments, and to assist the effective operation of "best execution" obligations. These considerations require a comprehensive transparency regime

applicable to all transactions in shares irrespective of their execution by an investment firm on a bilateral basis or through regulated markets or MTF.

- (33) In order to ensure a degree of pre-trade information needed to support the efficient formation of prices in shares and to allow market participants to determine the most favourable terms for concluding transactions, it is appropriate to require investment firms dealing on own account to make public a firm two-sided quote for transactions of a specified size in respect of liquid shares.
- (34) Investment firms should all have the same opportunities of joining or having access to regulated markets throughout the Community. Regardless of the manner in which transactions are at present organized in the Member States, it is important to abolish the technical and legal restrictions on direct, indirect and remote access to the regulated markets.
- (35) In order to facilitate the finalisation of cross-border transactions, it is also appropriate to provide for the access to clearing and settlement systems throughout the Community, by investment firms including those operating MTF, irrespective of whether transactions have been concluded through regulated markets in the Member State concerned. Investment firms which wish to participate directly in partner country settlement systems should have to comply with the relevant operational and commercial requirements for membership and the prudential measures to uphold the smooth and orderly functioning of the financial markets.
- (36) The authorisation to operate a regulated market should extend to all activities which are directly related to the display, processing, execution, confirmation and reporting of orders from the point at which such orders are received by the regulated market to the point at which they are transmitted for subsequent finalisation, and to activities related to the admission of financial instruments to trading. This should also include transactions concluded through the medium of designated market makers appointed by the regulated market which are undertaken under its rules and systems.
- (37) Operators of a regulated market should also be able to operate an MTF without being required to obtain additional authorisation as an investment firm.
- (38) The provisions of this Directive concerning the admission of instruments to trading under the rules enforced by the regulated market should be without prejudice to the application of Directive 2001/34/EC of the European parliament and of the Council of 28 May 2001 on the admission of securities to official stock exchange listing and on information to be published on those securities¹¹. A regulated market should not be prevented from applying more demanding requirements in respect of the issuers of securities or instruments which it is considering for admission to trading than are imposed pursuant to this Directive.
- (39) Member States should be able to designate different competent authorities to enforce the wide-ranging obligations laid down in this Directive. Such authorities should be of public nature guaranteeing its independence of economic actors and avoiding conflicts of interest. The designation of public authorities should not exclude delegation under the responsibility of the competent authority.

¹¹ OJ L 184, 6.7.2001, p. 1.

- (40) It is necessary to enhance convergence of powers at the disposal of competent authorities so as to pave the way towards equivalent intensity of enforcement across the integrated financial market. A common minimum set of powers coupled with adequate resources should guarantee supervisory effectiveness.
- (41) With a view to protecting clients and without prejudice to the right of customers to bring their action before the courts, it is appropriate that Member States encourage public or private bodies established with a view to settling disputes out-of-court, to cooperate in resolving cross-border disputes, taking into account Commission Recommendation 98/257/EC of 30 March 1998 on the principles applicable to the bodies responsible for out-of-court settlement of consumer disputes¹². When implementing provisions on complaints and redress procedures for out-of-court settlements, Member States are encouraged to use existing cross border co-operation mechanisms, notably the Financial Services Complaints Network (FIN-Net).
- (42) It is necessary to reinforce provisions on exchange of information between national competent authorities and to strengthen the duties of assistance and cooperation which they owe to each other. Due to increasing cross-border activity, competent authorities should provide each other with the relevant information for the exercise of their functions, so as to ensure the effective enforcement of this Directive including in situations where infringements or suspected infringements may be of concern to authorities in two or more Member States. In the exchange of information, strict professional secrecy is needed to ensure the smooth transmission of that information and the protection of particular rights.
- (43) At its meeting on 17 July 2000, the Council set up the Committee of Wise Men on the Regulation of European Securities Markets. In its final report, the Committee of Wise Men proposed the introduction of new legislative techniques based on a four-level approach, namely framework principles, implementing measures, cooperation and enforcement. Level 1, the Directive, should confine itself to broad general "framework" principles while Level 2 should contain technical implementing measures to be adopted by the Commission with the assistance of a committee.
- (44) The Resolution adopted by the Stockholm European Council of 23 March 2001 endorsed the final report of the Committee of Wise Men and the proposed four-level approach to make the regulatory process for Community securities legislation more efficient and transparent.
- (45) According to the Stockholm European Council, Level 2 implementing measures should be used more frequently, to ensure that technical provisions can be kept up to date with market and supervisory developments, and deadlines should be set for all stages of Level 2 work.
- (46) The Resolution of the European Parliament of 5 February 2002 on the implementation of financial services legislation also endorsed the Committee of Wise Men's report, on the basis of the solemn declaration made before Parliament the same day by the Commission and the letter of 2 October 2001 addressed by the Internal Market Commissioner to the chairman of Parliament's Committee on Economic and Monetary Affairs with regard to the safeguards for the European Parliament's role in this process.

¹² OJ L 115, 17.4.1998, p.31.

- (47) The measures necessary for the implementation of this Directive should be adopted in accordance with Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission¹³.
- (48) The European Parliament should be given a period of three months from the first transmission of draft implementing measures to allow it to examine them and to give its opinion. However, in urgent and duly justified cases, this period may be shortened. If, within that period, a resolution is passed by the European Parliament, the Commission should re-examine the draft measures
- (49) With a view to take into account further developments in the financial markets the Commission should submit reports to the European Parliament and the Council on the application of the provisions concerning the professional indemnity insurance, the scope of the transparency rules and the possible authorisation of specialized dealers in commodities derivatives as investment firms.
- (50) Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities¹⁴, Directive 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council of 20 March relating to the taking up and pursuit of the business of credit institutions¹⁵ should be amended in order to align them with the provisions of this Directive.
- (51) The objectives of creating an integrated financial market in which investors are effectively protected and the efficiency and integrity of the overall market are safeguarded, require the establishment of common regulatory requirements relating to investment firms wherever they are authorised in the Community and governing the functioning of regulated markets and other trading systems so as to prevent opacity or disruption on one market from undermining the efficient operation of European financial system as a whole. Given that these objectives may be better achieved at Community level, the Community may adopt measures in accordance with the principle of subsidiarity as set out in Article 5 of the Treaty. In accordance with the principle of proportionality, as set out in that Article, this Directive does not go beyond what is necessary in order to achieve those objectives,

HAVE ADOPTED THIS DIRECTIVE:

TITLE I

DEFINITIONS AND SCOPE

Article 1 *Scope*

1. This Directive shall apply to investment firms and regulated markets.

¹³ OJ L 184, 17.7.1999, p. 23.

¹⁴ OJ L 375, 31.12.1985, p.3; Directive as last amended by European Parliament and Council Directive 2001/108/EC (OJ L 41, 13.2.2002,p.35).

¹⁵ OJ L 126, 26.5.2000, p. 1; Directive as amended by Directive 200/28/EC (OJ L 275, 27.10.2000, p.37).

2. Articles 12 and 13 and Chapters II and III of Title II shall apply also to credit institutions authorised under Directive 2000/12/EC to perform one or more investment services.

Article 2
Exemptions

1. This Directive shall not apply to:
 - (a) insurance undertakings as defined in Article 1 of Directive 73/239/EEC or in Article 1 of Directive 79/267/EEC or undertakings carrying on the reinsurance and retrocession activities referred to in Directive 64/225/EEC;
 - (b) firms which provide investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings;
 - (c) persons providing an investment service where that service is provided in an incidental manner in the course of a professional activity and that activity is regulated by legal or regulatory provisions or a code of ethics governing the profession which do not exclude the provision of that service;
 - (d) firms which provide investment services consisting exclusively in the administration of employee-participation schemes;
 - (e) firms which provide investment services which involve both administration of employee-participation schemes and the provision of investment services exclusively for their parent undertakings, for their subsidiaries or for other subsidiaries of their parent undertakings;
 - (f) the members of the European System of Central Banks and other national bodies performing similar functions and other public bodies charged with or intervening in the management of the public debt;
 - (g) collective investment undertakings whether co-ordinated at Community level or not and the depositaries and managers of such undertakings;
 - (h) persons dealing on own account in financial instruments as an ancillary activity to their main business, where that main business is not the provision of investment services within the meaning of this Directive or banking services under Directive 2000/12/EC;
 - (i) undertakings whose main business, when considered on a consolidated basis, consists of dealing on own account in commodity derivatives;
 - (j) firms which provide investment services consisting exclusively in dealing for their own account on financial-futures or options markets or which deal for the accounts of other members of those markets or make prices for them and which are guaranteed by clearing members of the same markets, and where responsibility for ensuring the performance of contracts entered into by such firms is assumed by clearing members of the same markets;

- (k) associations set up by Danish pension funds with the sole aim of managing the assets of pension funds that are members of those associations;
- (l) 'agenti di cambio' whose activities and functions are governed by Article 201 of Italian Legislative Decree No 58 of 28 February 1998.
2. The rights conferred by this Directive shall not extend to the provision of services as counterparty in transactions carried out by members of the European System of Central Banks performing their tasks as provided for by the Treaty and the Statute of the European System of Central Banks and of the European Central Bank.
3. In order to take account of developments on financial markets, and to ensure the uniform application of this Directive, the Commission, acting in accordance with the procedure referred to in Article 59(2), may clarify the exemptions provided for under paragraph 1 of this Article.

Article 3
Definitions

1. For the purposes of this Directive, the following definitions shall apply:
- (1) *Investment firm* means any legal person whose regular occupation or business is the provision of investment services on a professional basis;
 - (2) *Investment service* means any of the services listed in Section A of Annex I relating to any of the instruments listed in Section C of Annex I;
 - (3) *Ancillary service* means any of the services listed in Section B of Annex I relating to any of the instruments listed in Section C of Annex I;
 - (4) *Investment advice* means the provision of personal recommendation to a client in respect of one or more transactions relating to financial instruments;
 - (5) *Execution of orders on behalf of clients* means acting as an agent to conclude agreements to buy or sell one or more financial instruments on behalf of clients;
 - (6) *Dealing on own account* means active trading against proprietary capital, on a regular and professional basis, resulting in the conclusion of transactions in one or more financial instruments;
 - (7) *Client* means any natural or legal person seeking the provision of investment and ancillary services from an investment firm;
 - (8) *Professional client* means a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs, in accordance with the criteria and procedures laid down in Annex II;
 - (9) *Market operator* means a person or persons who effectively direct the business of a regulated market;

- (10) *Regulated market* means a multilateral system, operated by a market operator, 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, in respect of the financial instruments admitted to trading under its rules and systems, and which is authorised and functions regularly and in accordance with the provisions of Title III;
- (11) *Multilateral trading facility (MTF)* means 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;
- (12) *Market order* means an order to buy or sell a financial instrument at the best available price;
- (13) *Limit order* means an order to buy or sell a financial instrument at its specified limit or better;
- (14) *Financial instrument* means those instruments specified in Section C of Annex I;
- (15) *Transferable securities* means those classes of securities which are negotiable on the capital market, with the exception of instruments of payment, such as:
- (a) shares in companies and other securities equivalent to shares in companies, partnership or other entities, and depositary receipts in respect of shares;
 - (b) bonds or other forms of securitized debt;
 - (c) any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures;
- (16) *Money-market instruments* means those classes of instruments which are normally dealt in on the money market, such as treasury bills, certificates of deposit and commercial papers and excluding instruments of payment;
- (17) Home Member State means:
- (a) in the case of investment firms:
 - i) if the investment firm is a natural person, the Member State in which its head office is situated;
 - ii) if the investment firm is a legal person, the Member State in which its registered office is situated. In this case, the competent authority shall also ensure that the head office of the firm is located in this Member State;
 - iii) if the investment firm has, under its national law, no registered office, the Member State in which its head office is situated;

- (b) in the case of a regulated market, the Member State in which the regulated market is registered or, if under the law of that Member State it has no registered office, the Member State in which the head office of the regulated market is situated;
- (18) *Host Member State* means the Member State in which an investment firm has a branch or provides services;
- (19) *Competent authority* means the authority, designated by the home Member State in accordance with Article 45, unless otherwise specified in this Directive;
- (20) *Credit institutions* means credit institutions as defined under Directive 2000/12/EC;
- (21) *UCITS Management company* means a management company as defined in Directive 85/611/EEC;
- (22) *Tied agent* means a natural or legal person who, without being considered as an investment firm for the purposes of this Directive, promotes the investment and ancillary services of an investment firm to clients or prospective clients, collects and transmits instructions or orders from the client in respect of investment services or financial instruments to that investment firm, and provides advice to clients or prospective clients in respect of the financial instruments or services offered by the investment firm under the full and unconditional responsibility of the investment firm on whose behalf it acts;
- (23) *Branch* means a place of business which is a part of an investment firm, which has no legal personality and which provides investment services for which the investment firm has been authorised;
- (24) *Qualifying holding* means any direct or indirect holding in an investment firm which represents 10 % or more of the capital or of the voting rights, as set out in Article 7 of Council Directive 88/627/EEC¹⁶, or which makes it possible to exercise a significant influence over the management of the investment firm in which that holding subsists;
- (25) *Parent undertaking* means a parent undertaking as defined in Articles 1 and 2 of Council Directive 83/349/EEC¹⁷;
- (26) *Subsidiary* means a subsidiary undertaking as defined in Articles 1 and 2 of Directive 83/349/EEC, including any subsidiary of a subsidiary undertaking of an ultimate parent undertaking;
- (27) *Control* means control as defined in Article 1 of Directive 83/349/EEC;
- (28) *Close links* means a situation in which two or more natural or legal persons are linked by:

¹⁶ OJ L 348, 17.12.1988, p. 62.

¹⁷ OJ L 193, 18.7.1983, p. 1.

- (a) *participation* which means the ownership, direct or by way of control, of 20 % or more of the voting rights or capital of an undertaking,
- (b) *control* which means the relationship between a parent undertaking and a subsidiary, in all the cases referred to in Article 1(1) and (2) of Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking, any subsidiary undertaking of a subsidiary undertaking also being considered a subsidiary of the parent undertaking which is at the head of those undertakings.

