The European Financial Market

The Banks’ Overview of the Development of the Single European Financial Market and Reflections on Upcoming Challenges
In this document the European Banking Federation (EBF) presents an informed commentary on recent financial regulatory and market developments and a framework for further policy action in the short to medium term. Financial markets are by their very nature fast paced and dynamic. The policy recommendations set out in this document take into account the challenging backdrop to all current financial activity. Nonetheless they aim to enable innovation and competition to flourish, whilst providing the necessary degree of protection to investors.

The document is intended to serve as the starting point for a wider discussion with key interlocutors in the official and private sectors who have a hand in shaping the regulatory and supervisory conditions for the securities business in Europe and beyond. It has been written to present the historical facts and background information in a neutral manner.

For EBF opinion and specific policy objectives please refer to the blue boxes that appear throughout the text. The orange boxes give a brief overview of key issues and legislative initiatives.
Executive Summary

The Financial Services Action Plan (FSAP), Europe’s blueprint for regulatory reform to create the Single Financial Market, in combination with the better regulation agenda, have achieved a great deal. As a result Europe remains on the right path to become more competitive whilst increasing investor protection standards.

The 2008-2009 financial crisis has tested Europe’s political and regulatory apparatus to the limit and we are currently in a critical phase of regulatory and supervisory repair. All stakeholders recognise that there is a great deal to be achieved from making targeted and proportionate adjustments to Europe’s financial regulatory regime.

There is also a great deal to be lost from premature and heavy-handed responses that undermine flexibility so essential to allow Europe to recover and prosper in the future. New regulation must always be proportionate, fit for purpose and subject to an impact assessment before its adoption. Long term thinking set in an outward looking, global context should underpin all new regulatory initiatives.

Building on the existing robust FSAP framework and finding the appropriate corrective balance between protection and openness is the key challenge for the coming years for Europe. The following principles can go a long way to achieving that goal:

- Less can often be more. Targeted regulatory initiatives, underpinned by sound better regulation principles of pre-consultation and ongoing stakeholder feedback, are of primordial importance.

- Europe should move in step with the global consensus, for example by adhering to the guidelines developed at the global level for securities supervision by IOSCO.

Towards Mutual recognition with Europe’s key trading partners in targeted areas of financial markets regulation should be the objective.

- Cross-border supervisory cooperation must become a reality. Developing a common supervisory culture through the CESR network and reinforcing its capacity to act in the common European interest on the key issues are particularly important.

- Rebalance the discussion away from suspicion and fear towards understanding and appreciation: well articulated legislation on Alternative Investment Fund Managers can make funding easier and cheaper for firms in the non-financial sector, making saving for investors more efficient, more flexible and more tailored to individual needs. First time home buyers taking out fixed rate mortgages rely on derivative instruments traded bilaterally in the ‘over the counter markets’ to enable that choice. Short selling is legitimately used to hedge exposure and improve risk management practices.

- More appropriate information to investors is a shared priority. In the discussion on the Commission’s proposal for pre-contractual product disclosures for packaged retail investment products, keep in mind the different products’ characteristics, avoid over-simplification, and retain the necessary degree of flexibility to adequately explain product functioning and risk and reward profile.

- However, all of the above developments are only possible if Europe creates the conditions for safe, competitive and efficient post-trading infrastructures to clear and settle trades. Development of pan-European post trading infrastructure must continue.
The European Banking Federation

The European Banking Federation (EBF) is the representative voice of banking in Europe. Set up in 1960, the EBF speaks for some 5,000 banks in 31 European countries. The EBF’s constituency is diverse and the banks it represents are large and small, wholesale and retail, local and cross-border financial institutions.

Under the EBF banner the banks unite to support policies to create the single European financial market, by advocating free and fair competition and applying the principles of ‘better regulation’. The EBF is increasingly winning support for regulatory convergence beyond the EU’s borders and is seeking to raise awareness of corporate social responsibility in the banking sector as a whole.

European banks are active all along the value chain of securities markets activities, from advising clients at the point of sale, through to trading, clearing and settlement. Therefore, given the EBF’s broad representation, combined with a deep pool of technical expertise at its disposal, the Federation is uniquely placed to offer a perspective on recent securities market and regulatory developments as well as to make policy recommendations for the future.

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Page</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>7</td>
<td>Historical Perspective and Context</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Integrating ‘s financial markets - creating a globally competitive single market</td>
</tr>
<tr>
<td>II</td>
<td>14</td>
<td>Regulation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Striking a balance between protecting investors and allowing firms to perform</td>
</tr>
<tr>
<td>III</td>
<td>17</td>
<td>Supervision</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Towards a common supervisory culture in Europe</td>
</tr>
<tr>
<td>IV</td>
<td>20</td>
<td>Wholesale Market</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Re-oiling the wheels of Europe’s economy</td>
</tr>
<tr>
<td>V</td>
<td>44</td>
<td>Retail Market</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Offering choice and providing protection to Europe’s retail investors</td>
</tr>
<tr>
<td>VI</td>
<td>52</td>
<td>Conclusions</td>
</tr>
<tr>
<td>Annex I</td>
<td>54</td>
<td>The Financial Services Action Plan</td>
</tr>
<tr>
<td>Annex II</td>
<td>57</td>
<td>Intermediation in the Capital Markets</td>
</tr>
<tr>
<td>Annex III</td>
<td>58</td>
<td>Index of keywords</td>
</tr>
</tbody>
</table>
Chapter I - Historical Perspective and Context

**Integrating Europe’s financial markets** - creating a globally competitive single market

International financial integration denotes the process of integration of financial markets and activities – that is, first, the elimination of legal obstacles in the movement of capital, financial services and financial institutions and, second, the economic and technological forces that facilitate cross-border financial activities, so that with respect to finance, there are no ‘foreigners’ within the integrated area.

**Integrating Europe’s financial markets**

There was a genuine expectation that the 1992 ‘single market programme’ would be capable of delivering a truly integrated European capital market for capital and investment services. However, a report by the European Commission in the late 1990s demonstrated that the avalanche of regulatory measures adopted during the previous decade had made little impact on furthering financial integration within the EU – rather, considerable further work to create the single financial market was necessary.

1 See Annex I for details of FSAP measures and their relation to creating Europe’s single financial market.

The European Commission released in 1999 the Financial Services Action Plan to complete the single market in financial services.

The European Commission responded to the challenge by releasing on 11 May 1999 a blueprint and framework for further action – the so-called Financial Services Action Plan (FSAP)¹. The FSAP outlined a series of policy objectives and specific measures to improve the Single Market for financial services over the next five years in view of integrating European markets by 2005.

The FSAP suggested indicative priorities and timescales for legislative and other measures to tackle three strategic objectives – namely, ensuring a Single Market for wholesale financial services, open and secure retail markets and state of the art prudential rules and supervision.

1 Inter alia, amendments to the 4th and 7th Company Law Directives.
2 Inter alia, proposals for Directives on cross-border mergers and transfers of company headquarters.
3 Inter alia, clarification and possible amendment of the Investment Services Directive and a proposal for a Directive on market manipulation and insider dealing.
4 Inter alia, proposal for a Directive on the cross-border use of collateral.
5 Inter alia, proposals for European Company Statute and takeover bids.
This report focuses on how far the FSAP has delivered on the three objectives, especially with respect to financial markets business in general and securities business in particular. With regard to the legal framework for primary and secondary securities markets, the FSAP envisaged a number of significant reforms focusing on:

- the removal of outstanding barriers to raising capital on an EU-wide basis;
- a common legal framework for integrated securities and derivatives markets;
- moving towards a single set of financial statements for listed companies;
- providing legal certainty to underpin cross-border securities trades;
- creating a secure and transparent environment for cross-border restructuring;
- creating a sound framework in which asset managers could optimise the performance of their portfolios in the interests of fund holders.

To facilitate progress on the cornerstone pieces of securities markets legislation, at the request of the European Commission, a group of experts under the guidance of Baron Alexander Lamfalussy proposed a new law making model, which would avoid the delays and difficulties associated with traditional Community law making and allow quick responses to capital market developments. The "Lamfalussy Process" is unique insofar as it differentiates between 'general principles' of capital markets law and 'technical details'.

Under the Lamfalussy Process, the general legal principles of the law of investment services, market manipulation, insider trading and so forth are still negotiated and adopted by the European Parliament, the Council and the Commission in accordance with traditional law making procedures. However, the formulation of technical advice with respect to detailed technical implementing measures is now a responsibility of a number of supervisory committees. On 11 September 2001 the Committee of European Securities Regulators (CESR) was created to fulfil such a role for securities market legislation. The four level Lamfalussy approach is set out in the diagram below.

7 Proposals for Directives on prudential supervision of and tax arrangements for supplementary pensions and on closed-end collective investment funds.
8 Followed by the creation of the Committee of European Banking Supervisors (CEBS) and the Committee for European Insurance and Pension Supervisors (CEIOPS), respectively for the banking and insurance sectors, in 2004
The Lamfalussy approach distinguishes four levels of policy-making.

**Level 1: Legislative principles and definition of implementing powers**

- European Commission
- European Parliament
- Council
- Framework principles

**Level 2: Definition of implementing measures**

- CEBS/ CESR/ CEIOPS provides advice
- Council + EP scrutiny
- European Commission adopts measures

**Level 3: Practical supervisory cooperation and convergence**

- National supervisory authorities work towards common interpretation and application of rules
- CEBS/ CESR/ CEIOPS

**Level 4: Implementation checks**

- European Commission checks national implementation of EU law
By 20 June 2008 most EU Member States had successfully transposed an overwhelming majority of FSAP measures. Such impressive progress was made possible by a clearly defined objective and timetable, a carefully planned strategy, high quality resources, systematic monitoring, and the goodwill of Member States, the European Parliament and market participants. The FSAP has clearly proved its worth as an important vector for economic integration within the EU in general and for the creation of the Single Market in securities in particular.

