

TOWARDS A SINGLE MARKET IN EUROPEAN SECURITIES TRADING: AN AGENDA FOR REFORM OF THE ISD

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Introduction

Over the past decade, the development of the European securities exchanges has been a remarkable success story. Owing directly to the force of cross-border competition, European exchanges have implemented major reforms in trading systems and internal governance which have significantly improved their efficiency and reduced investor trading costs. Yet the exchanges are now facing enormous pressure from the major international trading houses to cut costs much further by consolidating trading and settlement operations on far fewer platforms. This has led to a wave of dramatic merger and alliance proposals which augur a fundamental restructuring of the competitive landscape in trading operations and the reallocation of market regulation authority across EU national securities commissions.

The European Commission is currently conducting a major review of the 1993 Investment Services Directive (ISD) as part of its "Financial Services Action Plan", with the aim of proposing wide-ranging reforms. In this statement the ESFRC urges the European Commission to address a key weakness of the ISD – the so-called "regulated markets" concept – which, as things stand, may be used by national authorities as a protectionist weapon.

"Regulated Markets" in the ISD

Article 15.4 of the ISD provides for a "single passport" for EU trading systems, allowing a system authorized by the competent authority in one national jurisdiction to provide remote services in all the others. This single passport is a manifestation of the concepts of "mutual recognition" and "home country control", utilized in a number of Single Market Programme directives to facilitate market integration without the need for prior harmonization of laws and regulations across the Union. Home country control provides a major stimulus to market integration by negating the natural protectionist tendencies of host state authorities, which may attempt to hinder the operations of foreign competitors when they threaten the franchises of domestic incumbents.

The ISD single passport, however, only applies to so-called "regulated markets". The definition of such markets was the source of enormous controversy within the Council of Ministers during the original ISD negotiations, which began in 1988. If an exchange or trading system was not legally a "regulated market", then it was obliged to seek explicit authorization to operate in each and every national jurisdiction in which it wished to provide services, even if only by remote cross-border electronic link. Local protectionism was therefore a real threat to any trading system operator which could not satisfy the "regulated market" criteria.

The London Stock Exchange's SEAQ International trading platform was the primary target for protectionist manipulation of the "regulated market" definition in the ISD negotiations. A significant competitor to the continental exchanges in the late 1980s, it had nonetheless been overtaken by the time of the ISD implementation deadline in 1996. Cross-border expansion of electronic trading systems proceeded rapidly in the late 1990s, but as the exchanges generally refrained from competing in each other's products there were few opportunities for testing the

A significant recent example has emerged in electronic bond trading. The Italian Treasury has given an effective monopoly in electronic trading of Italian government securities to the MTS "telematico" system by restricting central clearing counterparty services to official "regulated markets", as designated by the Treasury in accordance with the ISD. MTS is the sole operator so recognized for Italian government securities. Aspiring foreign competitors such as Instinet, eSpeed and Brokertec Global must therefore operate at a significant competitive disadvantage.

There are also worrying signs emanating from both Frankfurt and London that the long-overdue cross-border consolidation of exchanges may be blocked or distorted by local protectionism. And given the clear indications that existing exchanges will in short order be expanding their cross-border services, and that new electronic competitors will be entering the fray, it is now more important than ever to ensure that the ISD does not act as a barrier to the long sought integration of the European capital markets. If flaws in the ISD are not addressed, we are bound to witness the wholly undesirable transformation of EU national securities commissions from market regulators into trade negotiators, operating on behalf of local incumbent exchanges threatened by more efficient foreign competition. This trend is already clear in the US, where the Securities and Exchange Commission has steadfastly refused direct electronic access for non-US exchanges, while at the same time turning a blind eye to US brokers providing their own electronic links direct from US investor desks to foreign trading systems.

In this statement, we focus on four clauses in the ISD which relate to the legal concept of the "regulated market":

- the listing requirement in article 1.13;
- the "new markets" provision in article 15.5;
- the "concentration principle" in article 14.3; and
- the "transparency" rules in article 21.

We explain the source of their protectionist potential, and recommend surgical revisions of the text to mitigate it while minimizing the likelihood of provoking political gridlock.

De-linking Listing and Trading

The ISD unnecessarily conflates the regulation of corporate disclosure with the regulation of trading systems. "Listing" of securities in conformance with basic standards is held to be a hallmark of a "regulated market", and acquisition of a single passport is therefore made contingent on it. As SEAQ International did not list the continental stocks which it traded in the late 1980s and early 1990s, a formal listing requirement was clearly a threat to its cross-border

operations at the time. A North-South split emerged in the Council of Ministers during the ISD negotiations over the appropriateness of a listing requirement, leading to a compromise around deliberately ambiguous text. Article 1.13 therefore specifies that a "regulated market" must satisfy the requirements of the Listing Particulars Directive (79/279/EEC) "where [the Directive] is applicable". Failure to identify who ultimately determines applicability leaves considerable room for protectionism by host state authorities on behalf of their own domestic exchange operators.

Listing is a major revenue-generating function at most exchanges, akin to rating debt in the bond markets, and does not need to be carried out by the same body which operates the trading system. Indeed, newer European trading platforms (*eg*, Tradepoint and Jiway) intend

We would like to see a competitive market emerge for listing services in Europe, with non-exchanges competing directly with exchanges for establishing standards appropriate to the age and size of the companies which wish to be publicly traded. The lack of trading interest in London's small cap AIM market clearly demonstrates the commercial cost of establishing insufficiently high disclosure standards. Market forces can only improve on the current situation by allowing specialization between listing service provision and trading service provision.