A situation in which two or more natural or legal persons are permanently linked to one and the same person by a control relationship shall also be regarded as constituting a close link between such persons.

- 2. In order to take account of developments on financial markets, and to ensure the uniform application of this Directive, the Commission, acting in accordance with the procedure referred to in Article 59(2), may clarify the definitions provided in paragraph 1 of this Article.

TITLE II

AUTHORISATION AND OPERATING CONDITIONS FOR INVESTMENT FIRMS

Chapter 1

CONDITIONS AND PROCEDURES FOR AUTHORISATION

Article 4

Requirement for authorisation

- 1. Each Member State shall reserve the provision of investment services to investment firms. It shall ensure that all investment firms for which it is the home Member State operate only after authorisation in accordance with the provisions of this Directive.
- 2. By way of derogation from paragraph 1, Member States shall allow any market operator to operate an MTF, subject to compliance with Articles 13, 24, 27 and 28.
- 3. By way of derogation from point 1 of Article 3(1), Member States may authorise as investment firms undertakings which are not legal persons, provided that:
 - (a) their legal status ensures a level of protection for third parties' interests equivalent to that afforded by legal persons, and
 - (b) they are subject to equivalent prudential supervision appropriate to their legal form.

However, where a natural person provides services involving the holding of third parties' funds or transferable securities, it may be considered as an investment firm for the purposes of this Directive only if, without prejudice to the other requirements imposed in this Directive and in Directive 93/6/EEC, it complies with the following conditions:

- (a) the ownership rights of third parties in instruments and funds must be safeguarded, especially in the event of the insolvency of the firm or of its proprietors, seizure, set-off or any other action by creditors of the firm or of its proprietors;
 - (b) the firm must be subject to rules designed to monitor the firm's solvency and that of its proprietors;
 - (c) the firm's annual accounts must be audited by one or more persons empowered, under national law, to audit accounts;
 - (d) where the firm has only one proprietor, he must make provision for the protection of investors in the event of the firm's cessation of business following his death, his incapacity or any other such event.
4. Member States shall establish a register of all investment firms. This register shall be publicly accessible and shall contain information on the services for which the investment firm is authorised. It shall be updated on a regular basis.
5. In the case of investment firms which provide only investment advice, Member States may allow the competent authority to delegate the function of granting authorisation to a body which meets the conditions set out in Article 45(2).

Article 5
Scope of authorisation

1. The home Member State shall ensure that the authorisation specifies the investment services which the investment firm is authorised to provide. The authorisation may cover one or more of the ancillary services set out in Section B of Annex I. Authorisation may in no case be granted solely for the provision of ancillary services.
2. An investment firm seeking authorisation to extend its business to additional investment or ancillary services not foreseen at the time of initial authorisation shall submit a request for extension of its authorisation.
3. The authorisation shall be valid for the entire Community and shall allow an investment firm to provide the services, for which it has been authorised, throughout the Community, either through the establishment of a branch or the free provision of services.

Article 6
Procedures for granting and refusing requests for authorisation

1. The competent authority shall not grant authorisation unless and until such time as it is fully satisfied that the applicant complies with all requirements under the provisions adopted pursuant to this Directive.
2. The investment firm shall provide all information, including a programme of operations setting out *inter alia* the types of business envisaged and the organisational structure, necessary to enable the competent authority to satisfy itself

that the investment firm has established, at the time of initial authorisation, all the necessary arrangements to meet its obligations under the provisions of this Chapter.

3. An applicant shall be informed, within six months of the submission of a complete application, whether or not authorisation has been granted.

Article 7

Withdrawal of authorisations

1. The competent authority may withdraw the authorisation issued to an investment firm where such an investment firm:
 - (a) does not make use of the authorisation within 12 months, expressly renounces the authorisation or has provided no investment services for the preceding six months, unless the Member State concerned has provided for authorisation to lapse in such cases;
 - (b) has obtained the authorisation by making false statements or by any other irregular means;
 - (c) no longer meets the conditions under which authorisation was granted, such as compliance with the conditions set out in Directive 93/6/EEC;
 - (d) has seriously and systematically infringed the provisions adopted pursuant to this Directive governing the operating conditions for investment firms;
 - (e) falls within any of the cases where national law, in respect of matters outside the scope of this Directive, provides for withdrawal.

Article 8

Persons who effectively direct the business

1. Member States shall require the persons who effectively direct the business of an investment firm to be of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the investment firm.
2. Member States shall require the investment firm to notify the competent authority of any changes to its management, along with all information needed to assess whether the new staff appointed to manage the firm are of sufficiently good repute and sufficiently experienced.
3. The competent authority shall refuse authorisation if it is not satisfied that the persons who will effectively direct the business of the investment firm are of sufficiently good repute or sufficiently experienced, or if there are objective and demonstrable grounds for believing that proposed changes to the management of the firm pose a threat to its sound and prudent management.
4. Member States shall ensure that the management of investment firms is undertaken by at least two persons meeting the requirements laid down in paragraph 1.

By way of derogation from the first subparagraph, Member States may grant authorisation to investment firms which are natural persons or to investment firms which are legal persons managed by a single natural person in accordance with their constitutive rules and national laws. Member States shall nevertheless ensure that alternative arrangements are in place which ensure the sound and prudent management of such investment firms.

Article 9

Persons exercising effective control and acquisitions of qualifying holdings

1. Member States shall require any shareholder owning a qualifying holding in the investment firm to be suitable, having regard to the need to ensure the sound and prudent management of the investment firm.

Where close links exist between the investment firm and other natural or legal persons, the competent authority shall grant authorisation only if those links do not prevent the effective exercise of the supervisory functions of the competent authority.

2. The competent authority shall refuse authorisation if the laws, regulations or administrative provisions of a third country governing one or more natural or legal persons with which the undertaking has close links, or difficulties involved in their enforcement, prevent the effective exercise of its supervisory functions.
3. Member States shall require any natural or legal person who proposes to acquire or sell, directly or indirectly, a qualifying holding in an investment firm, first to notify, in accordance with the second subparagraph, the competent authority of the size of the resulting holding. Such persons shall likewise be required to notify the competent authority if they propose to increase or reduce their qualifying holding, if in consequence the proportion of the voting rights or of the capital that they hold would reach or fall below or exceed 20%, 33% or 50% or the investment firm would become their subsidiary.

Without prejudice to the provisions of paragraph 4, the competent authority shall have up to three months from the date of the notification provided for in the first subparagraph to oppose such a plan if, in view of the need to ensure sound and prudent management of the investment firm, it is not satisfied as to the suitability of the persons referred to in the first subparagraph. If the competent authority does not oppose the plan, it may fix a deadline for its implementation.

4. If the acquirer of any holding referred to in paragraph 3 is an investment firm, a credit institution or an insurance undertaking authorised in another Member State, or the parent undertaking of an investment firm, credit institution or insurance undertaking authorised in another Member State, or a person controlling an investment firm, credit institution or insurance undertaking authorised in another Member State, and if, as a result of that acquisition, the undertaking would become the acquirer's subsidiary or come under his control, the assessment of the acquisition shall be subject to the prior consultation provided for in Article 55.
5. Member States shall require that, if an investment firm becomes aware of any acquisitions or disposals of holdings in its capital that cause holdings to exceed or

fall below any of the thresholds referred to in the first subparagraph of paragraph 3, that investment firm is to inform the competent authority without delay.

At least once a year, investment firms shall also inform the competent authority of the names of shareholders and members possessing qualifying holdings and the sizes of such holdings as shown, for example, by the information received at annual general meetings of shareholders and members or as a result of compliance with the regulations applicable to companies whose transferable securities are admitted to trading on a regulated market.

6. Member States shall require that, where the influence exercised by the persons referred to in the first subparagraph of paragraph 1 is likely to be prejudicial to the sound and prudent management of an investment firm, the competent authority takes appropriate measures to put an end to that situation.

Such measures may consist in applications for judicial orders and/or the imposition of sanctions against directors and those responsible for management, or suspension of the exercise of the voting rights attaching to the shares held by the shareholders or members in question.

Similar measures shall be taken in respect of persons who fail to comply with the obligation to provide prior information in relation to the acquisition or increase of a qualifying holding. If a holding is acquired despite the opposition of the competent authorities, the Member States shall, regardless of any other sanctions to be adopted, provide either for exercise of the corresponding voting rights to be suspended, for the nullity of the votes cast or for the possibility of their annulment.

Article 10

Membership of an authorised Investor Compensation Scheme

The competent authority shall verify that any entity seeking authorisation as an investment firm meets its obligations under European Parliament and Council Directive 97/9/EC¹⁸ at the time of authorisation.

Article 11

Initial capital endowment

1. Member States shall ensure that the competent authority does not grant authorisation unless the investment firm has sufficient initial capital in accordance with the requirements of Directive 93/6/EEC having regard to the nature of the investment service in question.
2. Member States shall ensure that investment firms exempted from the scope of Directive 93/6/EEC, pursuant to points (c) and (d) of Article 2(2) thereof, hold professional indemnity insurance covering the whole territory of the Community or some other comparable guarantee against liability arising from professional negligence, representing at least EUR 1 000 000 applying to each claim and in aggregate EUR 2 000 000 per year for all claims.

¹⁸ OJ L 84, 26.3.1997, p.22.

3. The amounts referred to in paragraph 2 of this Article shall be periodically reviewed by the Commission in order to take account of changes in the European Index of Consumer Prices as published by Eurostat, in line with and at the same time as the adjustments made under Article 4(7) of Directive 2002/./EC [Insurance Mediation]..

Article 12
Organisational requirements

1. The home Member State shall ensure that investment firms comply with the organisational requirements set out in paragraphs 2 to 9.
2. An investment firm shall establish adequate policies and procedures to ensure compliance of the firm and its directors, employees and tied-agents with its obligations under this Directive when conducting business with and on behalf of clients and which require it to act in accordance with market integrity. Those policies and procedures shall be such as to enable the investment firm to demonstrate, at the request of the competent authority, that it has acted in accordance with those obligations.
3. An investment firm shall be structured and organised in such a way as to minimise the risk of client interests being prejudiced by conflicts of interest between the firm and its clients or between one of its clients and another.
4. An investment firm shall employ such systems, resources and procedures as are necessary to ensure continuity and regularity in the provision of the service.
5. An investment firm shall ensure that, when relying on a third party for the performance of functions which are critical for the provision of continuous and satisfactory service to clients, that it takes reasonable steps to avoid undue additional operational risk. Outsourcing of important operational functions may not be undertaken in such a way as to impair the quality of its internal control and the ability of the supervisor to monitor the firm's compliance with all obligations.
6. An investment firm shall have sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems, including, in particular, rules governing personal transactions by employees.
7. An investment firm shall arrange for records to be kept of all services and transactions undertaken by it which shall be sufficient to enable the competent authority to monitor compliance with the requirements under this Directive, and in particular to ascertain that the investment firm has complied with all obligations with respect to clients.
8. An investment firm shall, when holding financial instruments belonging to clients, make adequate arrangements so as to safeguard clients' ownership rights, especially in the event of the investment firm's insolvency, and to prevent the use of a client's instruments on own account except with the client's express consent.
9. An investment firm shall, when holding funds belonging to clients, make adequate arrangements to safeguard the clients' rights and, except in the case of credit institutions, prevent the use of client funds for its own account.

10. In the case of branches of investment firms, the competent authority of the Member State in which the branch is located shall, without prejudice to the possibility of the competent authority of the home Member State of the investment firm to have direct access to those records, enforce the obligation laid down in paragraph 7 with regard to transactions undertaken by the branch.
11. In order to take account of technical developments on financial markets and to ensure the uniform application of paragraphs 2 to 10, the Commission shall adopt, in accordance with the procedure referred to in Article 59(2), implementing measures which specify the concrete organisational requirements to be imposed on investment firms providing different investment and ancillary services or combinations thereof.

Article 13

Trading process and finalisation of transactions in an MTF

1. Member States shall require that investment firms operating an MTF, in addition to meeting the requirements laid down in Article 12, establish transparent and non-discretionary rules and procedures for fair and orderly trading and establish objective criteria for the efficient execution of orders so as to enable users to obtain the best price available on or through the MTF, at any given moment for the size of transaction envisaged. Those rules and procedures shall be subject to prior approval by the competent authority of the home Member State.
2. Member States shall require that investment firms operating an MTF provide for access to the facility in accordance with transparent and objective commercial conditions. Investment firms operating an MTF shall be able to make the use of its facilities and access thereto available only to eligible counterparties as referred to in Article 22(3).
3. Member States shall require that investment firms operating an MTF clearly inform their users of their respective responsibilities for the settlement of the transactions executed in that facility. If investment firms operating an MTF assume part of the responsibility for the settlement of those transactions, the competent authority shall ensure that they have put in place the necessary arrangements to facilitate efficient settlement.
4. Where a transferable security, which has been admitted to trading on a regulated market, is also traded on an MTF without the consent of the issuer, the issuer shall not be subject to any obligation relating to initial, ongoing or ad hoc financial disclosure with regard to that MTF.
5. Member States shall ensure that any investment firm operating an MTF complies immediately with any instruction from its competent authority pursuant to Article 46(1) to suspend or remove a financial instrument from trading.
6. In order to take account of technical developments on financial markets and to ensure uniform application of paragraphs 1 and 2, the Commission shall adopt, in accordance with the procedure referred to in Article 59(2), implementing measures governing the content of trading rules to promote fair and orderly trading through the MTF.

Article 14
Authorisation of third country firms and branches

1. The Member States shall inform the Commission of any general difficulties which their investment firms encounter in establishing themselves or providing investment services in any third country.
2. Whenever it appears to the Commission, on the basis of information submitted to it under paragraph 1, that a third country does not grant Community investment firms effective market access comparable to that granted by the Community to investment firms from that third country, the Commission may submit proposals to the Council for an appropriate mandate for negotiation with a view to obtaining comparable competitive opportunities for Community investment firms. The Council shall act by a qualified majority.
3. Whenever it appears to the Commission, on the basis of information submitted to it under paragraph 1, that Community investment firms in a third country are not granted national treatment affording the same competitive opportunities as are available to domestic investment firms and that the conditions of effective market access are not fulfilled, the Commission may initiate negotiations in order to remedy the situation.