Commentators generally conclude that it is still too early to tell whether the FSAP has achieved its stated objectives. Not only is financial integration an extremely difficult concept to measure; furthermore, the implementation of significant initiatives such as the Markets in Financial Instruments Directive (MiFID) continues and the Directive will be subject to a review in a number of important areas in 2010. Integrated pan-European clearing and settlement arrangements – a necessary precondition for a single European securities market – remain an illusion, despite a renewed and concerted effort by all stakeholders to make progress on this complex subject since 2006. Weaknesses in the operation of the passport for securities under the Prospectus Directive have been identified but need to be addressed with appropriate amendments. In sum, Europe has never been as close as it is today to a single capital market, but national borders for the purpose of finance still exist and still remain a significant cause of economic burden for pan-European institutions.

Prospects for further integration in today’s economic conditions

The financial crisis of 2007-2008 followed by the severe economic downturn of 2008-2009 created a number of important and additional challenges to building the pan-European financial market. These were subject to an analysis by the High Level Expert Group on financial supervision in the EU, set up in October 2008 and chaired by Jacques de Larosière. The many recommendations of this group are summarised in Annex 1, together with an overview of the objectives and initiatives of the FSAP.
In this and other documents, the origins of the financial crisis and its impact on the global banking industry, and consumer confidence in the industry, have been well documented. Therefore, it is not the purpose of this paper to describe these events in historical perspective and/or to set these issues apart from the wider context of European financial integration. Rather, the intention is to note the following observations:

- Banks generally accept that the industry has been heavily criticised – justifiably so in certain circumstances – for its role in the financial crisis. There is a general consensus however that a degree of short-termism in areas of public policy and at times ineffective supervisory oversight were also significant contributory factors to precipitate the crisis and to consequently lead to the currently testing economic conditions.

- The unprecedented nature and scale of events during September and October 2008 will have a profound effect on the shape of banking in Europe and general confidence in the system for years to come. Banks are now actively attempting to restore confidence in the system as well as in the financial services they offer by *inter alia* taking important steps to improve the transparency around the more complex product offerings.

- Some banking models will be rendered obsolete while others will thrive and will become increasingly popular. Although some notable and lamentable banking failures have occurred in Europe, the generally more conservative lending practices and the diversified structure of European universal banks have proven their worth.

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In view of the ‘real economy’ impact of the financial crisis, a renewed appetite to regulate in the formal way has become apparent over the past months, accompanied by scepticism about the viability of self-regulation. This goes along with a perceptible risk of abandoning better regulation principles and over-regulating, in the attempt to find a way out of the current conditions.

It is also unclear what the overall impact of the crisis will be on European integration. Despite frequent political reassurance about the need to avoid protectionist and unilateral action, such reflexes have become apparent on several occasions.

There is therefore a clear need to focus on priorities to continue to stabilise the markets and restore confidence in the short term, while keeping in mind the longer term goals of developing the single European market in financial services and winning support for global convergence abroad.
The years ahead

The political leaders and captains of the financial industry deserve a good deal of credit for their tireless pursuit of financial integration in Europe, during the stable economic conditions under which the majority of the initiatives came to fruition as well as during the current turbulent and challenging market conditions. Without such vision and in the absence of strong political will to make progress on this project, the European single market would remain an illusion which would be to the detriment of Europe’s approximately half billion potential consumers as well as Europe’s global economic standing as a whole.

The banking industry has demonstrated a degree of contrition for events that have taken place and has learnt some important lessons in key areas such as robust risk management practices and improving transparency with respect to structured products and OTC derivative markets. Future priorities however should have the cherished prize of greater financial integration at their core. Bedding down existing FSAP measures in the wholesale space and then drawing conclusions in an evidenced-based way would prove to be a positive tonic for a critically important industry which is currently under severe economic pressure.

The EBF’s view

The EBF positions Europe’s banking industry to play an important and dynamic role in the evolution of the single financial market in Europe.

The upcoming challenges will require bold and confident decisions taken in a consensual manner between the public and private spheres. This will prove to be additionally challenging coming as it does at a time when it would be all too easy to abandon the nobler cause of European integration and global convergence in favour of immediately impacting responses to the financial crisis.

Europe already has in place a regime of financial regulation, based on sound principles, that is very much fit for purpose. A testament to this is the fact that Europe’s regime has been studied and copied in part across the globe.

The Federation would urge all policy makers to keep in mind the longer term aims of a confident Europe, based on this solid legislative foundation, which is essentially well placed to respond to the significant but not insurmountable challenges in the coming five year legislative period.
The concept of regulation refers broadly to the creation of formal standards and the codes of conduct which private individuals and firms must follow.

From an academic perspective, regulation is the art of setting boundaries and limiting commercial freedom, to change standards of behaviour and to enforce a new economic order which accords with the overriding public policy aims.

From the public policy perspective, regulation is a key tool most often employed to provide a series of safeguards for typically less sophisticated consumers from industry professionals. Where the market interfaces with its clients, regulation mitigates the possibility of professionals being able to use their assumedly superior knowledge to that of their client for their own ends, rather than those of the client. This in turn inculcates a degree of trust and confidence in the banking system as a whole.

From an industry perspective, regulation delimits the boundaries in legal terms of acceptable behaviours and practices towards clients as well as setting common norms by which to appropriately organise business lines.

The industry lobby often talks of the ‘regulatory burden’ – the costs of regulation – with a degree of justification given recent experiences where regulation sometimes lacked either efficiency or effectiveness.

However, the industry does not question that regulation is necessary. Rather, the challenge lies in designing regulation that is well targeted at clearly defined objectives; achieves these at the lowest necessary costs; keeps unintended side effects and competitive distortions at a minimum; and respects the global nature of the financial markets.

Indeed, for the most dynamic firms and markets, such well crafted regulation can open doors onto new business opportunities by levelling the playing field for competition and eroding barriers to trade.

The task for policy makers is therefore a difficult one, all the more so in times where sentiment often dominates thorough and facts-based analysis and where well thought-through decisions might be put to the test of public opinion.

A typology of financial regulation

If economic regulation refers to restrictions on prices, interest rates, quantity of production, the entry in or exit from the industry then social regulation seeks to correct some form of market imperfection or failure. Regulation in general is distinct from supervision insofar as the former refers to the process of setting out legal norms and rules whereas the latter is the process of ensuring that the rules are observed.
In very broad terms there are two types of financial regulation: prudential regulation, which purports to ensure that financial institutions are financially strong, sound and viable, and conduct of business regulation, which regulates the dealings of financial firms with their customers, investors and depositors.

Prudential regulation seeks to anticipate future problems by focusing on the internal affairs and organisation of a firm. Prudential regulatory standards typically purport to limit managerial discretion in the internal organisation of the firm and the structure and nature of the firm’s activities and assets, thereby aiming to prevent losses and financial distress by managing carefully the risk profile of the financial institution. On the other hand, conduct of business regulation does not seek to manage or eliminate risk. It refers to those standards applicable in the relationship between the financial institution and its customers. Conduct of business regulation imposes certain standards of behaviour, standards of fairness, transparency and competence in dealing with the customer’s financial affairs or entering into contractual arrangements. This report will predominantly focus on conduct of business supervision, the branch of regulation most readily associated with financial markets.

It is possible however to conceive a third category of financial regulation – market regulation – which sets out the norms with respect to the sound operation of the market on an ongoing basis.

This is for example addressed by the Markets in Financial Instruments Directive, as well as by the Market Abuse Directive which defines and identifies market abuse, i.e. the express attempts to manipulate the direction of the market and/or to trade on insider information.

*Europe’s approach to regulation*

To level the playing field for firms operating in the single European financial market a significant legislative impulse was generated by working through the initiatives listed in the FSAP.

Excessive regulatory burden on firms (and national legislatures) and the consequent need for a regulatory pause were messages that were well heeded when Charlie McCreevy assumed office as Commissioner for the Internal Market and Services in 2004.

As part of a wider Commission initiative to reduce legislative burden – by re-evaluating and cancelling unnecessary legislative initiatives – and to carefully consider new initiatives by scrutinising them against the so called ‘better regulation principles’, key stakeholders, such as the banking industry, began to engage constructively with the public sector to identify legislative under- and over-laps. Whilst this welcome process has continued, financial stakeholders sense that rigorous cost benefit analysis and adherence to better regulation principles with respect to certain proposals emanating from the European Commission in response to the financial crisis have appeared to have waned.
To ensure that consensual and costed law making remains the norm in Europe, confidence on the part of law makers is needed. A continued, if not renewed, willingness for dialogue with the industry to come to the most appropriate conclusions to restoring confidence in dynamic, open and globally competitive European markets whilst appropriately protecting its consumers is also very necessary.

However, to fail to meet this challenge potentially undermines the shared longer term regulatory aims - in which the public and private sectors have already invested heavily - to position Europe as the partner of choice for global business, whilst raising the living standards and prosperity for its citizens in a sustainable and balanced way.

The EBF’s view

The EU has come a long way along a good path towards instilling a ‘better regulation reflex’ in the policy proposals that it has generated in recent years and especially towards the end of the FSAP process.

This positive development has been reinforced by the welcome consultative procedures that have been established by the three pan-European supervisory committees in respect to the technical advice to support complex pieces of principles-based legislation.

This generally positive and participatory regulatory process ought not to be sacrificed going forward, especially not now in the most challenging law making environment.