To move us in this direction, the ISD should be revised to make clear (a) that whereas "regulated markets" *may* be obliged by home state authorities to deal only in formally "listed" stocks, the actual listing function may be performed by *any* exchange or other body (such as an accounting firm, rating agency or government institution) duly authorized to provide listing services in any EU national market; and (b) that it is the home state authority which is authorized to decide whether the Listing Particulars Directive is applicable in any given case. This would ensure that a trading system operator designated as a "regulated market" in one jurisdiction is not denied single passport rights in another jurisdiction on the basis that that particular operator does not itself "list" the securities which it trades.

"New Markets"

Article 15.5 states that article 15 "shall not affect the Member States' right to authorize or prohibit the creation of new markets within their territories". This clause is clearly unnecessary if its true intent was merely to reinforce home state discretion in designating "regulated markets". But the intent was actually to furnish host states with an escape clause from the single passport provision for screen-based trading systems. By declaring a foreign trading system to be a "new market", a host state could deny it single passport rights.

Indeed, an early sign of the potential for abuse of the new markets clause came in 1995, when the Dutch Ministry of Finance opined that a foreign screen-based system wishing to provide for remote access in the Netherlands might be considered as intending to create a "new market" in the Netherlands. The Dutch position provoked considerable criticism from abroad, and was never applied. If its validity were to be upheld, however, the single passport would be entirely negated. With the recent establishment of new trading platforms for equities and bonds the potential for abuse is now considerable. In order to eliminate this possibility, article 15.5 should simply be extirpated from the Directive.

"Concentration"

Through the removal of the new markets clause, the protectionist potential of another provision, the so-called "concentration principle", article 14.3, will be considerably lessened. Another source of North-South tension in the drafting of the Directive, the concentration principle gives Member States the right to mandate that transactions in domestically traded securities be carried out only on a "regulated market". The new markets clause gives Member States the possibility of claiming that a trading system designated a "regulated market" by its home authority is not actually a "regulated market" outside its home state if tries to expand its product base – as it would then be creating a "new market". This would further restrict the scope of the single passport and severely limit the prospects for cross-border trading system competition.

Having been incorporated into law in a number of Member States, the concentration principle will be exceedingly difficult to remove, or even significantly amend. Therefore reducing the

Transparency

Transparency in the ISD refers to rapid publication of post-trade transaction data. In a competitive market, government-mandated transparency rules are either unnecessary or damaging. They are unnecessary for the electronic auction systems being operated by the EU exchanges, since all of them have the incentive to sell real-time transaction data to private vendors, such as Reuters and Bloomberg. They are damaging for block transactions facilitated by dealers, because dealers will not quote prices on blocks if they are forced to reveal the transactions to their competitors before they have rebalanced their portfolios. And if block transactions are eliminated by transparency rules, the market is not actually made more transparent. Whether the investor breaks up a large sell order for execution in an auction market, or sells the entire block to a dealer who then does the same, the transactions will always get published through the auction market.

The ISD transparency rules (article 21) are in their present form inconsequential, so there is no pressing need either to amend or remove them. A further compromise in the ISD negotiations led to a bizarre requirement for "regulated markets" to publish "at least" weighted average prices at regular intervals, with unspecified delays permitted for "very large" transactions. Deutsche Börse demonstrated that the requirements could be avoided entirely by declaring all trades which they did not wish to publish, those done by telephone, to be "off market". Since, logically, only their electronic trading system (IBIS, now Xetra) required a single passport to accommodate remote access, this system itself became the "regulated market", and trades off the system remained outside the scope of the ISD transparency rules.

The FESCO document, "Standards for Regulated Markets Under the ISD" (December 1999), endorses real time disclosure of "all completed transactions", but acknowledges the application of delays or suspensions in accordance with article 21. However, the document also calls for real-time disclosure of bid-ask prices and volumes, known as "pre-trade transparency", without derogation. Such limit order revelation, however, is not clearly desirable in all market architectures. New electronic call market structures, where trading occurs at specific pre-designated points in time, process complex contingent orders which are frequently not amenable to pre-trade revelation. Furthermore, disclosure of pre-trade "indication" prices may actually

encourage undesirable gaming of such systems, through manipulative order placement and retraction strategies. Therefore, FESCO's statement that the organization "does not regard it as the role of the regulator to prescribe market design" is incompatible with regulations requiring order revelation. The latter is intimately related with market design, and should therefore not be mandated.

Recommendations for Revising the ISD

In conclusion, we recommend the following two amendments to the ISD:

Article 1.13 should be rewritten so as to make clear that a "regulated market" need not *itself* meet the requirements of the Listing Particulars Directive. A trading system operator should not be required to enter the listing business as a condition for acquiring a single passport. Home state regulators should be permitted, but not obliged, to require trading systems which they designate to be ISD "regulated markets" to trade only formally "listed" securities, but any institution authorized to provide listing services in any EU jurisdiction should be considered competent to carry out such a listing requirement.

Article 15.5 should be eliminated, so as to preclude an EU authority from denying single passport rights to a foreign "regulated market" on the grounds that it is seeking to create a "new market" in its territory.

These changes will further serve to mitigate the protectionist potential of the "concentration principle" enshrined in article 14.3. With regard to the transparency provisions in article 21, we prefer to let sleeping text lie. We consider these provisions unnecessary, but fundamentally harmless in their current form. We simply urge FESCO not to seek to expand their application to "off market" transactions facilitated through dealer capital, or to pre-trade price and volume information in the case of periodic call auctions.