In the circumstances referred to in the first subparagraph, the Commission may decide in accordance with the procedure referred to in Article 59(2), at any time and in addition to the initiation of negotiations, that the competent authorities of the Member States must limit or suspend their decisions regarding requests pending or future requests for authorization and the acquisition of holdings by direct or indirect parent undertakings governed by the law of the third country in question. Such limitations or suspensions may not be applied to the setting up of subsidiaries by investment firms duly authorized in the Community or by their subsidiaries, or to the acquisition of holdings in Community investment firms by such firms or subsidiaries. The duration of such measures may not exceed three months.

Before the end of that three-month period referred to in the preceding paragraph and in the light of the results of the negotiations, the Commission may decide, in accordance with the procedure referred to in Article 59(2), to extend these measures.

4. Whenever it appears to the Commission that one of the situations referred to in paragraphs 2 and 3 obtains, the Member States shall inform it at its request:
 - (a) of any application for the authorization of any firm which is the direct or indirect subsidiary of a parent undertaking governed by the law of the third country in question;
 - (b) whenever they are informed in accordance with Article 9(3) that such a parent undertaking proposes to acquire a holding in a Community investment firm, in consequence of which the latter would become its subsidiary.

That obligation to provide information shall lapse whenever agreement is reached with the third country concerned or when the measures referred to in the second and third subparagraphs of paragraph 3 cease to apply.

5. Measures taken under this Article shall comply with the Community's obligations under any international agreements, bilateral or multilateral, governing the taking up or pursuit of the business of investment firms.

Chapter II.

OPERATING CONDITIONS FOR INVESTMENT FIRMS

Section 1

General provisions

Article 15

General obligation in respect of on-going supervision

1. Member States shall ensure that the competent authorities keep under regular review the organisational arrangements which investment firms have been required to put in place as a condition for initial authorisation..
2. Member States shall require investment firms to notify the competent authorities of any material changes to their programme of operations and to provide the competent authorities with all information needed to verify that modified organisational requirements are sufficient to ensure continued compliance with the obligations under this Directive.
3. Member States shall ensure that the competent authorities monitor the activities of investment firms so as to assess compliance with the operating conditions provided for in this Chapter and other obligations under this Directive. Member States shall ensure that the competent authorities obtain the information needed to assess the compliance of investment firms with those obligations.
4. In the case of investment firms which provide only investment advice, the competent authority may delegate the function of regular monitoring of operational and organisational requirements to a body meeting the requirements set out in Article 45(2).

Article 16

Conflicts of interest

1. Member States shall require investment firms to take all reasonable steps to identify conflicts of interest between themselves, including their managers and employees, and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof.
2. Member States shall require that investment firms whose activities give rise to conflicts of interest maintain and operate effective organisational and administrative arrangements to prevent those conflicts from adversely affecting the interests of clients, or otherwise manage them so as to achieve the same result.
3. Where organisational or administrative arrangements made by the investment firm to manage conflicts of interest are not sufficient to ensure, with reasonable confidence,

that risks of damage to client interests will be effectively avoided, the investment firm shall clearly disclose the general nature and/or sources of conflicts of interest to the client before undertaking business on its behalf.

4. In order to take account of technical developments on financial markets and to ensure uniform application of paragraphs 1, 2 and 3, the Commission shall adopt, in accordance with the procedure referred to in Article 59(2), implementing measures to:
 - (a) define the steps that investment firms might reasonably be expected to take to identify, prevent, manage and/or disclose conflicts of interest when providing various investment and ancillary services and combinations thereof;
 - (b) address conflicts that arise from any inducement that is received or self-interest that arises in connection with the performance of an investment service which may compromise the quality or fairness of a related investment service that is performed on behalf of or provided to a client.

Article 17
Ongoing capital endowment

The Member States shall require that investment firms comply at all times with the rules laid down in Directive 93/6/EEC, having regard to the nature of the investment service in question.

Section 2

Provisions to ensure investor protection

Article 18
Conduct of business obligations when providing investment services to clients

1. Member States shall ensure that, when providing investment services to clients, an investment firm acts honestly, fairly and professionally in accordance with the best interests of its clients and complies, in particular, with the principles set out in paragraphs 2 to 8.
2. Marketing communications, or information contained therein, addressed to clients or potential clients, shall be identified as such, and shall be fair, clear and not misleading.
3. Timely information shall be provided in a comprehensible form to clients or potential clients about the investment firm and its services, so that they are able to understand the precise nature and risks of the investment service and financial instrument that is being offered.
4. The necessary information shall be obtained from the client regarding its knowledge and experience in the investment field, its investment objectives and financial situation so as to enable the investment firm to determine the investment services and financial instruments suitable for that client.

5. Timely information shall be provided to the client regarding financial instruments, proposed investments and execution venues which is fair, clear and not misleading, so as to enable the client to take investment decisions on an informed basis.
6. Appropriate guidance and warnings on the risks associated with investments in particular instruments or investment strategies shall be provided to the client, having particular regard to the client's knowledge and experience.
7. A documentary record of an agreement between the firm and the client shall be established which sets out the rights and obligations of the parties, and the other terms on which the firm will provide services to the client.
8. Reports shall be provided to the client on the progress of and the costs associated with the transactions and services undertaken on behalf of the client.
9. In order to ensure the necessary protection of investors and the uniform application of paragraphs 1 to 8, the Commission shall adopt, in accordance with the procedure referred to in Article 59(2), implementing measures to ensure that investment firms comply with the principles set out therein when providing investment or ancillary services to their clients. Those implementing measures shall take into account:
 - (a) the nature of the service(s) offered or provided to the client or potential client, including the particular procedures and systems which investment firms use to execute orders on behalf of clients;
 - (b) the nature of the financial instruments being offered or considered;
 - (c) the retail or professional nature of the client or potential clients.
10. Member States shall allow an investment firm receiving an instruction to perform investment or ancillary services on behalf of a client through the medium of another investment firm to rely on client information transmitted by the firm which mediates the instructions.

The investment firm which receives an instruction to undertake services on behalf of a client in this way shall also be able to rely on any recommendations in respect of the service or transaction that have been provided to the client by another investment firm.

The investment firm which receives client instructions or orders through the medium of another investment firm shall remain responsible for concluding the service or transaction, based on any such information or recommendations, in accordance with measures adopted pursuant to paragraph 9.
11. The competent authority of the home Member State shall ensure that the obligations of this provision and the implementing measures adopted under paragraph 9 are complied with by investment firms when providing services in other Member States.
12. The competent authority of the Member State in which a branch is located shall enforce the obligations referred to in paragraphs 1 to 8 and the implementation measures adopted pursuant to paragraph 9 in respect of the services provided by a branch to its clients.

Article 19

Obligation to execute orders on terms most favourable to the client

1. Member States shall require that investment firms providing services which entail the execution, whether by the firm itself or another investment firm, of client orders in financial instruments ensure that those orders are executed in such a way that the client obtains the best possible result in terms of price, costs, speed and likelihood of execution, taking into account the time, size and nature of customer orders, and any specific instructions from the client.
2. The competent authority shall verify that investment firms implement effective and efficient procedures which form a systematic, repeatable and demonstrable method for facilitating execution of client orders on terms that are most favourable to the client. In assessing these procedures, regard shall be had to the extent to which the procedures enable the firm to obtain the best possible result having regard to the conditions prevailing in the marketplace to which the investment firm can reasonably be expected to have access.
3. Member States shall require investment firms to review, on a regular basis, the procedures which they employ to obtain the best possible result for their clients and, where necessary, to adapt those procedures so as to obtain access to the execution venues which, on a consistent basis, offer the most favourable terms of execution available in the marketplace.
4. In order to ensure the protection necessary for investors, the fair and orderly functioning of markets, and to ensure the uniform application of paragraphs 1, 2 and 3, the Commission shall, in accordance with the procedure referred to in Article 59(2), adopt implementing measures concerning:
 - (a) the factors that may be taken into account for determining best execution or the calculation of best net price prevailing in the marketplace for the size and type of order and type of client;
 - (b) the procedures which, taking into account the scale of operations of different investment firms, may be considered as constituting reasonable and effective methods of obtaining access to the execution venues which offer the most favourable terms of execution in the marketplace.

Article 20

Client order handling rules

1. Member States shall require that investment firms authorised to execute orders on behalf of clients implement procedures and arrangements which provide for the fair and expeditious execution of client orders, relative to other client orders or the trading interests of the investment firm.
2. Member States shall ensure that investment firms operate procedures or arrangements for executing otherwise comparable client orders in accordance with their time of their reception by the investment firm, and for preventing client interests from being adversely affected by any conflicts of interest.

3. Member States shall ensure that investment firms obtain the express prior consent of clients before proceeding to execute client orders outside the rules and systems operated by a regulated market or MTF. Member States shall allow the investment firm to obtain this consent either in the form of a general agreement or in respect of individual transactions. If the prior consent of clients is given in the form of a general agreement, it should be contained in a separate document and should be renewed annually.
4. Member States shall require that, in the case of a client limit order which cannot be immediately executed under prevailing market conditions, investment firms are, unless the client expressly instructs otherwise, to take measures to facilitate the earliest possible execution of that order by making public immediately the terms of that client limit order in a manner which is easily accessible to other market participants. Member States shall provide that the competent authorities are to be able to waive the obligation to make public a limit order that is large in scale compared with normal market size as determined under Article 41(2).
5. In order to ensure that measures for the protection of investors and fair and orderly functioning of markets take account of technical developments in financial markets, and to ensure the uniform application of paragraphs 1 to 4, the Commission shall adopt, in accordance with the procedure referred to in Article 59(2), implementing measures which define:
 - (a) the conditions and nature of the procedures and arrangements which result in the prompt, fair and expeditious execution of client orders and the situations in which or types of transaction for which investment firms may reasonably deviate from prompt execution so as obtain more favourable terms for clients;
 - (b) the procedures for obtaining and renewing client consent prior to executing those orders outside the rules and systems of a regulated market or MTF;
 - (c) the different methods through which an investment firm can be deemed to have met its obligation to disclose unexecuted client limit orders to the market.

Article 21

Obligations of investment firms when employing tied agents

1. Member States shall require an investment firm to employ tied agents only for the purposes of promoting the services of the investment firm, soliciting business or collecting orders from clients or potential clients and transmitting these to that investment firm, and providing advice in respect of financial instruments or services offered by that investment firm.
2. Member States shall require an investment firm employing a tied agent to remain fully and unconditionally responsible for any action or omission on the part of the tied agent when acting on behalf of the firm. Member States shall require the investment firm to ensure that a tied agent discloses immediately to any client or potential client the capacity in which he agent is acting and the firm which he is representing.

3. Member States shall ensure that investment firms monitor the activities of their tied agents and adopt measures and procedures so as to ensure that they operate, on a continuous basis, in compliance with this Directive.
4. Each Member State shall ensure that tied agents which act or wish to act on its territory are entered in a public register which is established and maintained under the responsibility of the competent authority.

The competent authority shall ensure that tied agents are only admitted to the public register if it has been established that they are of sufficiently good repute and that they possess appropriate general, commercial and professional knowledge so as to be able to communicate accurately all relevant information regarding the proposed service to the client or potential client.

The register shall be updated on a regular basis. It shall be publicly available for consultation.

5. Member States shall ensure that investment firms employ only tied agents entered in the public registers referred to in paragraph 4.
6. Member States may allow the competent authority to delegate the establishment and maintenance of the public register pursuant to paragraph 4 and the tasks of monitoring compliance of tied agents with the requirements of paragraph 4 to a body meeting the conditions laid down in Article 45(2).

Article 22 *Transactions executed with eligible counterparties*

1. The Member States shall ensure that investment firms authorised to execute orders on behalf of clients and/or to deal on own account, may enter into transactions with eligible counterparties without being obliged to comply with the obligations under Articles 18, 19 and 20 in respect of those transactions.
2. In order to conclude transactions in accordance with paragraph 1, the investment firm shall obtain confirmation from the prospective counterparty that it agrees to be treated as an eligible counterparty. This confirmation shall be obtained either before or during the course of the transaction, or in the form of a general agreement.
3. Member States shall recognise as eligible counterparties for the purposes of this Article and Articles 13 and 39 investment firms, credit institutions, insurance companies or any other authorised or regulated financial intermediary considered as such by Community legislation, but excluding UCITS and their management companies and pension funds and their management companies.

Member States may also recognise as eligible counterparties UCITS and their management companies, pension funds and their management companies, and other companies meeting pre-determined proportionate requirements, including quantitative thresholds. In the event of a transaction where the prospective counterparties are located in different jurisdictions, the investment firm shall defer to the status of the other company as determined by the law or measures of the Member State in which that company is established.

Classification as an eligible counterparty under the second subparagraph shall be without prejudice to the right of such entities to request treatment as clients whose business with the investment firm is subject to Articles 18, 19 and 20.

4. Member States shall ensure that transactions undertaken by users or participants of a regulated market or an MTF, on or through the systems of the regulated market or MTFs, are treated as transactions between eligible counterparties.
5. In order to ensure the uniform application of paragraphs 1, 2 and 3 in the light of changing market practice and to facilitate the effective operation of the single market, the Commission may adopt, in accordance with the procedure referred to in Article 59(2), implementing measures concerning the classification of eligible counterparties.

SECTION 3

MARKET TRANSPARENCY AND INTEGRITY

Article 23

Obligation to uphold integrity of markets, report transactions, and maintain records

1. Without prejudice to the allocation of responsibilities for enforcing the provisions of European Parliament and Council Directive 2003/6/EC¹⁹ [on Market Abuse], the competent authority shall also monitor the activities of investment firms to ensure that they act honestly, fairly and professionally and in a manner which promotes the integrity of the market.
2. Member States shall require investment firms to keep at the disposal of the competent authority, for at least five years, the relevant data relating to all transactions in financial instruments which they have carried out, whether on own account or on behalf of a client. In the case of transactions carried out on behalf of clients, the records shall contain all the information and details of the identity of the client, and the information required under Council Directive 1991/308/EEC²⁰.
3. Member States shall require investment firms which execute transactions in any financial instruments admitted to trading on a regulated market to report details of such transactions to the competent authority in the home Member State of the investment firm. This obligation shall apply whether or not such transactions were carried out on a regulated market.
4. Those reports shall be transmitted as quickly as possible, and no later than the close of the following working day. The reports shall specify the instrument bought/sold, the quantity, the date and time of execution, and transaction prices. They shall identify the party executing the transaction and indicate the market, trading system or other means through which the transaction was concluded.