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10 Cf. e.g. Commission press release of 14 November 2006, “Proposed cuts of 25% in red tape to lead to increase in EU GDP of 1.5%”:

11 Cf. the creation of the European Securities Markets Expert (ESME) Group in 2006.
Chapter III - Supervision

Towards a common supervisory culture in Europe

Key references
- Conduct of business supervision
- CESR
- International dimension (IOSCO)

The EBF adopts a functional approach to the concept of financial supervision. This briefing focuses on the priorities for financial markets; this current chapter focuses primarily therefore on conduct of business supervision.

Conduct of business supervision focuses on ensuring orderly and transparent financial market processes, proper relationships between market participants and the exercise of due care by financial undertakings in dealing with clients. Prudential supervision on the other hand, more associated with the business of accepting deposits and granting loans, aims to ensure the financial soundness of financial undertakings and contributes to the stability of the financial sector as a whole.

Europe has historically organised supervisory coordination along sectoral lines – i.e. separating the supervision of banking from securities from insurance businesses - corresponding approximately to the broad distinction drawn between conduct of business (mainly securities) and prudential (mainly banking and insurance) supervision.

Given the diversity of the supervisory institutional architecture in Europe and the complex and highly charged subsidiarity questions that currently reinforce such an approach, the EBF has historically stated desirable principles to achieve particular supervisory outcomes as opposed to stating preferences for a particular supervisory model.

The Committee of European Securities Regulators

In the securities arena, European supervisory action and approaches to implementing legislation have been coordinated by the Committee of European Securities Regulators (CESR) since September 2001 and by FESCO – the Forum of European Securities Commissions – prior to that.

CESR has achieved a degree of prominence and justifiable significance in the drive towards creating the single European financial market, since it is mandated by the European Commission to:

- coordinate and provide technical advice to the European Commission in respect of Level 2 measures of securities legislation that are subject to the Lamfalussy approach;
- to issue guidance at Level 3 of the Lamfalussy procedure to facilitate common pan-European implementation of securities directives; and increasingly
- to focus on operational tasks – such as facilitating the exchange of supervisory transaction reports required by MiFID amongst its members – as well as reviewing the national implementation of securities markets directives.

Key references
- Conduct of business supervision
- CESR
- International dimension (IOSCO)
The Committee of European Securities Regulators (CESR) is making notable progress in these areas which is to the good of European financial integration. However, the recent financial crisis has reopened the debate about the optimal approach to financial supervision in Europe, especially with respect to prudential supervision and installing effective early warning mechanisms that are connected to central bank oversight to best avert financial shocks in the future.

The discussions of the High Level Expert Group on EU financial supervision – a group of supervisory experts created in the wake of the crisis to diagnose weaknesses and prescribe appropriate solutions – therefore focus mainly on the more effective identification of systemic risks at the macro level and better coordinated banking supervision at the micro level.

The global dimension

An analysis of European securities supervision ought not to overlook the global context in which Europe’s supervisors interact with their counterparts world-wide, most frequently under the aegis of the International Organization of Securities Commissions (IOSCO). The banking community attaches considerable weight to the work carried out by IOSCO to analyse particular issues and set out common global standards which IOSCO members would be expected to take up in the supervision of firms at the national level.
The recent financial crisis has underscored the importance of supervisory cooperation and coordination beyond Europe’s borders. In 2008 in particular, European and US industry and regulatory institutions made considerable efforts towards establishing a mutual recognition regime between the US and Europe, underscored by an increasing understanding and trust in each other’s regulatory and supervisory method. When the financial crisis took hold however in late 2008, immediate priorities around stabilising the system took over the space to make progress on longer term multilateral supervisory projects.

The **EBF’s view**

**Global consistency** between European and global approaches to key supervisory topics should be ensured by working with IOSCO and CESR in parallel.

**Discussions between European and US authorities need to be restarted**, with the objective of engendering a regulatory mindset of trust and cooperation leading to a mutual recognition regime for selected areas of the transatlantic securities market.

The discussions around reaching a **common definition of investor** should be considered in the context of global crisis management, as well as in consideration of ongoing business efficiency and consistency.

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The International Organisation of Securities Commissions (IOSCO).
Sets global standards for securities markets regulation
Chapter IV - Wholesale market

Re-oiling the wheels of Europe’s economy

Banks in the capital markets

Banking is crucial for market economies in its function of channelling funds from savers to borrowers, allowing the latter to undertake wealth-generating investments and the former to benefit from the economic growth that this generates. Commercial banks - which comprise the vast majority of the membership of EBF’s member associations - primarily accept customers’ deposits and lend money for their own account in view of profit. Retail commercial banking refers to small value banking services offered to the general public. This is as opposed to wholesale commercial banking, which concentrates on large scale transactions with other financial institutions (on the inter-bank market), typically of a low volume and high value.

Both retail and wholesale banking business lines have important interactions with capital markets. Yet, it is possible to argue that banks and capital markets are antagonistic institutions, since a firm wishing to raise funds will either go to the bank for a loan or go to the capital markets and receive funds from potential investors in exchange for equity and debt securities. However, an ongoing decline of bank lending as a proportion of the overall provision of finance has prompted banks to explore other business opportunities and steadily engage in fee generating activities in the capital markets. Therefore, the role of banks in capital markets has become increasingly important as banks more and more broaden their securities and capital markets activities.

Generally, commercial banks, which accept deposits and grant loans, are involved in securities markets directly (unless the national legal system prohibits the notion of universal banking, which is not usually the case in Europe) or indirectly (through a subsidiary or affiliated investment bank).

In the primary markets, banks in some countries are permitted to underwrite security issues either directly or through subsidiaries. In the secondary market, similar considerations apply.

A commercial bank may simply apply for a regulatory licence to provide broker-dealer services to its clients, purchasing financial instruments on the customer’s behalf. More frequently a deposit-taking bank will be affiliated to a financial institution engaging in securities activities, including broker-dealer services, investment advice, portfolio management or individual wealth planning and private banking services. Further, investment bankers and brokers will, on occasion, need to accumulate large amounts of stock to satisfy a block purchase and high customer demand, for which they may need short-term credit from a commercial bank in the interbank market. Dealers demand credit to finance their proprietary positions and to facilitate the buying and selling required of them in their role as market makers. Most financial institutions involved in capital markets normally need access to bank lines of credit to manage settlement delays or failures.

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12 Even where underwriting is not permitted, underwriters will often turn to banks for credit to finance their activities.
I. Removing the outstanding barriers to raising capital on an EU-wide basis

Key references
- Prospectus Directive
- Private Equity

Fund-raising on the capital markets

Following the value chain of investment products, the first step is the issuance of products on the primary market. The Prospectus Directive, which was adopted by the European Parliament and Council in 2003, has been designed in order to enhance the single market in this respect. The Prospectus Directive sets out the initial disclosure requirements for issuers that wish to raise capital on the European markets. At the same time, the Directive provides a passport that allows the issuer to market the investment product throughout the EU once that it has been authorised in one EU Member State.

The Prospectus Directive applies to a large number of products, including to equities, closed-end investment funds, warrants, certificates, and most types of bonds. It does not apply to open-end funds which are subject to separate legislation, notably the UCITS (Undertakings for Collective Investments in Transferable Securities) Directive.

A study carried out on behalf of the European Commission in 2008 concludes that since the coming into effect of the Prospectus Directive and its implementing regulation in 2005, the Directive has led to considerable improvements in the process of offering and listing securities cross-border.

In particular, the Prospectus Directive has opened the European capital markets to issuers in a wider range of Member States. This is as compared to the previous system which relied on mutual recognition, i.e. issuers did not have the choice to seek approval in another country than their home Member State. The Directive now allows some regulatory competition with regard to the most effective approval system.

Number and share of prospectuses approved by main market.


However, whilst a certain degree of specialisation amongst regulators and regulatory competition might be healthy and desirable, questions have nevertheless been raised over the extent to which the Prospectus Directive has been interpreted in different ways across Member States. Furthermore, the work so far carried out by the European
Commission has identified a certain number of shortcomings with regard to the legal drafting of the EU Directive. These are currently being considered further by the European Commission, with the objective of making a formal proposal for amendments to the Prospectus Directive in the course of 2009, to be considered by the European Parliament and Council.

The issues that have so far been targeted by the European Commission include most notably:

- the definition of qualified investors, which the Commission suggests to align with MiFID;
- clarifications about which securities offers are exempt from the Prospectus Directive (for example in the case of re-sales of securities and of employee share schemes); and
- modifications to align the requirements of the Prospectus Directive with those of the Transparency Directive, which was introduced after the Prospectus Directive and contains some partly overlapping requirements.

Whilst endorsing some of the suggestions received, the European Commission has so far preferred to leave out some other issues raised by market participants. For some issues the Commission referred to work at Level 3 of the Lamfalussy process, i.e. ongoing cooperation between the national supervisory authorities. These include, for example:

- questions of liability for the information contained in a prospectus;
- questions about the process of notifying host authorities about issuers’ intention of distributing the security in the respective host Member State; and
- the process of incorporating information that should be part of a prospectus ‘by reference’, i.e. by referring to other previously or simultaneously published documents that contain the relevant information.

There is always a delicate balance in deciding about the level of detail of formal regulation. Less detail and an outcomes-focused as opposed to product-focused approach has the advantage of being more flexible to be adapted to changing circumstances. It can however also lead to different interpretations in different Member States, with the potential result of legal uncertainty and competitive distortions. Some market participants would therefore prefer that the amendments to the Prospectus Directive go further than initially envisaged by the European Commission.

Against this background, a thorough consideration of the European Commission’s amendment proposals will be necessary, with the ultimate objective of making it yet easier for issuers to finance ‘real’ economy investments as efficiently as possible.

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13 Study on the Impact of the Prospectus Regime on EU Financial Markets - prepared by the Centre for Strategy and Evaluation Services (CSES):  
Private equity

The term private equity denotes investment in companies whose stock is not publicly traded, i.e. typically smaller companies. Private equity is special in that investing firms do not only provide financing to the companies in which they invest, but also business advice.