¹⁹ OJ L

²⁰ OJ L 166, 28.6.1991, p.77.

5. Member States shall provide that the reports are to be made to the competent authority either by the investment firm itself or by the regulated market or MTF through whose systems the transaction was completed. In cases where transactions on a regulated market or MTF are reported directly to the competent authority by the regulated market or MTF, the obligation on the investment firm laid down in paragraph 3 may be waived.
6. In order to ensure that measures for the protection of market integrity are modified to take account of technical developments in financial markets, and to ensure the uniform application of paragraphs 1 to 5, the Commission may adopt, in accordance with the procedure referred to in Article 59(2), implementing measures which stipulate the methods and arrangements for reporting financial transactions, the form and content of these reports, as well as arrangements for communicating them to the competent authorities of other Member States.

Article 24

Monitoring of trading on or through an MTF

1. Member States shall ensure that investment firms operating an MTF establish adequate and effective arrangements to facilitate the effective and regular monitoring of transactions undertaken on or through the facility in order to identify disorderly trading conditions or behaviour that may involve market abuse.

Member States shall ensure that under those arrangements, investment firms supply immediately the information gathered pursuant to the first subparagraph to the competent authority and provide full assistance to the latter in investigating and prosecuting market abuse undertaken on or through the MTF.

In order to promote the orderly and effective monitoring of trading on MTFs so as to sustain overall market integrity, and to ensure the uniform application of paragraph 1, the Commission shall adopt, in accordance with the procedure referred to in Article 59(2), implementing measures which define the arrangements referred to in paragraph 1.

Article 25

Obligation for investment firms to make public firm bid and offers

1. Member States shall require 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 on 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.

2. Member States shall provide that the obligation set out in paragraph 1 is waived in respect of investment firms which do not represent an important provider of liquidity for the share(s) in question on a regular or continuous basis.

3. Member States shall ensure that the bid and offer prices required under paragraph 1 are made public in a manner which is easily accessible to other market participants, free of charge, on a regular and continuous basis during normal trading hours.

The competent authority shall verify that published quotes reflect prevailing market conditions for that share, and that the investment firm regularly updates the bid and offer prices that it makes public pursuant to paragraph 1.

4. In order to ensure the uniform application of paragraphs 1, 2 and 3, in a manner which supports the efficient valuation of shares and maximises the possibility of investment firms to obtain the best deal for their clients, the Commission shall, in accordance with the procedure referred to in Article 59(2), adopt implementing measures which:

- (a) specify the size of transactions customarily undertaken by a retail investor in respect of which the investment firm shall make public firm bid and offer prices;
- (b) define the shares or classes of share for which there is sufficient liquidity to allow application of the obligation under paragraph 1;
- (c) determine which types of investment firms shall be exempted, pursuant to paragraph 2, from the obligation under paragraph 1;
- (d) specify the means by which investment firms may comply with their obligations under paragraph 3, which shall include the following possibilities:
 - i) through the facilities of any regulated market which has admitted the instrument in question to trading;
 - ii) through the offices of a third party;
 - iii) through proprietary arrangements.

Article 26

Post-trade disclosure by investment firms

1. Member States shall require investment firms which, either on own account or on behalf of clients, conclude transactions in shares admitted to trading on a regulated market outside the rules and systems of a regulated market or MTF, to make public the volume and price of those transactions and the time at which they were concluded. This information shall be made public immediately, on a reasonable commercial basis, and in a manner which is easily accessible to other market participants.
2. The competent authority shall ensure that the information which is made public in accordance with paragraph 1 and the time-limits within which it is published comply with the requirements adopted pursuant to Article 42. Where the measures adopted pursuant to Article 42 provide for deferred reporting for certain categories of transaction in shares, this possibility shall apply *mutatis mutandis* to those transactions when undertaken outside the rules and systems of regulated markets or MTFs.

3. In order to ensure the transparent and orderly functioning of markets and the uniform application of paragraph 1, the Commission shall adopt, in accordance with the procedure referred to in Article 59(2), implementing measures which:
 - (a) specify the means by which investment firms may comply with their obligations under paragraph 1 including the following possibilities:
 - (i) through the facilities of any regulated market which has admitted the instrument in question to trading;
 - (ii) through the offices of a third party;
 - (iii) through proprietary arrangements.
 - (b) clarify the application of the obligation under paragraph 1 to transactions involving the use of shares for collateral, lending or other purposes where the exchange of shares is determined by factors other than the current market valuation of the share.

Article 27

Pre-trade transparency requirements for MTFs

1. Member States shall require that investment firms operating an MTF make public current bid and offer prices which are advertised through their systems in respect of shares admitted to trading on a regulated market. Member States shall provide that this information is to be made available to the public on reasonable commercial terms and on a continuous basis during normal trading hours.
2. The competent authority shall ensure that the content, timing and publication of pre-trade reporting by MTFs comply with the same requirements as apply pursuant to Article 41 in respect of transactions in those instruments when undertaken on a regulated market.

Competent authorities shall also waive the obligations referred to in paragraph 1 in respect of trading methods operated by MTFs when exemptions are provided, under Article 41, for the same trading methods when operated by regulated markets.

Article 28

Post-trade transparency for MTFs

1. Member States shall require that investment firms operating an MTF make public the price, volume and time of the transactions executed under its rules and systems in respect of shares which are admitted to trading on a regulated market. Member States shall require that details of all such transactions be made public, on a reasonable commercial basis, as close to real-time as possible.
2. The competent authority shall ensure that the content and timing of the post-trade information, and the methods for its publication comply with the same requirements as apply pursuant to Article 42 in respect of transactions in shares undertaken on a regulated market.

Chapter III

RIGHTS OF INVESTMENT FIRMS

Article 29

Freedom to provide services

1. Member States shall ensure that any investment firm authorised and supervised by the competent authorities of another Member State in accordance with this Directive may freely provide investment and ancillary services within their territories, provided that such services are covered by its authorisation. Member States shall not impose any additional requirements on such an investment firm in respect of the matters covered by this Directive.
2. Any investment firm wishing to provide services within the territory of another Member State for the first time, or which wishes to change the range of services so provided, shall communicate the following information to the competent authorities of its home Member State:
 - (a) the Member State in which it intends to operate;
 - (b) a programme of operations stating in particular the investment or ancillary services which it intends to provide and whether it intends to employ the services of tied agents in the territory of the Member States in which it intends to provide services.
3. The competent authority of the home Member State shall, within one month of receiving the information, forward it to the competent authority of the host Member State. The investment firm may then start to provide the investment service or services concerned in the host Member State.
4. In the event of a change in any of the particulars communicated in accordance with paragraph 2, an investment firm shall give written notice of that change to the competent authority of the home Member State at least one month before implementing the change. The competent authority of the home Member State shall inform the competent authority of the host Member State of those changes.
5. Member States shall, without further legal or administrative requirement, allow MTFs from other Member States to provide appropriate arrangements on their territory so as to facilitate access to and use of their systems by remote users or participants established in their territory.

Article 30

Establishment of a branch

1. Member States shall ensure that investment and ancillary services may be provided within their territories through the establishment of a branch of an investment firm provided that those services are covered by the authorisation granted to the investment firm in the home Member State.

Member States shall not impose any additional requirements, with the exception of those allowed under paragraph 7, on the organisation and operation of the branch in respect of the matters covered by this Directive.

2. Member States shall require any investment firm wishing to establish a branch within the territory of another Member State first to notify the competent authority of its home Member State and to provide it with the following information:
 - (a) the Member States within the territory of which it plans to establish a branch;
 - (b) a programme of operations setting out *inter alia* the services to be offered and the organisational structure of the branch and indicating whether the branch intends to employ the services of tied agents;
 - (c) the address in the host Member State from which documents may be obtained;
 - (d) the names of those responsible for the management of the branch.
3. Unless the competent authority of the home Member State has reason to doubt the adequacy of the administrative structure or the financial situation of an investment firm, taking into account the activities envisaged, it shall, within three months of receiving all the information, communicate that information to the competent authority of the host Member State and inform the investment firm concerned accordingly.
4. In addition to the information referred to in paragraph 2, the competent authority of the home Member State shall communicate details of the accredited compensation scheme of which the investment firm is a member in accordance with Directive 97/9/EC to the competent authority of the host Member State. In the event of a change in the particulars, the competent authority of the home Member State shall inform the authority of the host Member State accordingly.
5. Where the competent authority of the home Member State refuses to communicate the information to the competent authority of the host Member State, it shall give reasons for its refusal to the investment firm concerned within three months of receiving all the information.
6. On receipt of a communication from the competent authority of the host Member State, or failing such communication from the latter at the latest after two months from the date of transmission of the communication by the competent authority of the home Member State, the branch may be established and commence business.
7. The competent authority of the host Member State shall assume responsibility for ensuring that the services provided by the branch comply with the obligations laid down in Articles 12(7) and 18 and in measures adopted pursuant thereto.

The competent authority of the host Member State shall have the right to examine branch arrangements and to request such changes as are strictly needed to enable the competent authority to enforce the obligations under Articles 12(7) and 18 and measures adopted pursuant thereto.

8. Each Member State shall provide that, where an investment firm authorised in another Member State has established a branch within its territory, the competent

authority of the home Member State of the investment firm, in the exercise of its responsibilities and after informing the competent authority of the host Member State, may itself or through the intermediary of persons instructed for that purpose, carry out on-site inspections in that branch.

9. In the event of a change in any of the information communicated in accordance with paragraph 2, an investment firm shall give written notice of that change to the competent authority of the home Member State at least one month before implementing the change. The competent authority of the host Member State shall also be informed of those changes by the competent authority of the home Member State.

Article 31

Access to regulated markets

1. Member States shall ensure that investment firms from other Member States which are authorised to execute client orders or to deal on own account have the right of membership or have access to regulated markets established in their territory by means of any or all of the following arrangements:
 - (a) directly, by setting up branches in the host Member States;
 - (b) indirectly, by setting up subsidiaries in the host Member States or by acquiring firms in the host Member States that are already members of their regulated markets or already have access thereto; and/or
 - (c) by becoming remote members of or having remote access to the regulated market without having to be established in the home Member State of the regulated market, where the trading procedures and systems of the market in question do not require a physical presence for conclusion of transactions on the market.
2. Member States shall not impose any additional regulatory or administrative requirements, in respect of matters covered by this Directive, on investment firms exercising the right conferred by paragraph 1.
3. The right conferred by paragraph 1 shall be without prejudice to the obligation of the investment firm to comply with any transparent and objective commercial criteria which the regulated market imposes as a condition for membership or access in accordance with Article 39.

Article 32

Access to clearing and settlement facilities and right to designate settlement system

1. Member States shall ensure that investment firms from other Member States have the possibility of direct or indirect access to central counterparty, clearing and settlement systems in their territory for the purposes of finalising transactions in financial instruments.

Member States shall ensure that access of those investment firms to such facilities is subject to the same transparent and objective commercial criteria as apply to local

participants. Member States shall not restrict the use of those facilities to the clearing and settlement of transactions in financial instruments undertaken on a regulated market or MTF in their territory.

2. Member States shall ensure that regulated markets in their territory offer direct, indirect and remote members or participants the right to designate the system for the settlement of transactions in financial instruments undertaken on that regulated market, subject to:
 - (a) such links and arrangements between the designated settlement system and any other system or facility as are necessary to ensure the efficient and economic settlement of the transaction in question; and
 - (b) agreement by the competent authority responsible for the regulated market that technical conditions for settlement of transactions concluded on the regulated market through a settlement system other than that designated by the regulated market are such as to allow the smooth and orderly functioning of financial markets.
3. The rights of investment firms under paragraphs 1 and 2 shall be without prejudice to the right of operators of central counterparty, clearing or securities settlement systems to refuse on legitimate commercial grounds to make the requested services available.
4. In order to ensure the uniform application of paragraphs 1, 2 and 3, the Commission shall adopt, in accordance with the procedure referred to in Article 59(2), implementing measures which clarify:
 - (a) the nature of the technical links between settlement systems designated by investment firms and other systems and facilities which are needed to ensure the efficient and economic settlement of transactions, and the conditions under which those links are to be considered adequate for the purposes of this Article;
 - (b) those considerations which a competent authority is entitled to take into account when assessing whether the settlement of transactions on a regulated market through a securities settlement system other than that designated by the regulated market might prove prejudicial to the smooth and orderly functioning of financial markets.

TITLE III

REGULATED MARKETS

Article 33

Authorisation and applicable law

1. Member States shall reserve authorisation as a regulated market to those entities on their territory which comply with the provisions of this Title.

Authorisation as a regulated market shall be granted only where the competent authority is satisfied that both the market operator and the rules and systems of the regulated market comply with the requirements laid down in this Title.

2. Member States shall require the regulated market to perform tasks relating to its organisation and operation under the supervision and responsibility of the competent authority. Member States shall ensure that competent authorities keep under regular review the compliance of regulated markets with the provisions of this Title.
3. Without prejudice to any relevant provisions of Directive 2002/..EC [Market Abuse], the public law governing the transactions conducted under the rules and systems of the regulated market shall be that of the home Member State of the regulated market.
4. Member States shall require the regulated market to notify the competent authority of any intended change to the conditions under which authorisation was granted or to its programme of operations.

The competent authority shall refuse to authorise the proposed changes where the resulting programme of operations would not fulfil the conditions laid down in this Title.

5. Member States shall provide that the competent authority may withdraw the authorisation granted to a regulated market where failure to comply with the provisions of this Title has resulted or may result in demonstrable and significant prejudice to the sound and prudent operation of the regulated market or the smooth and orderly functioning of financial markets.

Article 34

Requirements for the market operator

1. Member States shall require the market operator to be of sufficiently good repute and sufficiently experienced as to ensure the sound and prudent management of the regulated market. Member States shall also require the regulated market to inform the competent authority of any changes to the identity of the persons who effectively direct the business of the regulated market.

The competent authority shall refuse to approve proposed changes to the personnel of the market operator where there are objective and demonstrable grounds for believing that they pose a threat to the sound and prudent management of the regulated market.

2. Member States shall ensure that the market operator is responsible, in particular, for ensuring that the regulated market complies with all requirements under this Title.
3. Member States shall require that the market operator possess, at the time of authorisation and on an ongoing basis, sufficient financial resources to facilitate the orderly functioning of the regulated market, having regard to the nature and extent of the transactions concluded on the regulated market and the range and degree of the risks to which the regulated market is exposed.

4. In order to ensure the uniform application of paragraph 3, the Commission shall adopt, in accordance with the procedure referred to in Article 59(2), implementing measures to determine the financial resources that a market operator is to be required to hold, taking into account any other arrangements that may be used by the regulated market to mitigate the risks to which it is exposed.
5. Market operators which are recognised by the competent authority of their home Member State as complying with paragraph 1 shall be deemed to comply with those requirements when seeking authorisation to establish a regulated market in another Member State.

Article 35

Requirements relating to persons exercising effective control of the regulated market

1. Member States shall require the persons who are in a position to exercise, directly or indirectly, effective control of the regulated market to be suitable.
2. Member States shall require the regulated market:
 - (a) to provide the competent authority with, and to make public, information regarding its ownership structure, and in particular, the identity and scale of interests of any parties in a position to exercise control over its operation;
 - (b) to inform the competent authority of and to make public any transfer of ownership which gives rise to change in the identity of the persons exercising effective control.
3. The competent authority shall refuse to approve proposed changes to the controlling interests of the regulated market where there are objective and demonstrable grounds for believing that they would pose a threat to the sound and prudent management of the regulated market.

Article 36

Organisational requirements

1. Member States shall require the regulated market:
 - (a) to have arrangements to identify clearly and manage the potential adverse consequences, for the operation of the regulated market or its participants, of any conflict of interest between the interest of the regulated market, its owners or its operator and the sound functioning of the regulated market, and in particular where such conflicts of interest might prove prejudicial to accomplishment of any functions delegated to the regulated market by the competent authority;
 - (b) to be adequately equipped to manage the risks to which it is exposed, implements appropriate arrangements and systems to identify all significant risks to its operation, and has put in place effective measures to mitigate those risks;

- (c) to have arrangements for the sound management of the technical operations of the system, including the establishment of effective contingency arrangements to cope with risks of systems disruptions;
- (d) to have transparent and non-discretionary rules and procedures that provide for the efficient execution of orders in accordance with objective criteria so as to enable market participants to obtain the best price available on the market, at the time and for their size of interest. Those rules and procedures shall be subject to prior approval by the competent authority of the home Member State;
- (e) to have effective arrangements to facilitate the efficient and timely finalisation of the transactions executed under its rules and systems.

Article 37

Admission of financial instruments to trading

1. Member States shall ensure that regulated markets have clear and transparent rules regarding the admission of financial instruments to trading. Member States shall require those rules to be approved by the competent authority, taking into account all implementing measures adopted pursuant to paragraph 6.

Those rules shall ensure that any financial instruments admitted to trading in a regulated market have been issued in a manner conducive to free negotiability and trading under conditions which are fair, orderly and efficient.

2. In the case of derivatives, the rules shall ensure in particular that the design of the derivative contract allows for orderly pricing both in the derivative and in the underlying market as well as for the existence of effective settlement conditions.
3. In addition to the obligations set out in paragraphs 1 and 2, Member States shall require the regulated market to establish and maintain effective arrangements to verify that issuers of transferable securities being considered for admission to trading comply with their obligations under Community law in respect of initial, ongoing or *ad hoc* financial disclosure.

The competent authority shall ensure that the regulated market establishes arrangements which facilitate its members or participants in obtaining access to information which has been made public under Community law.

4. Member States shall ensure that regulated markets have established the necessary arrangements to review regularly the compliance with the admission requirements of the financial instruments which they admit to trading.
5. Member States shall provide that once a transferable security issued in their territory has been admitted to trading on a regulated market, it can subsequently be admitted to trading on other regulated markets without the consent of the issuer. The issuer shall be informed by the regulated market of the fact that its securities are traded on that regulated market. The issuer shall not be subject to any obligation to provide information required under paragraph 3 directly to any regulated market which has admitted the issuer's securities to trading without its consent.

6. In order to ensure the uniform application of paragraphs 1 to 5, the Commission shall, in accordance with the procedure referred to in Article 59(2) adopt implementing measures which:
 - (a) specify the characteristics of different classes of instruments to be taken into account by the regulated market when assessing whether an instrument is issued in a manner consistent with the conditions laid down in the second subparagraph of paragraph 1 for admission to trading on the different market segments which it operates;
 - (b) clarify the arrangements that the regulated market is to implement so as to be considered to have fulfilled its obligation to verify that the issuer of a transferable security complies with its obligations under Community law in respect of initial, ongoing or *ad hoc* financial disclosure.

Article 38

Suspension and removal of instruments from trading

1. Without prejudice to the right of the competent authority under Article 46(1)(j) and (k) to demand suspension or removal of an instrument from trading, the regulated market may suspend or remove from trading a financial instrument which no longer complies with its rules unless such a step would be likely to prove detrimental to investors' interests or the orderly functioning of the market.

Member States shall ensure that a regulated market which suspends or removes from trading a financial instrument makes public this decision and communicates relevant information to the competent authority. The competent authority shall be required to inform competent authorities of other Member States accordingly.

2. A competent authority which demands the suspension or removal of a financial instrument from trading on one or more regulated markets shall immediately make public its decision and inform the competent authorities of other Member States accordingly.

Article 39

Access to the regulated market

1. Member States shall require the regulated market to establish and maintain transparent rules, based on objective commercial criteria, governing access to or membership of the regulated market. Those rules shall specify any obligations for the members or participants arising from:
 - (a) the constitution and administration of the regulated market;
 - (b) rules relating to transactions on the market;
 - (c) professional standards imposed on staff operating on and in conjunction with the market;
 - (d) the rules and procedures for the clearing and settlement of transactions concluded on the regulated market.

Member States shall also ensure that regulated markets establish effective arrangements to monitor the continued compliance of members and participants with those rules.

2. Member States shall ensure that regulated markets limit membership or access to eligible counterparties as referred to in Article 22(3).
3. Member States shall ensure that the rules on access to or membership of the regulated market provide for the direct, indirect or remote participation of investment firms.
4. Member States shall, without further legal or administrative requirement, allow regulated markets from other Member States to provide appropriate arrangements on their territory so as to facilitate access to and trading on those markets by remote members or participants established in their territory.
5. Member States shall require the regulated market to communicate, on a regular basis, the list of its members and participants to its competent authority.

Article 40

Monitoring of trading on regulated markets

1. Member States shall ensure that regulated markets establish and maintain effective arrangements and procedures for the regular monitoring of transactions undertaken by their members or participants under their rules and systems in order to identify breaches of those rules, disorderly trading conditions or conduct that may involve market abuse.
2. Member States shall require regulated markets to report breaches of their rules or of legal obligations relating to market integrity to the competent authority. Member States shall also require the regulated market to supply the relevant information immediately to the competent authority and to provide full assistance to the latter in investigating and prosecuting market abuse undertaken on or through the systems of the regulated market.

Article 41

Pre-trade transparency requirements for regulated markets

1. Member States shall require regulated markets to make public current bid and offer prices which are advertised through their systems for shares admitted to trading. Member States shall require this information to be made available to the public on reasonable commercial terms and on a continuous basis during normal trading hours.

Member States shall also require any regulated market to make public, through the arrangements employed for making public the information required under the first subparagraph, firm bid and offer prices in shares which it has admitted to trading and which are communicated to it by investment firms pursuant to Article 25.

2. Member States shall provide that the competent authorities are to be able to waive the obligation for regulated markets to make public the information referred to in

paragraph 1 in respect of transactions that are large in scale compared with normal market size for the share or type of share in question.

3. In order to ensure the uniform application of paragraphs 1 and 2, the Commission shall, in accordance with the procedure referred to in Article 59(2) adopt implementing measures as regards:
 - (a) the range of bid and offers or designated market-maker quotes, and the depth of trading interest at those prices, to be made public;
 - (b) the types of order or market-maker quote to be made public;
 - (c) the size or type of transactions for which pre-trade disclosure may be waived under paragraph 2;
 - (d) the applicability of paragraphs 1 and 2 to trading methods operated by regulated markets which conclude transactions under their rules by reference to prices established outside the rules and systems of the regulated market or by periodic auction;
 - (e) appropriate arrangements for making the information public on a reasonable commercial basis.

Article 42

Post-trade transparency requirements for regulated markets

1. Member States shall require regulated markets to make public the price, volume and time of the transactions executed under their rules and systems in respect of shares admitted to trading. Member States shall require details of all such transactions to be made public, on a reasonable commercial basis and as close to real-time as possible.

Member States shall also require any regulated market to make public, through the arrangements employed for making public the information required under the first subparagraph, details of transactions in shares which it has admitted to trading and which have been reported to it by investment firms pursuant to Article 26.
2. Member States shall provide that the competent authority may authorise regulated markets to provide for deferred publication of the details of transactions that are large in scale compared with the normal market size for that share or that class of shares. The competent authority must give prior approval to proposed arrangements for deferred trade-publication, and ensure that these arrangements are clearly disclosed to market participants and the investing public.
3. In order to provide for the efficient and orderly functioning of financial markets, and to ensure the uniform application of paragraphs 1 and 2, the Commission shall, in accordance with the procedure referred to in Article 59(2) adopt implementing measures in respect of:
 - (a) the scope and content of the information to be made available to the public;

- (b) the conditions under which a regulated market may provide for deferred publication of trades and the sizes of transaction or types of share for which deferred publication is allowed;
- (c) appropriate arrangements for making the information public on a reasonable commercial basis.

Article 43

Provisions regarding clearing arrangements

1. Member States shall provide that regulated markets have the right to enter into appropriate arrangements with a central counterparty or clearing house of another Member State with a view to providing for the novation or netting of some or all trades concluded by market participants under their rules and systems.
2. The competent authority of a regulated market may not oppose the use of central counterparty or clearing houses in another Member State except where this is demonstrably necessary in order to maintain the orderly functioning of that regulated market.

Article 44

List of regulated markets

Each Member State shall draw up a list of the regulated markets for which it is the home Member State and shall forward that list to the other Member States and the Commission. A similar communication shall be effected in respect of each change to that list. The Commission shall publish a list of all regulated markets in the *Official Journal of the European Communities* and update it at least once a year.

TITLE IV

COMPETENT AUTHORITIES

Chapter I.

DESIGNATION, POWERS, RESOURCES AND REDRESS PROCEDURES

Article 45

Designation of competent authorities

1. Each Member State shall designate a competent authority to carry out each of the duties provided for under the different provisions of this Directive. Member States shall inform the Commission of the identity of the competent authority responsible for enforcement of each of those duties, and of any division of those duties.

The Commission shall publish a list of competent authorities in the *Official Journal of the European Communities* and update it at least once a year.

2. The competent authorities referred to in paragraph 1 shall be public authorities, without prejudice to the possibility of delegating functions to other entities where that is expressly provided for.

Such delegation may take place only if a clearly defined and documented framework for the exercise of any delegated functions has been established. Prior to delegation, competent authorities shall ensure that the body to which functions are to be delegated has the capacity and resources to effectively execute all responsibilities and that it has established the necessary arrangements to clearly identify and avoid the potential negative effects of any conflict of interest between the exercise of the delegated functions and any other proprietary or commercial interest.

Competent authorities shall periodically review the effectiveness of these arrangements. They shall retain ultimate responsibility for ensuring that the provisions adopted pursuant to this Directive are applied.

3. If a Member State designates more than one competent authority to enforce a provision of this Directive, their respective roles shall be clearly defined and they shall cooperate closely.

Each Member State shall ensure that such cooperation also takes place between the competent authorities for the purposes of this Directive and the competent authorities responsible in that Member State for the supervision of credit and other financial institutions and insurance undertakings.

Member States shall ensure that those authorities exchange any information which is essential or relevant for the exercise of their duties.

Article 46

Powers to be made available to competent authorities

1. Member States shall ensure that the competent authorities possess all supervisory, investigatory and enforcement powers necessary for the exercise of their functions. They shall exercise such powers in conformity with national law, either directly or, where appropriate, in cooperation with other authorities, including judicial authorities.

In particular, Member States shall ensure that competent authorities have at least the powers to:

- (a) have access to any document in any form whatsoever;
- (b) request additional information from any person, investment firm or regulated market, and if needed to summon and question a person with a view to obtaining information;
- (c) carry out on-site inspections;
- (d) require existing telephone and data traffic records;
- (e) require cessation of a practice that is contrary to the provisions laid down pursuant to this Directive;

- (f) request the freezing and/or the sequestration of assets;
 - (g) request temporary prohibition of professional activity;
 - (h) require authorised entities' auditors to provide information;
 - (i) adopt any type of measure to ensure that authorised entities continue to comply with the legal requirements;
 - (j) demand the suspension of trading in a financial instrument;
 - (k) demand the removal of a financial instrument from trading, whether on a regulated market or under other trading arrangements;
 - (l) seek judicial orders and take other action to ensure compliance with these regulatory, administrative and investigation powers;
 - (m) impose administrative sanctions;
 - (n) initiate or refer matters for criminal prosecution .
2. Member States shall ensure that competent authorities have the adequate resources for the exercise of their functions, and that the staff of such authorities observe professional standards and are subject to appropriate internal procedures or rules of conduct which ensure, in particular, the protection of personal data, procedural fairness and the proper observance of confidentiality and secrecy provisions.