Private equity investment can take different forms, including
- leveraged buy-outs, where investors – often senior management or existing shareholders of a company – use leverage (borrowed money) to buy those parts of the firm that they do not already own;
- venture capital, to invest in new companies and help them establish themselves;
- growth capital, for firms which are mature but looking to expand in a certain market segment or to enter new markets;
- distressed investments, where private equity firms invest in companies that have run into difficulties, in particular in under-performing and no longer being competitive.

Private equity

In practice it is only possible for the larger and better-known companies to place their securities issues on the financial markets, whereas smaller companies mostly have to rely on bank financing. In particular start-ups and higher-risk companies find it often difficult to receive bank loans. This is because from banks’ point of view, companies with for example a new business model or a change in ownership represent particularly high and difficult-to-assess risks.

Private equity firms have therefore specialised in, not only financing these types of companies, but also in providing additional support and guidance to these firms about how to structure their business. That is to say, they also provide special expertise, and acquire in the process of doing so a much better understanding of the growth opportunities of the individual company.

This allows them to better assess their financing risks and to take or suggest corrective action, if necessary.

Much academic research exists about the activities of private equity companies, demonstrating the benefits of private equity to finance those parts of the economy that are amongst the most likely to bring innovation and related economic growth.

However, private equity firms have also been subject to much criticism as their business often necessitates the restructuring of under-performing companies. This is normally done in agreement with the target company’s management, which seeks ways to ensure the survival of the company.
The reform measures that are subsequently taken sometimes lead to staff redundancies in the short term. Even though target firms often start hiring again once that they have again become profitable, this is of little consolation to those employees that are laid off after a private equity investment.

Concerns about the protection of employees in such cases have over the past years repeatedly been voiced by the European Parliament. In principle, employment law in all Member States sets out the rights of employees vis-à-vis their employers and the protection standards that all employers have to respect.

This was however not deemed sufficient by many members of the European Parliament who felt that cases where firms received private equity financing often became controversial where private equity firms were set up as mutual funds, i.e. received financing from third parties.

In response to these concerns, the European Commission made in April 2009 a formal proposal for the regulation of managers of non-UCITS type funds, including specific provisions foreseen for all types of funds that acquire controlling influence in companies.
Integration of the European securities markets is well advanced. The Markets in Financial Instruments Directive (MiFID), which has been in effect since November 2007, is seen to have made an important contribution to overcome some remaining single market obstacles and to further increase competition.

As compared to its predecessor, the Investment Services Directive (ISD), MiFID facilitates firms’ cross-border operations by introducing the principle of home state supervision. Whereas under the ISD investment firms were subject to the rules of the authority competent in the country where services were provided, under MiFID investment firms can obtain a single authorisation in one Member State and will be subject to the rules of this home Member State for all services that are provided directly out of the home Member State.

Where investment firms operate out of branches in the host Member State, supervision of the branch is agreed between the home and the host Member State authorities. In order to achieve consistency CESR has agreed on two principal models for the supervision of branches – one that foresees joint supervision or ‘common oversight’, and alternatively, one where the home authority provides supervisory assistance for the supervision of the branch located in the host Member State.
Markets in Financial Instruments Directive (MiFID)

MiFID replaced in 2007 the Investment Services Directive (ISD) as the piece of legislation that provides a harmonised regulatory regime for the provision of investment services in the EU. The most important changes brought about by MiFID include the following:

A larger number of services, as compared to the ISD, that can be provided cross-border without separate registration in the host Member State ('passport');
Greater harmonisation of the requirements regarding the organisation and conduct of business of investment firms;
The abolition of the ‘concentration rule’, which previously gave stock exchanges in several EU Member States a monopoly for executing trades in shares:
A number of requirements to increase client protection, including for example the requirement for client categorisation and related to that, clear procedures to test the suitability and appropriateness of products recommended to these clients or requested by them on their own initiative;
A ‘best execution’ requirement that requires that client orders be executed in a way to achieve the best possible result for the client, taking into account, for example: price, cost, speed and likelihood of execution;
Increased transparency requirements (towards the markets) and reporting requirements (towards supervisory authorities).

The most visible impact from MiFID so far has been the creation of new trading venues, and in parallel, the increased competition on the trading markets. This has come as a result of the removal of the concentration rule. Multilateral Trading Facilities (MTFs), for example, rely on a lighter infrastructure to locate counterparties to a transaction. MiFID has also introduced the status of ‘systematic internaliser’ to designate a firm that executes client orders against its own book or against orders received from other clients.

Furthermore, MiFID is a ‘maximum harmonisation’ Directive in that it does not allow Member States to impose additional rules, unless in exceptional and well-justified circumstances.

The one feature of MiFID that has had the greatest practical impact on the markets to date is the abolition of the so-called concentration rule, which gave Member States the option to require investment firms to route client orders through regulated markets.

Regulated markets are distinct from the Multilateral Trading Facilities (MTFs) which have become a feature of the trading landscape in Europe in recent months, ending the effective oligopoly of the incumbent and often national stock exchanges. Multilateral Trading Facilities (MTFs) generally rely on lighter infrastructure than the traditional exchanges and have therefore been able to offer lower trading prices. In turn, this competition has also led the traditional exchanges to both lower their prices and offer improved services.
The increased competition between trading venues has at the same time led to market fragmentation. The same instruments are now often traded in parallel on different regulated exchanges and MTFs, meaning that it has become more difficult to track and compare prices. However, this challenge has been identified as a commercial opportunity by data vendors, and market solutions are being established to provide consolidated price and volume data.

As another alternative to regulated markets and MTFs, orders can be executed anonymously, through ‘dark pools,’ most often set up by the larger regulated markets to allow for anonymous matching of particularly large orders. Large orders would otherwise likely have an impact on the market prices – i.e., if there was no possibility to trade without disclosing the size of the order, such trades would have to be carried out in smaller tranches and would take longer to execute.

MiFID foresees furthermore the possibility for firms to execute orders received from their clients against their own books – i.e., to match client orders against each other instead of trading either on a regulated exchange or through an MTF. This is a straight-forward and cost-effective way of executing orders. However, MiFID requirements for ‘systematic internalisers’ – firms that carry out such internal trading on a systematic basis – have been criticised by many market participants as being overly onerous. Whilst there was initially an expectation that a large number of firms would act as systematic internalisers, CESR lists to date only around a dozen banks from four countries.

Apart from these rapid developments in Europe’s securities trading landscape, most observers are of the view that it is still relatively early to draw conclusions on the impact of MiFID. Calls for evidence conducted by the Commission and CESR show that market impressions are at this stage overall positive on many aspects, for example regarding the functioning of the passport. Some concerns have been voiced with regard to the different approaches taken by Member States to implement certain parts of the Directive. CESR is working on these issues with the objective of achieving a common understanding between its member authorities.

Furthermore, some questions about MiFID rules were only answered temporarily during the negotiations, with the caveat of their later review. Both in recognition of the need to gather more experience before drawing conclusions and as a result of the more urgent issues that arose over the course of 2008 around the financial crisis the European Commission decided to defer most of these reviews, which were otherwise foreseen for 2008, to 2010 when they shall be submitted in a single report.

The 2010 MiFID Review is also likely to consider the structure of the over the counter (OTC) markets. OTC markets are not markets as such but refer to the bilateral trades that take place between authorised firms in products such as derivative contracts and/or secured finance. The OTC markets have developed to accommodate innovative and bespoke contracts and products that typically trade among the larger firms active in the wholesale space most often for the purpose of sound risk management.
Following the financial crisis, the political imperative to look in depth at all aspects of financial markets will imply that the OTC market arrangement will come into question. As evidenced by the G20 declaration of 15 November 2008, politicians feel that regulators would receive more reliable information about OTC trades if the products were traded on-exchange.

Regulated markets would certainly benefit from a shift to on-exchange trading as it would lead to a substantial increase in volumes and fees. However, banks are cautious in this respect as not all products traded OTC are susceptible to exchange trading due to their inherent heterogeneous qualities and diverse risk management objectives. Liquidity in such products could not be guaranteed and the data generated as a result of trading on-exchange could not be relied upon for the purposes of regulatory oversight.

Participants in the OTC market are therefore putting greater emphasis on establishing common global processes for derivatives trading, such as developing the ISDA Framework. At the same time, firms are redoubling efforts to establish safe and reliable regional infrastructures to support OTC trading, such as central clearing facilities and data warehousing projects, thereby improving operational efficiency and providing an enhanced information flow to supervisors as regards exposures to underlying securities.

The EBF’s view

The EBF believes that the most value to Europe’s securities and derivatives markets would stem from practical supervisory work and the creation of robust infrastructures to support in particular the OTC markets, combined with CESR activities to ensure the consistency of its member authorities’ approaches.

The Commission’s 2010 MiFID review will be instructive on specific issues but comes at a politically sensitive time when the future of the financial markets, in particular the OTC markets, is in question. The outcomes of the review have to be seen in this context and stakeholder consultation will be a critical element of reaching fair and balanced conclusions.

The EBF feels strongly that a broader review on whether MiFID is fit for purpose and has been achieving all of its objectives should be conducted several years after the introduction of MiFID.

MiFID is after all a new piece of legislation, and more experience needs to be acquired before drawing any conclusions on possible legislative amendments. In terms of legislative drafting, most parts of MiFID seem to work well, and most remaining difficulties might be best resolved through practical non-legislative solutions. The EBF, for its part, is monitoring developments in its members’ jurisdictions with a view to
Post trading of securities and derivatives

Equity and debt

Not only has MiFID fundamentally changed the trading landscape but this has had a galvanising effect further down the value chain as well. This has also been partially provoked by regulatory and other infrastructural developments such as the Pan-European Code of Conduct on Clearing and Settlement (‘the Code’), and TARGET2-Securities (T2S).