Article 47
Sanctions

1. Without prejudice to the procedures for the withdrawal of authorisation or to the right of Member States to impose criminal penalties, Member States shall ensure, in conformity with their national law, that the competent authorities take appropriate administrative measures or impose administrative sanctions in respect of the persons responsible where the provisions adopted pursuant to this Directive have not been complied with. Member States shall ensure that these measures are effective, proportionate and dissuasive.
2. Member States shall determine the sanctions to be applied for failure to co-operate in an investigation.
3. Member States shall provide that the competent authority may disclose to the public any measure or sanction that will be imposed for infringement of the provisions adopted pursuant to this Directive, unless the disclosure would jeopardise the financial markets or cause disproportionate damage to the parties involved.

Article 48
Right of appeal

1. Member States shall ensure that any decision taken under laws, regulations or administrative provisions adopted in accordance with this Directive is properly

reasoned and is open to appeal or review by the courts. The same shall apply where, in respect of an application for authorisation which provides all the information required, no decision is taken within six months of its submission.

2. With regard to the right of appeal referred to in paragraph 1, Member States shall provide that one or more of the following bodies, as determined by national law, may, in the interests of consumers and in accordance with national law, take action before the competent authority or the courts:
 - (a) public bodies or their representatives;
 - (b) consumer organisations having a legitimate interest in protecting consumers;
 - (c) professional organisations having a legitimate interest in acting to protect their members.

Article 49

Extra-judicial mechanism for investors' complaints

1. Member States shall set up efficient and effective complaints and redress procedures for the out-of-court settlement of consumer disputes concerning the provision of investment and ancillary services provided by investment firms, using existing bodies where appropriate.
2. Member States shall ensure that those bodies are not prevented by legal or regulatory provisions from co-operating effectively in the resolution of cross-border disputes.

Article 50

Professional secrecy

1. Member States shall ensure that all persons who work or who have worked for the competent authorities or bodies to whom functions are delegated pursuant to Article 45(2), as well as auditors and experts instructed by the competent authorities, are bound by the obligation of professional secrecy. No confidential information which they may receive in the course of their duties may be divulged to any person or authority whatsoever, save in summary or aggregate form such that individual investment firms cannot be identified, without prejudice to cases covered by criminal law.
2. Where an investment firm has been declared bankrupt or is being compulsorily wound up, confidential information which does not concern third parties involved in attempts to rescue that investment firm may be divulged in civil or commercial proceedings.

Article 51
Relations with auditors

1. Member States shall provide at least that any person authorised within the meaning of Council Directive 84/253/EEC²¹, performing in an investment firm the task described in Article 51 of Council Directive 78/660/EEC²², Article 37 of Directive 83/349/EEC or Article 31 of Directive 85/611/EEC or any other task prescribed by law, shall have a duty to report promptly to the competent authorities any fact or decision concerning that undertaking of which that person has become aware while carrying out that task and which is liable to:
 - (a) constitute a material breach of the laws, regulations or administrative provisions which lay down the conditions governing authorisation or which specifically govern pursuit of the activities of investment firms;
 - (b) affect the continuous functioning of the investment firm;
 - (c) lead to refusal to certify the accounts or to the expression of reservations.

That person shall also have a duty to report any facts and decisions of which the person becomes aware in the course of carrying out one of the tasks referred to in the first subparagraph in an undertaking having close links resulting from a control relationship with the investment firm within which he is carrying out that task.

2. The disclosure in good faith to the competent authorities, by persons authorised within the meaning of Directive 84/253/EEC, of any fact or decision referred to in paragraph 1 shall not constitute a breach of any contractual or legal restriction on disclosure of information and shall not involve such persons in liability of any kind.

Chapter II

Cooperation between competent authorities of different Member States

Article 52
Obligation to cooperate

1. Competent authorities of different Member States shall co-operate with each other whenever necessary for the purpose of carrying out their duties under this Directive, in the exercise of their powers under this Directive or national law.

Competent authorities shall render assistance to competent authorities of other Member States. In particular, they shall exchange information and co-operate in any investigation activities.
2. Member States shall take the necessary administrative and organisational measures to facilitate the assistance provided for in paragraph 1.

²¹ OJ L 126, 12.5.1985, p.20.

²² OJ L 222, 14.8.1978, p.11.

Competent authorities shall be able to use their powers for the purpose of cooperation, even in cases where the conduct under investigation does not constitute an infringement of any regulation in force in that Member State.

3. Where a competent authority is convinced that acts contrary to the provisions of this Directive, carried out by entities not subject to its supervision, are being or have been carried out on the territory of another Member State, it shall notify this in as specific a manner as possible to the competent authority of the other Member State. The latter authority shall take appropriate action. It shall inform the notifying competent authority of the outcome of the action and, to the extent possible, of significant interim developments.

Article 53

Cooperation in investigations

1. A competent authority of one Member State may request the co-operation of the competent authority of another Member State for an on-the-spot verification or in an investigation.

Competent authorities which receive such requests shall, within the framework of their powers, act upon them by:

- (a) carrying out the verifications themselves;
 - (b) allowing the authorities who have requested them to carry them out; or
 - (c) allowing auditors or experts to carry out the verification.
2. A competent authority may refuse to act on a request for cooperation in carrying out an investigation as provided for in paragraph 1 only where:
 - (a) such an investigation might adversely affect the sovereignty, security or public policy of the State addressed;
 - (b) judicial proceedings have already been initiated in respect of the same actions and the same persons before the authorities of the Member State addressed;
 - (c) final judgement has already been given in the Member State addressed in respect of the same persons and the same actions.

In the case of such a refusal, the competent authority shall notify the requesting competent authority accordingly, providing as detailed information as possible.

Article 54

Exchange of information

1. Competent authorities of Member States shall immediately supply one another with the information required for the purposes of carrying out their duties set out in the provisions adopted pursuant to this Directive.

Article 50 shall not prevent the competent authorities from exchanging information in accordance with this Directive .

Competent authorities communicating information shall indicate what information, or part of it, thus supplied shall be considered confidential and therefore covered by professional secrecy.

The Commission may adopt, in accordance with the procedure referred to in Article 59(2), implementing measures concerning procedures for the exchange of information.

2. Competent authorities receiving confidential information under paragraph 1 of this Article or under Articles 51 and 58 may use it only in the course of their duties:
 - (a) to check that the conditions governing the taking up of the business of investment firms are met and to facilitate the monitoring, on a non-consolidated or consolidated basis, of the conduct of that business, especially with regard to the capital adequacy requirements imposed by Directive 93/6/EEC, administrative and accounting procedures and internal-control mechanisms;
 - (b) to monitor the proper functioning of trading venues;
 - (c) to impose sanctions;
 - (d) in administrative appeals against decisions by the competent authorities; or
 - (e) in court proceedings initiated under Article 48.

However, where the competent authority communicating information consents thereto, the authority receiving the information may use it for other purposes.

3. Paragraphs 1 and 2 of this Article and Article 50 shall neither preclude the disclosure of information to bodies which administer compensation schemes where this is necessary for the performance of their functions nor the exchange of information needed for the performance of supervisory functions:
 - (a) within a Member State or between Member States, between competent authorities and
 - (i) bodies responsible for the liquidation and bankruptcy of investment firms and other similar procedures;
 - (ii) and persons responsible for carrying out statutory audits of the accounts of investment firms and other financial institutions and insurance undertakings,
 - (b) between competent authorities and the authorities or bodies of other Member States responsible for the supervision of credit institutions, other financial institutions and insurance undertakings.

Such information shall be subject to the conditions of professional secrecy laid down in Article 50.

4. Notwithstanding paragraphs 1 and 2 of this Article and Articles 50 and 58, Member States may authorise exchanges of information between, the competent authorities and:

- (a) the authorities responsible for overseeing the bodies involved in the liquidation and bankruptcy of investment firms and other similar procedures;
- (b) the authorities responsible for overseeing persons charged with carrying out statutory audits of the accounts of insurance undertakings, credit institutions, investment firms and other financial institutions.

Member States which have recourse to the option provided for in the first subparagraph shall require at least that the following conditions are met:

- (a) the information must be for the purpose of performing the task of overseeing referred to in the first subparagraph;
- (b) information received in that context must be subject to the conditions of professional secrecy laid down in Article 50;
- (c) where the information originates in another Member State, it must not be disclosed without the express agreement of the competent authorities which have transmitted it and, where appropriate, solely for the purposes for which those authorities gave their agreement.

Member States shall communicate to the Commission and to the other Member States the names of the authorities which may receive information pursuant to this paragraph.

5. Notwithstanding paragraphs 1 and 2 of this Article and Articles 50 and 58, Member States shall, with the aim of strengthening the stability and integrity of the financial system, authorise the exchange of information between the competent authorities and the authorities or bodies with legal responsibility for the detection and investigation of breaches of company law.

Member States which have recourse to the option provided for in the first subparagraph shall require at least that the following conditions are met:

- (a) the information shall be for the purpose of performing the task referred to in the first subparagraph;
- (b) information received in this context shall be subject to the conditions of professional secrecy imposed in Article 50;
- (c) where the information originates in another Member State, it must not be disclosed without the express agreement of the competent authorities which have transmitted it and, where appropriate, solely for the purposes for which those authorities gave their agreement.

Where, in a Member State, the authorities or bodies referred to in the first subparagraph perform their task of detection or investigation with the aid, in view of their specific competence, of persons appointed for that purpose and not employed in the public sector, the possibility of exchanging information provided for in the first

subparagraph may be extended to such persons under the conditions stipulated in the second subparagraph.

In cases referred to in point (c) of the second subparagraph, the authorities or bodies referred to in the first subparagraph shall communicate to the competent authorities which have transmitted the information the names and precise responsibilities of the persons to whom it is to be sent.

Member States shall communicate to the Commission and to the other Member States the names of the authorities or bodies which may receive information pursuant to this paragraph.

6. This Article and Articles 50 and 58 shall not prevent a competent authority from transmitting to central banks, the European System of Central Banks and the European Central Bank, in their capacity as monetary authorities, and, where appropriate, to other public authorities responsible for overseeing payment systems, information intended for the performance of their tasks.

Likewise such authorities or bodies shall not be prevented from communicating to the competent authorities such information as they may need for the purposes of paragraph 3. Information received in this context shall be subject to the conditions of professional secrecy laid down in Article 50.

7. This Article and Articles 50 and 58 shall not prevent the competent authorities from communicating the information to a clearing house or other similar body recognized under national law for the provision of clearing or settlement services for the markets of one of the Member States, if the competent authorities consider that it is necessary to communicate that information in order to ensure the proper functioning of those bodies in relation to defaults or potential defaults by market participants.

The information received shall be subject to the conditions of professional secrecy laid down in Article 50. The Member States shall, however, ensure that information received under paragraph 1 of this Article may not be disclosed in the circumstances referred to in this paragraph without the express consent of the competent authorities which transmitted it.

8. In addition to and notwithstanding the provisions referred to in paragraphs 1 and 2 and in Articles 50 and 58, Member States may, by virtue of provisions laid down by law, authorise the disclosure of certain information to other departments of their central government administrations responsible for legislation on the supervision of credit institutions, financial institutions, investment firms and insurance undertakings and to inspectors instructed by those departments.

Such disclosures may, however, be made only where necessary for reasons of prudential supervision.

9. This Article and Article 50 shall not prevent the competent authorities from communicating information to any body or bodies to whom they have delegated their functions if they consider it necessary in order to ensure the proper exercise of those functions.

The information received shall be subject to the conditions of professional secrecy laid down in Article 50. The Member States shall, however, ensure that information

received under paragraph 1 of this Article from the competent authorities of other Member States may not be disclosed in the circumstances referred to in this paragraph without the express consent of the competent authorities which transmitted it.

Article 55

Inter-authority consultation prior to supplementary authorisation

1. The competent authorities of the other Member State involved shall be consulted prior to granting authorisation to any investment firm which is:
 - (a) a subsidiary of an investment firm or credit institution authorised in another Member State;
 - (b) a subsidiary of the parent undertaking of an investment firm or credit institution authorised in another Member State;
 - (c) controlled by the same natural or legal persons as control an investment firm or credit institution authorised in another Member State
2. The competent authority of the Member State responsible for the supervision of credit institutions or insurance undertakings shall be consulted prior to granting an authorisation to an investment firm which is:
 - (a) a subsidiary of a credit institution or insurance undertaking authorised in the Community; or
 - (b) a subsidiary of the parent undertaking of a credit institution or insurance undertaking authorised in the Community;
 - (c) controlled by the same person, whether natural or legal, who controls a credit institution or insurance undertaking authorised in the Community.
3. The relevant competent authorities referred to in paragraphs 1 and 2 shall in particular consult each other when assessing the suitability of the shareholders and the reputation and experience of directors involved in the management of another entity of the same group. They shall exchange all information regarding the suitability of shareholders and the reputation and experience of directors that is of relevance to the other competent authorities involved, for the granting of an authorisation as well as for the ongoing assessment of compliance with operating conditions.

Article 56

Powers for host Member States

1. Host Member States may, for statistical purposes, require all investment firms with branches within their territories to report to them periodically on the activities of those branches.
2. In discharging their responsibilities under this Directive, host Member States may require branches of investment firms to provide the information necessary for the

monitoring of their compliance with the standards set by the host Member State that apply to them. Those requirements may not be more stringent than those which the same Member State imposes on established firms for the monitoring of their compliance with the same standards.

Article 57

Precautionary powers for host Member States

1. Where the competent authority of the host Member State has clear and demonstrable grounds for believing that an investment firm acting within its territory under the freedom to provide services is in breach of the obligations arising from the provisions adopted pursuant to this Directive, it shall refer those findings to the competent authority of the home Member State.
2. If, despite the measures taken by the competent authority of the home Member State or because such measures prove inadequate, the investment firm persists in acting in a manner that is clearly prejudicial to the interests of host country investors or the orderly functioning of markets, the competent authority of the host Member State, after informing the competent authority of the home Member State, shall take all the appropriate measures needed in order to protect investors and the proper functioning of the markets. The Commission shall be informed of such measures without delay.

Article 58

Exchange of information with third countries

1. Member States may conclude cooperation agreements providing for the exchange of information with the competent authorities of third countries or with third country authorities or bodies whose responsibilities are analogous to those of the bodies referred to in points (i) and (ii) of Article 54(3)(a) and points (a) and (b) of the first subparagraph of Article 54(4) only if the information disclosed is subject to guarantees of professional secrecy at least equivalent to those required under Article 50. Such exchange of information must be intended for the performance of the supervisory task of those authorities or bodies.
2. Where the information originates in another Member State, it may not be disclosed without the express agreement of the competent authorities which have transmitted it and, where appropriate, solely for the purposes for which those authorities gave their agreement.