As a result, there have been major changes, particularly in the clearing layer. A particular feature here is that these clearing propositions are linked to established or emerging platforms. In other words, this could be interpreted as the re-emergence of integrated trading and post trading structures or ‘vertical silos’ - predominantly in the derivatives space but also increasingly in equities clearing - driven by the reduction of fees (in some cases to insignificance) at the trading level. As a result, the only way to establish a viable business proposition or ‘group’ is to capture the trade (and data) flow by linking this to an allied clearing entity.

These new ‘groups’ must sign up to and follow the Code for cash equities, or in the case of MTFs adhere to ‘Code - like behaviour’ - since failure to agree to the price transparency and unbundling provisions could have the consequence of returning us to a pre-code environment with little clarity about the transparency of pricing or the scale of cross-subsidisation.

Nonetheless, competition is being seen to work, although the bewildering range of trading venues and clearing entities makes it harder for users to determine what the optimal solutions for their business are. At some point in the future, it is probably inevitable that movement will occur in the trading, and even clearing levels, with only a limited number of venues and facilities surviving.

At the settlement and asset servicing layers, matters have also become a little more confused. In July 2006, the ECB proposed T2S – de facto a single platform upon which securities transactions in Euro could be settled in a single place in central bank money by 2013.

There is an added complication that while it seems clear that at the trading and clearing levels relatively homogenised activities such as trading (execution, as well as data mining) and clearing and central counterparty services exist, this is not the case at settlement level. Here the range of services (e.g. pure settlement, asset servicing, corporate actions, and even custody) is much more extensive. Therefore, developments here will have not just cost, but also efficiency, implications.

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14 For example in London there are no less than six rivals (Eurex-CCP, X-Clear, CC&G, EMCF, LIFFE Clearing, ICE Clearing) emerging to challenge the pre-eminence of LCH.Clearnet Ltd.

15 Keeping in mind the trading platform experience in the United States.

16 There will be the functional possibility for T2S to settle securities transactions denominated in other currencies over time. currencies over time.
The EBF’s view

The EBF has concluded that it is not possible to advocate a single model approach for the evolution of post trading in Europe. Rather, the banks – the users of post trading services - have agreed that they favour the evolution of the market, in close dialogue with the community of users, to deliver solutions that are efficient, secure, risk neutral, cost effective, innovative and inclusive of user governance.

The market has proved its willingness and ability in recent months to restructure itself to provide what appear to be increasingly competitive service offerings to users, which promote European integration and take into account the global dimension. This environment has been facilitated by public policy intervention (e.g. MiFID and the Code) to facilitate market forces.

Structured and regular dialogue between the market infrastructure providers, the users and public policy officials is proving its worth. This dialogue should continue to provide consensual solutions that reward open and pro-European approaches.

The EBF does not suggest that the process can be completed in short order. However, user and public sector pressure ought not to relent on market infrastructure providers to offer solutions that are fit for Europe’s increasingly globally competitive single financial market.
## Overview of current clearing and settlement initiatives

<table>
<thead>
<tr>
<th>Main objective</th>
<th>Scope Assets</th>
<th>Functions</th>
<th>Adressee</th>
<th>Tools</th>
<th>Timeline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Code of Conduct</td>
<td>Efficiency through competition</td>
<td>Cash equities (possibly derivatives and bonds)</td>
<td>Trading and post-trading</td>
<td>Trading platforms, CCPs and (I)CSDs</td>
<td>Self regulation</td>
</tr>
<tr>
<td>Giovannini Barriers</td>
<td>Efficiency through harmonisation</td>
<td>All cash securities</td>
<td>Trading and post-trading</td>
<td>Members States, Trading platforms, CCPs and (I)CSDs</td>
<td>Private and public sector action</td>
</tr>
<tr>
<td>T2S</td>
<td>Efficiency through scale effects and harmonisation</td>
<td>All cash securities</td>
<td>Settlement</td>
<td>(I)CSDs (and CCPs)</td>
<td>Central bank service</td>
</tr>
<tr>
<td>CESR-ESCB Recommendations</td>
<td>Safety</td>
<td>All financial instruments</td>
<td>Post trading (some trading)</td>
<td>Authorities (CCPs and (I)CSDs)</td>
<td>Oversight</td>
</tr>
</tbody>
</table>
On 17 October 2008 Commissioner for Internal Market and Services, Charlie McCreevy, called for a ‘systematic look at derivatives markets in the aftermath of the lessons learned from the current turmoil’ and in particular ‘to have by the end of this year [2008] concrete proposals as to how the risks from credit derivatives can be mitigated.’ More specifically, Commissioner McCreevy decided to focus on improving transparency and facilitating a European solution for central clearing of the Credit Default Swap (CDS) market. The announcement came one month after the most tumultuous of weeks for the banking industry, when key players in the CDS market – AIG and Lehman Brothers – were taken into public ownership and became insolvent, respectively.

The CDS allows an investor to buy insurance against a company defaulting on its debt payments, which is an appealing notion since investors are generally more comfortable buying corporate debt if the associated risk of the issuer failing could be mitigated, if not eliminated. Contracts for CDS are generally traded over the counter (OTC), typically meaning between large banks rather than on exchange, and within the self regulatory ISDA framework. Whilst trading OTC – typical for the majority of derivatives contracts – is well suited to the bespoke and individual nature of derivatives contract writing, the events of mid-September brought the transparency and the stability of the system into sharp focus.

Derivatives Overview

Derivatives are financial contracts whose values are derived from the value of something else (known as the underlying). The underlying value on which a derivative is based can be an asset (e.g. commodities, equities, residential mortgages, commercial real estate, loans and bonds) an index (e.g. interest rates, exchange rates, stock market indices), weather conditions, or other items. Credit derivatives are based on loans, bonds or other forms of credit.

The main types of derivatives are forwards, futures, options and swaps. Derivatives can be used to mitigate the risk of economic loss arising from changes in the value of the underlying. This activity is known as hedging. Alternatively, derivatives can be used by investors to increase the profit arising if the value of the underlying moves in the direction they expect. This activity is known as speculation.

Because the value of a derivative is contingent on the value of the underlying, the notional value of derivatives is recorded off the balance sheet of an institution, although the market value of the derivative is recorded on the balance sheet.

An over-the-counter (OTC) contract is a bilateral contract in which two parties agree (bilaterally) on how a particular trade or agreement is to be settled in the future. It is usually from an investment bank to its clients directly. Forwards and swaps are prime examples of such contracts. It is mostly done via the computer or the telephone. For derivatives, these agreements are usually governed by an International Swaps and Derivatives Association agreement.
The notional amount of outstanding CDS contracts were worth $62 trillion at their peak in the second half of 2007, a figure which has been cited by public policy officials to further underscore the need for increased attention on this market.

On 18 February 2009 a group of large dealer firms and the EBF committed to European central clearing (CCP) of CDS following intense rounds of negotiations with firms over the location, ownership and functionality of the prospective CCPs. Central clearing both strengthens the infrastructures that support the OTC markets and provides a gateway for information to flow, in the case of CDS, to regulators in respect of counterparty credit risk. The CCPs that intend to offer services for CDS clearing aim to have the service in place by mid-2009. There are outstanding questions however about how buy-side firms and smaller operators in the market will be able to connect to the central infrastructures against such a tight timescale. In the meantime the industry will continue to work with officials to address the outstanding regulatory, legal and technical impediments to CCP clearing in Europe.

The EBF’s view

Credit derivatives, in particular credit default swaps (CDS), continue to be a key instrument for efficient and flexible credit-risk management.

The introduction of CCP clearing for a significant portion of the credit derivatives can help to significantly reduce the systemic risks involved by reducing counterparty risks and increasing transparency.

The EBF would urge law makers to recognise the benefits of CDS and the fact that this market functioned well following the events of September 2008.

Consensual, rapid and tangible progress has been made in this area and European banks feel strongly that this should be taken into account in any future review of the OTC markets and/or discussion about the capital treatment of CDS.
The financial crisis has triggered an intense discussion about ways of ensuring that both wholesale and retail investors are well informed when making their investment decisions. It has been underlined in that discussion that information must not only be available in the right substance and amount, but also in a location that is easily accessible and in a format that is conducive to the material being read and understood. In many cases where (both wholesale and retail) investors were not aware of some aspects of the risks involved in the products they were holding, the information had been available in substance, but had to all evidence not received a sufficient degree of attention.

Especially for the wholesale markets, it can be expected that market participants have individually learned important lessons for a more thorough review of potential investments.

Moreover, in February 2007 a number of industry associations from both the buy-side and the sell-side agreed between them on measures to enhance transparency on the markets for securitised products, including increased disclosure of banks’ individual holdings; an industry market data report with aggregated data; and improved standards for the information to be provided by the issuer to potential investors in those cases where the Prospectus Directive does not apply.17

This is in addition to the above-mentioned requirements of the Prospectus Directive for information on products offered to the wider public and in addition to also previously existing requirements for disclosure of certain information under the Transparency Directive (in force since 2005). The Transparency Directive sets out both minimum periodic information requirements for issuers whose products are traded on regulated markets and disclosure requirements for investors with major shareholdings in these products.

For issuers, the Transparency Directive specifies the minimum content of annual and bi-annual financial reports and of interim management statements. For shareholders, the Transparency Directive requires the notification of the issuer with regard to the voting rights that a shareholder has acquired, and when voting rights fall again below the specified thresholds. These minimum disclosure thresholds are of 5%, 10%, 15%, 20%, 25%, 30%, 50% and 75%. Several Member States have chosen to impose additional thresholds starting already at 3%.

The Transparency Directive furthermore requires Member States to put in place mechanisms for the storage and dissemination of regulated information pertaining to the issuers registered in their Member State.