TITLE V

FINAL PROVISIONS

Article 59

1. The Commission shall be assisted by the European Securities Committee instituted by Commission Decision 2001/528/EC²³ (hereinafter referred to as "the Committee").
2. Where reference is made to this paragraph, Articles 5 and 7 of Decision 1999/468/EC shall apply, having regard to the provisions of Article 8 thereof, provided that the implementing measures adopted in accordance with this procedure do not modify the essential provisions of this Directive.

The period laid down in Article 5(6) of Decision 1999/468/EC shall be three months.

3. Without prejudice to the implementing measures already adopted, on the expiry of a four-year period following the entry into force of this Directive, the application of its provisions requiring the adoption of technical rules and decisions in accordance with paragraph 2 shall be suspended. On a proposal from the Commission, the European Parliament and the Council may renew the provisions concerned in accordance with the procedure laid down in Article 251 of the Treaty and, to that end, they shall review them prior to the expiry of that period.

Article 60

Reports and review

1. No later than [31 December 2008, 4 years after the entry into force of this Directive], the Commission shall, on the basis of public consultation and in the light of discussions with competent authorities, report to the European Parliament and Council on the possible extension of the scope of the provisions of the Directive concerning pre and post-trade transparency obligations to transactions in classes of financial instrument other than shares.

On the basis of that report, the Commission may submit proposals for related amendments to this Directive.

2. No later than [31.12.2006] 2 years after the entry into force of this Directive, the Commission shall, on the basis of public consultations and in the light of discussions with competent authorities, report to the European Parliament and Council on:
 - (a) the continued appropriateness of the exemption under point (i) of Article 2(1) of this Directive for undertakings whose main business is dealing on own account in commodities derivatives;

²³ OJ L 191, 13.7.2001, p.45.

- (b) the content and form of proportionate requirements for the authorisation and supervision of such undertakings as investment firms within the meaning of this Directive.

On the basis of that report, the Commission may submit proposals for related amendments to this Directive.

Article 61
Amendment of Directive 85/611/EEC

In Article 5 of Directive 85/611/EEC, paragraph 4 is replaced by the following:

"4. Articles 2(2), 11, 12, 17 and 18 of European Parliament and Council Directive 200../.../EC* [OPOCE to insert number of the present directive] shall apply to the provision of the services referred to in paragraph 3 of this Article by management companies.

*OJ L [OPOCE to insert OJ reference of the present directive]"

Article 62
Amendment of Directive 93/6/EEC

In Directive 93/6/EEC, point (2) of Article 2 is replaced by the following:

“2. Investment firms shall mean all institutions that provide investment services in accordance with European Parliament and Council Directive 200../.../EC* [OPOCE to insert reference to present Directive] with the exception of:

- (a) credit institutions;
- (b) local firms;
- (c) firms which only receive and transmit orders from investors without holding money or securities belonging to their clients and which for that reason may not at any time place themselves in debit with their clients;
- (d) investment firms which are authorised to provide only the service of investment advice.

*OJ L [OPOCE to insert OJ reference of the present directive]"

Article 63
Amendment of Directive 2000/12/EC

Annex I of Directive 2000/12/EC is amended as follows:

- (a) In point 7 the following point is added:

"(f) commodity derivatives".

- (b) The following point is added:

"15. Operation of a multilateral trading facility".

Article 64
Repeal of Directive 93/22/EEC.

Directive 93/22/EEC is repealed with effect from the date of application set out in Article 64.

References to Directive 93/22/EEC shall be construed as references to this Directive.

Article 65
Transposition

Member States shall bring into force the laws, regulations and administrative provisions necessary to comply with this Directive by 30 June 2006 [18 months of its entry into force] at the latest. They shall forthwith inform the Commission thereof.

They shall apply those provisions as from 1 July 2006.

When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.

Article 66
Entry into force

This Directive shall enter into force on the day following that of its publication in the *Official Journal of the European Communities*.

Article 67
Addressees

This Directive is addressed to the Member States.

Done at Brussels,

For the European Parliament

For the Council

The President

The President

ANNEX I - LIST OF SERVICES AND FINANCIAL INSTRUMENTS

Section A: Investment services.

- (1) Reception and transmission₂ of orders in relation to one or more financial instruments.
- (2) Execution of orders on behalf of clients.
- (3) Dealing on own account.
- (4) Managing portfolios in accordance with mandates given by clients on a discretionary client-by-client basis where such portfolios include one or more financial instruments.
- (5) Investment advice
- (6) (a) underwriting and placing of financial instruments on a firm commitment basis;
(b) placing without a firm commitment or other activities undertaken in agreement with the issuer of the instrument to assist the distribution of or subscription to public or private offers of financial instruments.
- (7) Operation of Multilateral Trading Facilities.

Section B: Ancillary services.

- (1) Safekeeping and administration of financial instruments for the account of clients, including custodianship and related services such as cash/collateral management;
- (2) Granting credits or loans to an investor to allow him to carry out a transaction in one or more financial instruments, where the firm granting the credit or loan is involved in the transaction;
- (3) Advice to undertakings on capital structure, industrial strategy and related matters and advice and services relating to mergers and the purchase of undertakings;
- (4) Foreign exchange services where these are connected to the provision of investment services;
- (5) Investment research and financial analysis or other forms of general recommendation relating to transactions in financial instruments”.

Section C: Financial Instruments

- (1) Transferable securities;
- (2) Money-market instruments;
- (3) Units in collective investment undertakings;
- (4) Options and futures contracts in respect of securities, currencies, interest rates or yields, commodities or other derivatives instruments, indices or measures;
- (5) Interest-rate, currency and equity swaps;

- (6) Forward-rate agreements and any other derivative contract for a cash settlement determined by reference to prices of securities, interest rates or yields, foreign exchange rates, commodities or other indices or measures;
- (7) Contracts for differences or other derivative instruments for transfer of credit risk.

ANNEX II – PROFESSIONAL CLIENTS FOR THE PURPOSE OF THIS DIRECTIVE

I. Categories of client who are considered to be professionals

The following should all be regarded as professionals in all investment services and instruments for the purposes of the Directive.

- (1) Entities which are required to be authorised or regulated to operate in the financial markets. The list below should be understood as including all authorised entities carrying out the characteristic activities of the entities mentioned: entities authorised by a Member State under a European Directive, entities authorised or regulated by a Member State without reference to a European Directive, and entities authorised or regulated by a non-Member State:
 - (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 dealers.
- (2) Large companies and other institutional investors:
 - (a) large companies and partnerships 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.
 - (b) Other institutional investors whose corporate purpose is to invest in financial instruments.
- (3) National and regional governments, Central Banks, international and supranational institutions such as the World Bank, the IMF, the ECB, the EIB and other similar international organisations.

The entities mentioned above are considered to be professionals. They must however be allowed to request non-professional treatment and investment firms may agree to provide a higher level of protection. Where the client of an investment firm is a company or a partnership referred to above, the investment firm must inform it prior to any provision of services that, on the basis of the information available to the firm, the client is deemed to be professional client, and will be treated as such unless the firm and the client agree otherwise.

The firm must also inform the customer that he can request a variation of the terms of the agreement in order to secure a higher degree of protection.

It is the responsibility of the client, considered to be a professional client, to ask for a higher level of protection when it deems it is unable to properly assess or manage the risks involved.

This higher level of protection will be provided when a client who is considered to be a professional enters into a written agreement with the investment firm to the effect that it shall not be treated as a professional for the purposes of the applicable conduct of business regime. Such agreement should specify whether this applies to one or more particular services or transactions, or to one or more types of product or transaction.

II. Clients who may be treated as professionals on request

II.1. Identification criteria

Clients other than those mentioned in section I, including public sector bodies and private individual investors, may also be allowed to waive some of the protections afforded by the conduct of business rules.

Investment firms should therefore be allowed to treat any of the above clients as professionals provided the relevant criteria and procedure mentioned below are fulfilled. These clients should not, however, be presumed to possess market knowledge and experience comparable to that of the categories listed in section I.

Any such waiver of the protection afforded by the standard conduct of business regime shall be considered valid only if an adequate assessment of the expertise, experience and knowledge of the client, undertaken by the investment firm, gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved.

The fitness test applied to managers and directors of entities licensed under European Directives in the financial field could be regarded as an example of the assessment of expertise and knowledge.

In the case of small entities, the person subject to the above assessment should be the person authorised to carry out transactions on behalf of the entity.

In the course of the above assessment, as a minimum, two of the following criteria should be satisfied:

- The client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters;
- The size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments exceeds 0,5 million Euro;
- The client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

II.2. Procedure

The clients defined above may waive the benefit of the detailed rules of conduct only where the following procedure is followed:

- they must state in writing to the investment firm that they wish to be treated as a professional client, either generally or in respect of a particular investment service or transaction, or type of transaction or product;
- the investment firm must give them a clear written warning of the protections and investor compensation rights they may lose;
- they must state in writing, in a separate document from the contract, that they are aware of the consequences of losing such protections.

Before deciding to accept any request for waiver, investment firms must be required to take all reasonable steps to ensure that the client requesting to be treated as a professional client meets the relevant requirements stated in Section II.1 above.

However, if clients have already been categorised as professionals under parameters and procedures similar to those above, it is not intended that their relationships with investment firms should be affected by any new rules adopted pursuant to this paper.

Firms must implement appropriate written internal policies and procedures to categorise clients.

Professional clients are responsible for keeping the firm informed about any change, which could affect their current categorisation. Should the investment firm become aware however that the client no longer fulfils the initial conditions, which made him eligible for a professional treatment, the investment firm must take appropriate action.

FINANCIAL STATEMENT				
		DATE:		
1.	BUDGET HEADING: N.A.	APPROPRIATIONS:		
2.	TITLE: N.A			
3.	LEGAL BASIS: N.A			
4.	AIMS: N.A			
5.	FINANCIAL IMPLICATIONS	12 MONTH PERIOD (EUR million)	CURRENT FINANCIAL YEAR [n] (EUR million)	FOLLOWING FINANCIAL YEAR [n+1] (EUR million)
5.0	EXPENDITURE - CHARGED TO THE EC BUDGET (REFUNDS/INTERVENTIONS) - NATIONAL AUTHORITIES - OTHER	-	-	-
5.1	REVENUE - OWN RESOURCES OF THE EC (LEVIES/CUSTOMS DUTIES) - NATIONAL	-	-	-
		[n+2]	[n+3]	[n+4]
5.0.1	ESTIMATED EXPENDITURE	-	-	-
5.1.1	ESTIMATED REVENUE	-	-	-
5.2	METHOD OF CALCULATION: N.A			
6.0	CAN THE PROJECT BE FINANCED FROM APPROPRIATIONS ENTERED IN THE RELEVANT CHAPTER OF THE CURRENT BUDGET?	YES NO		
6.1	CAN THE PROJECT BE FINANCED BY TRANSFER BETWEEN CHAPTERS OF THE CURRENT BUDGET?	YES NO		
6.2	WILL A SUPPLEMENTARY BUDGET BE NECESSARY?	YES NO		
6.3	WILL APPROPRIATIONS NEED TO BE ENTERED IN FUTURE BUDGETS?	YES NO		
OBSERVATIONS:				

IMPACT ASSESSMENT FORM

THE IMPACT OF THE PROPOSAL ON BUSINESS WITH SPECIAL REFERENCE TO SMALL AND MEDIUM-SIZED ENTERPRISES(SMEs)

TITLE OF PROPOSAL

Proposal for a Directive of the European Parliament and of the Council modifying Directive (93/22/EEC) on Investment Services.

DOCUMENT REFERENCE NUMBER

THE PROPOSAL

1. Taking into account of the principle of subsidiarity, why is Community legislation necessary in this area and what are its main aims?

A single financial market should promote the competitiveness of the European economy, lowering the cost of capital and benefiting investors and companies alike. The existing Directive does not represent an adequate regulatory foundation for an integrated financial market.

An integrated financial market should be founded on a harmonised set of principles and rules. The objective of these rules will be to ensure a high level of investor protection and to promote the efficient and orderly functioning of the market.

The corollary of these harmonised rules will be the recognition by all Member states of the home country rule. This is, to enable Markets and Investment Firms to provide services through the single market on the basis of home country authorisation and supervision.

This action responds to the Lisbon, Stockholm and Barcelona European Council's request to achieve an integrated financial market and in particular to give priority to securities market legislation provided for in the Financial Services Action Plan and in the report by the Committee of Wise Men on the regulation of the European Securities Markets.

This Directive confines itself to the minimum required to achieve those objectives and does not go beyond what is necessary for that purpose.

THE IMPACT ON BUSINESS

2. Who will be affected by the proposal?
 - Which sectors of business? Those that provide Investment services as defined by the Directive and those that manage Regulated Markets.
 - Which sizes of business? All Investment Firms and Regulated Markets whatever size they are, are affected by the proposal. The directive takes into account the fact

that some services are provided mainly by small sized firms, i.e. investment advice when undertaken as the exclusive business of the firm.

- Are there particular geographical areas where these business are found? No. But trading in some specific products can concentrate in specific geographical areas.

3. What will business have to do to comply with the proposal?

For Investment Firms, They will have to comply with an enhanced set of conduct of business rules. This will suppose that their management and control systems as well as the compliance capabilities could need to be adapted in order to ensure an adequate protection of the interest of investors.

In particular, those firms that provide services in a way that could give rise to potential conflicts of interests will have to establish the necessary arrangements in order to detect and minimize those risks.

As regards trading shares on behalf of clients, the proposal requires firms to implement adequate and efficient procedures to ensure the best execution of those orders. In addition, it establishes rules aiming at defining the way those client orders should be handled. In particular referring to limit orders.

If investment firms provide for in-house execution services in equities or if they deal with eligible counterparties outside the rules and systems of Regulated Markets or Multilateral Trading Facilities they will also have to set up systems for making available on a post trade basis the details of the trades executed that way.