Whilst there is broad agreement between regulators, issuers and investors that the Transparency Directive has achieved its objective of greater harmonisation in most of its aspects, a number of remaining questions have been raised in the discussions to date.

Notably, the European Parliament has in the past questioned whether the requirements of the Transparency Directive are sufficient to ensure that issuers are well informed, and in a timely manner, about their shareholders and the intentions of these shareholders. Although the above-mentioned disclosure thresholds are clear for the majority of situations, uncertainties have arisen in some situations where voting rights were acquired indirectly through equity derivatives, such as options. Another issue of major interest in the context of transparency towards investors is the functioning of Credit Rating Agencies (CRAs), whose role it is to provide comparability of the credit risk involved in fixed-income instruments of different issuers. There is no doubt that the financial crisis has revealed serious shortcomings in the reliability of ratings, especially in structured finance. The ratings of a large number of debt instruments whose performance was linked to pools of loans turned out to have on the one hand misjudged the credit risk involved in the loan pools, and on the other hand to have underestimated the degree to which the performance of certain types of loans was inter-related.

This inter-dependence was in spite of these loans being of different types and originated in different geographic regions.

Many observers and users of ratings however also criticised some of the agencies’ ratings of traditional corporate debt. Although traditional ratings have historically proven a high degree of accuracy, there were a number of prominent cases where looking back, ratings of traditional corporate debt appeared clearly inaccurate. Moreover, it was pointed out that the downgrades of a number of major banks, as a result of the deteriorated business prospects over 2007 and 2008, occurred rather slowly.

At the same time, with the benefit of hindsight it must also be concluded that many investors over-relied on the judgements of the rating agencies and in some cases ignored the fact that these ratings were meant to express credit risk, but not other types of risk such as liquidity risk.
The role of credit rating agencies in the financial crisis

Credit rating agencies played an important role in the chain of events that facilitated the spreading of structured debt vehicles, which triggered the financial crisis. Structured debt allows the separation of the loan issuing function from the credit provision function. Whilst a bank still performs the former, the loans are then bundled into one large product that can be sold on, mostly in ‘tranches’, which each have a different risk and reward profile.

For an individual investor it is quite complex and cumbersome to evaluate the credit risk of each of these tranches. The issuers of structured debt therefore mandate rating agencies to assign ratings according to rating scales that are well known to potential investors. This evaluation can be done more cheaply by rating agencies for the two reasons that a) they have developed special expertise in this field, and b) they undertake the evaluation work once, for a larger number of individual investors.

However, when it became clear that rating agencies had misrepresented the risk for an entire class of products the impact on the market was vast, for the very reason that many investors had relied on the same assessment of credit risk.

It was often argued that conflicts of interests were amongst the main reasons for the overly optimistic ratings, and this is being addressed by the formal regulation that has been agreed between the Council and the European Parliament this spring. However, there can be no guarantee for the accuracy of credit ratings, for the simple reason that ratings try to predict the future conditions of firms on the basis of today’s knowledge. Ratings can therefore just be used as a complement by investors, who consistently make their own judgements about the desirability of investments in certain market segments.
The International Organisation of Securities Commissions (IOSCO) also made changes to its Code of Conduct Fundamentals with which the largest rating organisations were complying on a voluntary basis.

However, policy makers in several countries were of the opinion that the IOSCO Code of Conduct was not a sufficient tool to frame the functioning of the ratings market. Among them was the European Commission, which made a formal proposal for the regulation of rating agencies in the EU in November 2008. The European Parliament and Council agreed subsequently in a swift procedure on regulation for the registration and ongoing supervision of CRAs and for the substantive requirements that are to be met by CRAs whose ratings are used for regulatory purposes.

This was despite several opposed voices, including for example the Committee of European Securities Supervisors which initially questioned that formal regulation would achieve the objective of improved ratings, and raised instead concerns that formal regulation would likely encourage investors’ over-reliance on the ratings.

Another concern that was raised is the impact of formal regulation on competition in the ratings market. Against the backdrop of the large rating agencies’ quasi-oligopoly, market participants and regulators felt that it would certainly be an unwelcome effect if the formal regulation was to make entrance for new competitors yet more difficult.

In addition, concerns have arisen from the speed with which the CRA regulation was adopted. Clearly there was willingness from all sides to compromise and the lawmakers are to be complimented for successfully conducting these difficult negotiations within just a few months.

The short time frame to find solutions was however as opposed to the extensive consultations and time usually given to negotiate other pieces of EU legislation. Also, the process of adopting the Annexes at the same time as the Level 1 text was in contrast to other pieces of Lamfalussy legislation, which separates the drafting of the two levels of legislation and foresees advice to be provided by (depending on the area of legislation) CESR, CEBS or CEIOPS.

**The EBF’s view**

The *2009 Transparency Directive Review* will be a good opportunity to consider the conditions for the acquisition of voting rights, in particular as regards to the treatment of equity derivatives. The impact and justification of divergences in the thresholds for the disclosure of major holdings to issuers should be given thorough attention in these discussions. In the view of the industry, the minimum harmonisation requirements of the Transparency Directive have achieved their objective in most respects. However, the increased use of equity derivatives has raised questions that were less pertinent at the time of drafting the Transparency Directive.

Once in force, some time will be needed to assess whether the *EU Regulation on Credit Rating Agencies* is fit for purpose by achieving its intended objectives and avoiding harmful disruptions in the global dimension. As it currently stands the Directive foresees a review three years after its coming into force. However, it is not excluded that serious unintended consequences become apparent in a shorter timeframe. Should this be the case the EBF calls on policy makers to be prepared to swiftly address such urgent shortcomings.
IV. Safeguarding the integrity of the markets

Key references
- Market Abuse Directive
- Alternative investment funds

Reviewing the market abuse regulations

All applicable EU legislation foresees appropriate sanctions for the case of infringements. It is up to national supervisory authorities to carry out day-to-day supervision and ensure that infringements are in a first instance detected, and subsequently addressed in a proper and proportionate way.

As opposed to this, more serious cases of outright abuse are subject to the 2003 EU Directive on insider dealing and market manipulation. The Market Abuse Directive (MAD) has proved helpful in establishing, in the first instance, common definitions of market manipulation and inside information across Member States. As part of a formal review of the Directive, a number of consultations and hearings were recently carried out. These identified a limited number of areas where legislative amendments are warranted to make the Directive work more effectively. For example, it is envisaged to extend the scope of the Directive in some respects beyond regulated markets, to also cover Multi-lateral Trading Facilities.

In addition, attention is being given to the sanctions regimes under the MAD.

These have so far been left to Member States, for respective alignment with national law. This has resulted in wide divergences in the level of both fines and prison sentences that could be applied, opening in theory the possibility for ‘regulatory arbitrage’, i.e. a conscious choice of the location where market abuse is being committed. Arguably more importantly, diverging sanction regimes add to national supervisors’ lack of trust in each other’s work. A degree of harmonisation would help to enhance authorities’ mutual reliance.

However, given the limited remit of EU competences in this area there is broad agreement that harmonisation in this respect is best addressed through coordination between Member States for necessary amendments to be made to the implementation of the Directive into national law.

Discussions so far have furthermore pointed to the need for more practical enforcement work by national supervisors, both individually and through increased coordination with the authorities in other Member States.

At the same time, in terms of legislative initiatives, market participants are questioning the fact that the MAD only applies to instruments traded on regulated markets, as defined by MiFID. This is in particular in view of the growing market share of Multi-Lateral Trading Facilities. This question will certainly be a central point in the European Commission’s review of the MAD.
Hedge Funds

There is no clear-cut definition of hedge funds. Rather, hedge funds are a diverse group of investors with very different investment strategies. Hedge funds are typically defined by meeting several of a number of criteria typically associated with them. These include notably:

- the objective of achieving positive returns in any market situation;
- co-investment by the fund manager;
- the use of leverage (i.e. borrowing additional funds from banks);
- the use of derivatives for speculative purposes;
- the flexible use of a number of diverse trading strategies;
- an investor base which is predominantly comprised of professional investors and high net-worth individuals.

It is generally acknowledged that hedge funds did not play a particular role in the financial crisis. Some hedge funds were investors in structured debt products, but most hedge funds have different investment strategies. These can for example involve algorithmic trading (use of computer programmes to automatically execute orders according to certain criteria) or betting on price movements of currencies or commodities. Some hedge funds also engage in short selling (cf. box further down).

Such trading activities do not constitute market abuse, but are legitimate in that they express an opinion about fair security prices. They are also positive for the markets in adding liquidity, which smooths the market functioning and allows a larger number of opinions to be reflected in market prices. Furthermore, some markets would not exist without the trading contribution of hedge funds.

Concerns around hedge funds have on the other hand arisen in terms of, in particular:

- their growing overall importance and the possible related effect on the markets;
- the lack of information about their investment strategies - as opposed to regulated funds, which have to report on a regular basis;
- the ‘activist’ behaviour of some hedge funds, albeit in a small number of exceptional circumstances.

With a view to the latter, legislators and regulators were so far of the view that all investors have to be treated the same as regards their rights and obligations. However, the former two considerations have played a role in the European Commission’s decision to propose a Directive for the regulation of Alternative Investment Fund Managers in the EU.
Broadening the scope of EU regulation

In the discussions of the causes of the financial crisis, amongst many other things concerns were expressed about the role of ‘unregulated financial entities’, which in particular included hedge funds.

This was despite a broad recognition by policy-makers and securities supervisors that hedge funds were neither the cause of the crisis, nor unregulated in the strict sense. Instead, hedge funds are regulated in their investment activities. Specifically, they are subject to the MAD when they trade on regulated markets, and subject to the Transparency Directive when investing in listed companies.

However, hedge funds were not so far subject to regulation as regards their internal set-up and investment policies, i.e. aspects that are related to investor protection. This was for the reason that investors in hedge funds are mainly investment professionals, such as pension funds and insurance companies. It was assumed that such investors would apply their own due diligence about the hedge fund’s operations and internal structures, and agree bilaterally with hedge funds on e.g. the kind of information to be provided to them.

This approach has been questioned in recent months, also on the basis of the G20 conclusion that all actors in the financial markets should be subject to regulation or regulatory oversight. That is, in addition to questions about investor protection, questions were identified about the impact of hedge fund investment on the markets as a whole.

The EBF’s view

The EBF agrees that it would be consistent to extend the scope of the Market Abuse Directive beyond regulated markets. However, such an extension would not make sense for non-tradable instruments, i.e. the extension should be subject to the existence of a secondary market. Furthermore, issuers should be exempt from such an extension as a product listing may have been effected without the involvement or even the consent of the issuer.

In parallel, practical cooperation between supervisory authorities must be re-enforced both with regard to the prosecution of assumed cases of market abuse and on other matters that need cooperation. Multi-lateral agreement for further harmonisation of the national sanctioning regimes could help this cooperation process and further the authorities’ mutual trust.

The Committee of European Securities Regulators has acknowledged the need for coordination in the case of market interventions. By its very nature cooperation between national authorities is a gradual process, which should however be given the necessary political support to progress further.

The Directive on Alternative Investment Fund Managers must be designed carefully, with high emphasis on proportionality. It should neither impose overly tight restrictions on instruments that are almost exclusively traded on professional markets or by very wealthy retail customers, nor should it impose internal governance standards on managers of very small funds. Furthermore, the legislation must not result in any kind of protectionism, which would be the wrong signal sent to the EU’s international negotiation partners.
It is partly in response to such concerns, also voiced by the European Parliament, that the Commission has proposed regulation for all managers of non-UCITS type funds. Hedge fund managers, which would be covered by this piece of legislation alongside the managers of other types of funds, would be required to put in place internal structures intended to deliver a high level of protection of professional investors and make provision against fraud. Hedge fund managers would also be required to provide regulators with a range of information about the funds they manage.

V. Resolving the short selling question

During the most critical phases of the financial crisis, around October 2007, some national authorities took swift decisions of banning or restricting short selling activities on some or all shares traded in their markets. This discussion was being led in the context of market abuse although short selling is recognised as an established market practice in normal circumstances. It is, in principle, undertaken by investors who believe that a certain share is overpriced. In the case of ‘covered’ short selling, these investors borrow the respective security from a regular shareholder – for example a pension fund – with the commitment of returning it at a specified point in time. As opposed to this, no borrowing takes place in the case of naked short selling, i.e. the investor does not hold the security at the time of placing the sell order for that security in the market.

Proponents of short selling underline its positive effects in terms of enhancing market liquidity and helping to establish a fair share price, as it enables a larger number of opinions about the value of a share to be incorporated in the share price. Proponents also underline that in times of unrest short selling has furthermore the benefit, from an issuer and shareholder perspective, of establishing a lower threshold for the share price on the basis of the transactions conducted by the short seller.

Issues around short selling are often confused with manipulative trading strategies. This analogy is incorrect as short selling activities are subject to the MAD regulations in the same way as any other transactions carried out in the financial instruments defined by the MAD. Some national authorities did indeed decide to launch investigations on suspected market abuse on the basis of the MAD.

Nevertheless, the interventions taken by some national authorities last autumn started a discussion on alleged potential dangers of short selling in certain market situations.

Market participants, on the other hand, reported a harmful impact from the interventions. This was, in particular, as a result of the speed of the decisions, which in some cases forced market participants to adjust their trading patterns and exposures over one week. Furthermore, distortions arose from the different approaches taken by regulators.
Short selling

Short selling is the sale of a financial instrument, typically a share, by an investor that does not already own the security. With ‘covered’ short selling, the investor has temporarily borrowed the security in order to sell it, in the expectation that the price of the security will fall in the meantime. The investor will then buy back the security at a later point in time to return it to the borrower. With ‘naked’ as opposed to ‘covered’ short selling the investor does not hold the security at the time of selling it. The precise definition of short selling varies between jurisdictions, as a result of the differences in the underlying legal systems.

Short selling is seen as a legitimate market activity in that it adds liquidity to the market. It allows a wider range of opinions about the viability of listed companies to be reflected in the share prices and is therefore acknowledged to help price-finding in normal times.

The discussions around short selling became intensive in the autumn of 2008 when some regulatory authorities decided to temporarily ban or impose restrictions on short selling, either in general or for certain shares. This was on the basis of the assumption that short selling was driving down the prices of certain securities, especially shares in financial companies, to a greater extent than was justified by the ‘fundamentals’, i.e. the actual business prospects of these companies.

However, it has not been proven that short selling was indeed the reason for sharp falls in share prices. Instead, there is evidence that the prices of these securities would have fallen in any case, in response to the changed expectations of the market as a whole. The short selling bans might merely have led to a delay in these price adjustments.

Some regulators have therefore decided to lift the bans on short selling and instead, require investors to disclose large ‘short’ positions.

Some national authorities decided indeed to ban short selling altogether; some banned the short selling of shares in financial companies; and some imposed disclosure restrictions. This was in addition to the definitions of short selling varying between Member States.

Given the close inter-connectedness of the markets, a ban or restriction on short selling in one market can however, in principle, be easily circumvented by carrying out the transaction in another market that does not impose the same restrictions.
At the same time, it has not yet been determined what positive effect the regulators' decisions have had for the respective securities and for the markets more broadly. On the basis of the research that has been done so far, there is no indication that the bans have helped to support the share prices or to limit their volatility in a sustainable way.

These questions and the need for alignment in such market interventions have been acknowledged by CESR, which intends to coordinate actions as much as possible between its member authorities going forward.

The International Organisation of Securities Commissions has also started work on the topic and has proposed draft regulation on short selling.

The EBF's view

Short selling is after all a legitimate market activity and should be seen in the context of normal market conduct, rather than market abuse.

The discussion on short selling must be led in a non-ideological way and on the basis of a thorough assessment of the positive and potentially negative effects from short selling, also bearing in mind the impact of different legal systems on the way in which securities can be sold short. The EBF welcomes IOSCO’s initiative of proposing globally applicable regulation. This should allow the EU to find a solution that is consistent with the rules adopted in important non-EU jurisdictions.
Chapter V - Retail market

Offering choice and providing protection to Europe's retail investors

Participation of retail investors in the capital markets

From the perspective of the retail investor the function of the capital markets is to provide the tools to make financial provision for people's own retirement age and to make savings for their offspring or other spending purposes they plan to finance in the future.

As a result of demographic developments in Europe as well as in many other regions of the world, individual participation in the capital markets has gained in importance over recent decades. State pension schemes are not equipped to fully cover peoples' consumption habits at the high standard of living that they have become used to, and occupational schemes can only partially fill the gap. Increasing responsibility lies with individual consumers to make supplementary, personal provision.

These developments are positive and desirable to the extent that they give individuals more freedom to choose the level and form of savings that suits their needs. Many individual investors have also become aware of the opportunities offered by direct participation in the financial markets, especially in terms of the increased rewards that can be traded against a higher acceptance of risk. Well-informed retail investors are actively looking for these additional returns and often choose to replace traditional bank accounts at least partially with higher-yield products.

The markets have reacted to these changed needs and, for some investors, higher risk appetite by offering a larger number of products with a wide range of different risk-return profiles and the possibility for investors to get exposure to a wider range of underlying assets, including e.g. commodities and real estate, in addition to traditional bonds and stock equities.

Whilst the partial shift in retail investors' saving habits from traditional deposits to new investment opportunities is putting some pressure on banks' classical business model, banks are still among the most important intermediaries to provide retail investors with access to the capital markets. In most cases banks also play an advisory role.
From the perspective of financial intermediaries the retail business is quite different from the wholesale business not just in the smaller size of individual deals, but also with regard to individual investors’ different and diverse needs whose identification requires investing a considerable amount of time and effort. This can be accompanied with an important legal risk in the case that investments do not perform as expected.

These relatively higher efforts and higher risks are rewarded by higher profit margins, although providers of retail financial services have seen these margins shrinking in recent years as a result of the increased competition.

**Achieving investor confidence through a high level of investor protection**

In order to provide retail investors with the trust and reliance necessary to further support the developments towards more choice of products and more individual responsibility for investments in the capital markets, EU legislation strives to ensure that the right safeguards are in place. This is in particular in the form of an adequate regulatory framework in combination with ongoing conduct of business supervision. The most notable piece of legislation in this respect is again MiFID, which has improved investor protection as another objective alongside increased competition in the securities markets.

MiFID has been designed to cover the entire chain from first, financial advisers and distributors acquiring the necessary knowledge about the customer; making sure that the products recommended to her are in line with the client’s profile; and lastly, guaranteeing the best possible execution of the client’s orders. MiFID is a horizontal piece of legislation in that it applies to the distribution of a broad range of different products, notably shares, bonds, investment funds, and structured notes which are all among the products most frequently bought by retail investors. It does however not cover insurance products as these are subject to the Insurance Mediation Directive (IMD).

Specifically, MiFID provides stringent rules in the four areas of information requirements; general conduct of business rules; best execution; and conflicts of interest.