The Investment Firms that operate Multilateral Trading Facilities will be subject to specific rules that govern the operation of the facility. Those rules include aspects relating to the trading process, pre and post-trade transparency requirements, access, etc.

The firms that provide investment services in the meaning of the proposal will also be subject to Capital requirements as defined by CAD. This could have an impact in those firms specialised in those services which are new to the proposal in comparison with the previous directive (i.e. investment advice) or to the provision of investment services on financial instruments which were not previously contemplated (i.e. commodity derivatives).

For Regulated Markets, Concrete points set up in the Directive are designed to increase transparency and represent a reinforcement of the obligations laid down in the existing ISD (art. 21). Moreover, the Directive has codified a set of general principles developed at national, european (CESR) and international level (IOSCO).

These principles imply that Regulated Markets have to establish a clear set of rules concerning the functioning of the trading process, the access to the market, the instruments that can be admitted to trading, etc., that they have to monitor the compliance with those rules as well as survey the fairness of the trading at the market, that they have to ensure the correct functioning of their systems and that they should avoid any danger that could arise from any potential conflict of interest.

Regulated Markets are also subject to transparency requirements²⁴. They will have to make public, up to a certain extent, their order book (pre-trade). They will also have to publicise the details of the transactions concluded under their rules and systems.

The proposal also requires that the market operator allocates sufficient capital to the Regulated Market to ensure its smooth and orderly functioning.

4. What economic effects is the proposal likely to have?

Overall economic impact. A competitive and flexible market based financing can make a substantive contribution to the growth and employment of the European Union. The integration of the European Financial Markets will result in a significant reduction in the trading costs and the cost of the equity/corporate bond finance. Pooling European liquidity will maximise the depth of trading interests, reduce stock-specific volatility and limit adverse price impacts for large trades.

The consequence of lower costs of capital and increasing returns on investments should be an increase of the overall wealth of the European Union. This will mean a higher investment rate and its corollary of more employment.

The results of a study commended by the European Commission on the “Quantification of the Macro-economic impact of Integration of EU Financial Markets²⁵”, reflect that the integration of the European Financial Markets could result²⁶ in a 1.1% increase of the Union’s GDP and a 0.5% rise in the level of employment.

On the industry. The proposal will increase of the confidence of investors in the fair functioning of the market due to the application of the market efficiency and investor protection oriented rules. This could well soar the european savings rate.

In addition, it enhances the competitiveness of the financial industry as a whole. It creates a playing field which can adapt to the future evolution of the financial markets. It encourages innovation whilst taking due account of the interest that are to be protected.

This openness will reinforce the european financial industry making it stronger and more adapted to the needs of its customers.

Competitiveness, innovation and development will not only result in more employment in the financial sector but also in better shaped strategies towards investors. These will be able to get better risk-adapted financial products which should enhance the medium and long term returns of their savings.

5. Does the proposal contains measures to take account of the specific situation of small and medium sized firms?

²⁴ Equivalent to those foreseen for MTFs.

²⁵ Study by London Economics in association with PriceWaterhouseCoopers and Oxford Economic Forecasting.

²⁶ Static effects.

Where the Commission, through the consultation process detailed hereafter, has identified potential negative effects of its proposals to some of the investment services and activities that fall under the scope of the proposal it has reassessed those measures in order to take due account of those concerns.

One of the areas that has been identified has been the “investment advice”. The fact is that in some European jurisdictions advice is basically provided on a professional basis by small entities. Applying undifferentiated customer protection oriented rules could be considered as an excessive burden for them to carry.

Consequently the proposal lays down some specific measures aimed at those advisors that operate only at a national level. In particular it exempts them from the application of the CAD regime. However they will be subject to the application of Conduct of Business Rules.

CONSULTATION

The recommendations of the Lamfalussy Committee of Wise Men, endorsed by the Stockholm European Council in March 2001, have heavily shaped the preparation of this proposal.

The Commission published a Green Paper in November 2000 exploring a number of themes relating to the operation of the ISD²⁷. In the light of the 68 responses to the Green Paper, the Commission concluded that a wide-ranging review of the Directive was required.

Since publication of the original Green Paper, Commission services have twice solicited the reactions of interested parties, in an open and inclusive way, to informal and preliminary thinking on the scope and form of ISD revision. A first consultation, which comprehensively mapped out possible modifications to the Directive, was published in July 2001. These preliminary orientations were discussed in an open hearing, attended by 150 interested parties, in Brussels in September 18-19 2001. 77 submissions were received in response to this consultation.

On the light of the responses received to the first consultation, the Commission published a substantially revised set of orientations for ISD revision in March 2002. The revised orientations were again subjected to rigorous scrutiny in open forum (22 April 2002) attended by 200+ participants.

The present proposal has been drafted on the basis of a careful consideration of the 110 responses to these revised orientations.

ⁱ Notably, publication of details of transactions completed on the exchange.

ⁱⁱ Both time-series analysis and international comparisons confirm the powerful contribution that efficient financial markets can make to wealth-creation. Levine & Ross, etc.

ⁱⁱⁱ Schleiffer, Vishny etc (2000), Black (2000).

²⁷ COM(729) 2000, Upgrading the ISD.

iv London Economics: 2002. Quantification of the macro-economic impact of integration of EU financial markets.

v For example, Member States which allow off-exchange execution of client orders have been forced to develop more sophisticated “best execution” policies, whereas this have, to a large extent been unnecessary in Member States which require concentration of retail investor orders on a “regulated market”.

vi COM(729) 2000, Upgrading the ISD.

vii In performing this function, large dealers represented an alternative point of liquidity for market participants. The use of the term “market-making” in respect of this activity highlights the extent to which dealers could substitute for on-exchange trading. Therefore, the marketplace/intermediary distinction was by no means watertight.

viii The term “alternative trading system” (ATS) has entered into common parlance as a catch-all term for a wide range of new trading support facilities whose shared characteristic is that they are not licensed as exchanges. Some respondents to the consultation have noted that this terminology is not suitable for a legal text and does not capture the specific functionality of the entities which its is proposed to authorise as a new core service. In view of this, the term “alternative” has been replaced by “multilateral”. The word “system” is replaced by “facility” – to avoid confusion with a well-established bond-trading outfit.

ix J.P. Morgan (2002).

^x The effective spread is the difference between the average buy and sell price that an investor actually paid. The effective spread can be defined as $EPS = 2 * |P - M| / P$. Where P is the effective transaction price and M is the quote mid-point or $(Ask + Bid) / 2$. It is a more representative indicator of the actual spreads prevailing on any market as it takes the difference between the average prices to buy and sell a share at a given time as opposed to the nominal spread between the best bid and offer available at the top of an order-book and which will only be available to the traders which succeed in hitting those trades. The effective spread presented is the average of the daily spread of a 24 month time series for some 13,000 stocks.

xi Source International Federation of Stock Exchanges and FESE (2002).

xii There is a negative correlation between Turnover (-0.11) and Market capitalisation (-0.543) and Trading costs. Domowitz, Glen and Madhavan – Liquidity, Volatility and Equity Trading Costs across countries and over time – January 2000.

xiii OTC trading, upstairs trading, large block trading either on or off-exchange.

xiv Operate on-exchange block trading facilities, or appoint specialist liquidity providers.

xv Liquid markets allow transactions to be undertaken without triggering large price movements against the interests of the trader. In markets which are efficient from a price-formational perspective, prices quoted in the markets will embody all relevant and up-to-date information relating to the “real value” of an instrument

xvi London Economics 2002: The London Economics research highlights the opportunity costs associated with fragmentation of current levels of liquidity between leading EU exchanges.

xvii IOSCO (2001): report from TC on “transparency and market fragmentation” (p. 3).

xviii Idem, p. 13.

^{xix} Bilateral trading or internal order-execution do not involve the same trading processes as on-exchange or MTF-based trading. Dealing centres on the provision of quotes on a bilateral/selective basis. Dealer discretion is needed to protect its proprietary capital from exposure to position risk. Regular/continuous position-taking by dealers and broker-dealers (against their own capital) provides liquidity support to the market, which can help to smooth price fluctuations and ensure a permanent counterparty to trade with investors. These considerations do

not materialise in the case of exchanges or MTFs: there is no capital of the market/system operator at stake, and market participants/system users are voluntarily and knowingly making use of the system to advertise the terms at which they are willing to trade.

^{xx} Evidence from EU markets which allow off-exchange retail order execution suggests that fears regarding the degradation of price-formation are overstated. Bid-ask spreads on the London SE electronic order-book (SETS) have narrowed in recent years despite the widespread execution of investor orders outside the rules of the exchange (subject to post-trade reporting requirements). There is no obvious pattern in effective and quoted spreads between Member States which take a restrictive stance on off-exchange order execution and those which are more liberal in this respect. In some Member States which enforce a concentration rule, spreads are as high or higher than spreads in Member States which do not.

^{xxi} Euronext (2002): Internalisation. “Large financial conglomerates that already act in various capacities are setting their sights on another role which will enable them to expand their activities. After performing the role of stockbroker, market maker, analyst and portfolio manager, they now want to start playing at being exchanges.” (p.12). cf. also A. Murray (2002): Key issues facing European securities exchanges. (“the increasing ability of banks to act as quasi-exchanges..” (p.17).

^{xxii} [The London Economics research identifies important reductions in spreads adverse price impacts that can be expected if EU equity and corporate markets are pooled, and suggests that this will generate non-negligible reductions in the cost of equity and corporate bond finance].

^{xxiii} The proposed transparency rules seek to create the conditions in which traders and intermediaries are able to identify the trading arrangements which offer the best terms for transacting a trade in any given equity instrument and to move liquidity in response to price differences. This will allow orders to be executed at the venue which offers price improvement or best outcome for the end-investor, and assist the overall market system in converging on a price that reflects the full extent of price-relevant information across the entire market.

^{xxiv} Competition from SEAQ forced many continental exchanges to revolutionise trading methods and systems in early 90s. Fear of competition from TradePoint led LSE to introduce SETS order-book trading in 96.

^{xxv} To the extent that MTF are not vested with regulatory/self-regulatory responsibilities for screening the “quality” of instruments traded on the system, ATS need not be subjected to “regulated market”-type obligations on admission of instruments to trading.

^{xxvi} ECB survey on European equity markets, August 2001.

^{xxvii} Some of the principal particularities of “regulated markets” when compared to a pure trading facility include the following: “regulated markets” have assumed an important role in vetting the quality of instruments admitted to trading/the public quote. The continued role of regulated markets in verifying the conformity of securities/instruments with rules governing the constitution and issue, provides a “quality labelling” for instruments which are publicly traded. Only marketplaces which are willing to assume these obligations should have the possibility of authorisation as a “regulated market”. “Regulated markets” involve a distinct organisational form: they have assumed much autonomy and self-regulatory role in vetting members and policing activity on the market. “Regulated markets” also embody particular trading features: they guarantee efficient finalisation/settlement of transactions executed on the markets – although pure trading systems may also offer this level of functionality.

^{xxviii} Already have been episodes which highlight the high levels of inter-linkage between EU stock-markets. Earlier this year, trading error on DBAG stxxx index led to immediate and important disruption for trading of same index on other EU markets – but also for trading in substitute stock indices.

^{xxix} In UK, some 29 entities are thought to fall within the scope of the MTF definition. DE is also home to a large number of these systems, while IT, BE, IRL, FR also have granted authorisations to MTF. These systems are active in a range of asset classes – particularly bonds and foreign exchange swaps but also equity. Experience from US suggests a period of consolidation (at least for bond systems) may follow the first phase of market development.

^{xxx} A number of respondents have challenged the need to introduce a new authorisation regime for MTF. They argue that the activities of a MTF are adequately catered for by a combination of authorisation to provide “reception and transmission” and “execution” of client orders. The Commission does not concur with this analysis. The fundamental innovation represented by ATS is that they provide a non-exchange venue which users/clients can employ for dealing/trading at their discretion and for their own-account. This form of functionality means that MTF possess many of the features and give rise to the same regulatory issues as exchanges/marketplaces.

^{xxx}_i The revised orientations, published as a basis for open consultation in March 2002, envisaged a distinction between entities which systematically internalise client orders and those which do so on an incidental basis. A quantitative threshold (10% of client order flow internalised over preceding 4 quarters) was proposed as basis for dividing line. This distinction has been widely criticised on 2 counts: first, the rationale for the distinction is unclear. Internalisation implies a conflict of interest between client and broker/dealer interests irrespective of the scale of internalisation. Secondly, the proposed threshold was condemned as being unworkable, and resulting in different market consequences across large/small national markets. In view of these cogent criticisms, the Commission proposal abandons this distinction and seeks to create a general regulatory framework within which conflicts of interest related to all internalisation activity can be managed.

^{xxx}_{ii} Market structures where the client brokerage function and the dealing against client order are functionally separated, or undertaken by different entities do not give rise to the basic conflict of interest at issue. The Retail Service Provider regime in operation in the UK whereby a retail broker routes client orders to a different entity for execution against a proprietary position of the latter would not be considered “internalisation” in the sense of this proposal.

^{xxx}_{iii} The reasoning underlying this section has been developed more extensively in a related working paper of the Commission services, in order to do justice to the many complex facets of the debate.

^{xxx}_{iv} LSE charges 2p for filing of each off-exchange trade reported to it by its members.

^{xxx}_v M. Auguy and D. Davydoff, the European Market model, July 24. 2002.

^{xxx}_{vi} NASD rule 4710: rules of practice and procedure for the small order execution system. Cf. NASD manual pp. 2303-2308 and NASD notice to members 97-90 on changes to SOES tier-size levels Dec. 97)

^{xxx}_{vii} Host authorities shall be notified of the operation of partner country firms on their territory through the existing notification mechanism, have the possibility to request the home authority to intervene, and to intervene itself as a precautionary measure where circumstances demand it.

^{xxx}_{viii} Entities recognised as “eligible counterparties” by the national competent authority under this option will be able to trade as such with investment firms from throughout the EU. Investment firms in the same jurisdiction will not necessarily be able to presume that similar entities in other jurisdictions can also be dealt with as “eligible counterparties”.