- In terms of **information requirements**, MiFID requests that all information addressed by investment firms to potential clients shall be fair, clear, and not misleading. Investment firms are required to provide information, in a comprehensible format, about *inter alia* proposed financial instruments and investment strategies and the risks associated with them, and about costs and associated charges.
o The general **conduct of business rules** require that investment firms act honestly, fairly and professionally in accordance with the best interests of their clients. This includes for example that before providing investment advice, the firm has to obtain the relevant information about the client’s level of knowledge and expertise in investment matters, her financial situation and her investment objectives; and that clients are warned when they intend to invest, out of their own initiative, in products that might not be suitable for them.

o MiFID’s **best execution requirement** stipulates that investment firms obtain the best possible result for the client when executing an order. For retail investors, this is in particular with regard to the price of products and with regard to the cost of execution.

o The **conflict of interest rules** require investment firms to maintain effective operational and administrative arrangements to prevent conflicts of interests, as far as possible; or where conflicts of interest cannot be prevented, to disclose them and to take parallel steps to ensure that these conflicts of interest do not operate to the disadvantage of the client. In addition, investment firms may accept any inducements in the form of fees, commissions or non-monetary benefits only under very specific circumstances, where inducements are interpreted in quite a broad way, and provided that these inducements are disclosed to the client.

The practical experience of one and a half years of MiFID in operation is relatively short to draw conclusions, on the retail side even more so than on the wholesale side. This is partly also as a result of some delays in national MiFID transposition, which have in turn had an impact on the implementation of MiFID within investment firms.

Some national authorities and the European Commission are in some respects questioning whether MiFID has had the intended impact on the retail markets. Investment firms feel on the other hand that the important changes in their internal functioning that MiFID requires have been made and that the impact will become more clearly visible over the coming months and years, for example as regards the investment advice provided to retail investors.

In the meantime, national authorities are making increased efforts to verify firms’ full compliance with MiFID. CESR is in parallel working with all of its members to facilitate an exchange of experiences and ensure consistency in the practical application of MiFID, and with a high focus on intermediaries.

*Offering a choice of distribution models to cover different investor needs*

Firms are competing for retail business not only on the basis of prices, but also on the basis of distribution models. Many distributors offer so-called open architecture models, which give access to a large range of different products and often provide the necessary IT tools to allow comparison between them.
This model is especially appealing to financially literate investors whereas many financially less sophisticated investors would likely not feel at ease with structures that lack individual guidance and cannot provide more concrete support for their investment decisions. Instead most customers are used to a combination of advice and distribution, where adviser-distributors are rewarded for the advice they provide through the commissions they receive on the products sold.

This model has been identified as potentially problematic in view of its inherent conflicts of interest. MiFID therefore requires investment firms to avoid conflicts of interest as much as possible, and where not possible to disclose these conflicts as well as all commissions that firms receive for the sales of investment products. Retail customer representatives have nonetheless voiced concerns about remaining conflicts of interest and have suggested a full separation of advice from distribution.

Distributors and advisers, on the other hand, appreciate this concern but have in practice made the experience that retail customers are not willing to pay directly for the advice they receive. Attempts by firms to offer pure investment advice against a pre-defined fee have consistently remained without commercial success.

Against the backdrop of these experiences, rather than regulation imposing a mandatory distribution model distributors and advisers have expressed a preference to ensure that MiFID is fully implemented in practice, including all of the above-described requirements aiming at investor protection and avoidance of conflicts of interest. This does not prevent firms that offer investment advice in full separation from distribution from competing with established models.

Helping retail investors to make informed decisions

Research demonstrates that alongside many sophisticated retail investors, many other retail investors are less well-informed and rather find the increased choice of products and distribution channels confusing. Indeed, many consumers are not yet fully aware of the extent to which they are required to take responsibility for their own retirement provision. Many people are also struggling to make percentage calculations or to apply other basic concepts relevant in finance. Such a fundamental knowledge is however an essential precondition for people to understand the advice and suggestions made to them by distributors and advisers. Investment advice in itself is not sufficient to make up for potential shortcomings in basic financial education.

Several Member States and the European Commission have therefore concluded that complementary measures need to be taken to enhance all consumers’ understanding of financial matters and avoid a dividing line between those individuals that understand the choice and opportunities available, and those who would otherwise be excluded from grasping them.
At a basic level, financial literacy starts with the capability to understand some fundamental mathematical concepts. Building on that, retail investors also need to understand the practical possibilities of participating in the capital markets and related risks and rewards. In some Member States arrangements have been found between the public authorities and financial intermediaries such as banks to provide such information in a systematic manner.

Besides these personal factors, the EU’s markets also differ in collective investment preferences. This is a consequence of on the one hand, cultural factors, and on the other hand tax treatment and politically set incentives.

For example, in some countries retail participation in the capital markets is to a large degree through insurance products, such as in France. In other markets, retail investors’ direct holdings of equity are more common. In yet other markets such as Spain, there is a relatively high percentage of funds of funds.

However, there is one genuinely European retail investment product. The Directive on Undertakings for Collective Investments in Transferable Securities (UCITS) provides a common framework for the standards that must be met by investment funds to be sold cross-border without a separate authorisation process in the host Member State, i.e. a ‘passporting’ system. The first UCITS Directive came into effect in 1985, and UCITS funds have since then had great success both within the EU and beyond its borders. Around three fourths of investment funds sold in the EU are UCITS funds. Outside the EU, UCITS funds are popular in particular in some Asian and Latin American countries.
The UCITS Directive has just been reformed in a number of important areas to increase the efficiencies in the value chain and, as a result, give investors the same level of protection and the same quality of investment management at – expectedly – lower costs.

Broadening the choice of products

Whilst EU law-makers do not intend to interfere with national decisions regarding taxation and investment incentives, a discussion has started in recent years to look at other products sold nationally and consider whether similar passports to that of the UCITS Directive could also be introduced for other retail investment products to achieve further economies of scale. For example, open-ended real estate funds (OREFs) are a popular product for retail investors in Germany. These products have the advantage of historically, stable returns and an attractive risk-return relationship, in that volatility of real estate investment is generally much lower than e.g. for equity funds.

As last year’s events have again demonstrated, there is on the other hand an important liquidity risk to be aware of which can in certain market circumstances provoke the need to suspend redemptions. However, during the crisis OREFs performed in practice much better than many other types of funds, meaning that investors benefitted from such portfolio diversification.

According to the European Commission’s plans for the regulation of managers of alternative investment funds, managers of OREFs would fall under the scope of the planned legislation. This could have the advantage of introducing, at the same time, a passport for their trading by professional investors. It would however remain a decision to be taken by each Member State nationally whether to open the retail markets to OREFs.

Making meaningful product disclosures

As part of the overhaul of the UCITS Directive it has been decided to introduce a compulsory template for so-called Key Investor Information documents which summarise the most essential information on a UCITS fund on two to three pages and in a harmonised format. This is designed to facilitate investors’ understanding and to allow a comparison between different investment funds, as much as possible.

As opposed to this, the disclosure requirements for most other investment products offered to retail investors are currently governed either by MiFID rules, mostly in combination with the Prospectus Directive, or for unit-linked insurance products by the Insurance Mediation Directive.
Indeed, initiatives have been taken in some Member States – in some cases by the national regulator, in others by the industry – to provide guidance on the content and format for pre-contractual disclosure documents to inform retail investors about the products offered to them. This guidance is either principles-based to cover all kinds of retail investment products, such as in the UK; or it is quite specific with regard to just one kind of investment product, such as the guidelines of the Dutch Banking Association on the information to be provided on structured notes.

To give examples of the difficulty of comparing different investment products, such structured notes are products that define a certain pay-out on the basis of an underlying asset, such as a share, an index, a commodity, or a basket of commodities.

Structured notes provide protection against market movements in the level desired by the investor. Being debentures in legal terms, they have on the other hand an issuer default risk.

This risk profile is different from investment funds, where the investor legally acquires a claim on the underlying assets. Another basic difference between structured products and investment funds lies in the fact that with investment funds, the fund manager has a fiduciary duty to manage the funds in the best interest of the clients, for a pre-defined management fee; whereas with structured products, it is the net payout rather than any fee that is pre-defined in relation to the underlying assets.

Which product is preferable depends ultimately on the investor’s needs and specific profile. It is quite difficult, and in most cases over-simplifying, to make a line-by-line comparison between such different kinds of products. Moreover, for most investors the first step is that of understanding the functioning of the product and its potential risks.

Nevertheless, it seems likely that the European Commission will in the near future propose a separate piece of legislation that would require the provision of KII-type product disclosures for all ‘packaged’ products that are specifically marketed to retail customers, and where ‘packaged’ means that the risk and reward profile is changed as compared to the underlying financial instruments.
The EBF’s view

The ultimate objective should be to achieve high standards of protection of retail investors, whilst also providing a broad range of choice between different products and investment strategies. Measures to be taken should therefore aim to help clients to take an informed decision but should not result in a narrower choice of products.

In practice, efforts should therefore in a first instance focus on effective implementation of the rules within firms and on consistency of the rules across Member States. This is for the reason that enhanced investor protection was one of the principle objectives of MiFID. Supervisory authorities should review investment firms’ activities with regard to both product information and individual client advice and make sure that these respect the high MiFID standards.

Furthermore, all efforts to enhance retail investors’ understanding of the products available and their ability to compare between different products must take account of the different characteristics of these products. “Comparability must not be achieved to the expense of accuracy of product information. Any legislative solution must therefore leave sufficient flexibility for disclosures to be adjusted to each type of product.”
The 2009-2014 European legislative period will be the time which past mistakes are addressed, regulation is repaired and Europe builds a supervisory and market infrastructure fit to serve a truly integrated European financial market.

During the benign market conditions of the mid-part of the current decade, important legislative reforms were passed to harmonise key pillars of the European regulatory legislative apparatus so as to provide conditions for ever seamless financial interactions within Europe, an open and dynamic market in which the consumer benefited from a high but appropriate degree of investor protection.

The unprecedented events of 2008, the severest financial crisis in living memory followed by a deep and punishing economic recession, has naturally precipitated a period of reflection and robust responses in key areas. Important reforms to the European regulatory environment have already been passed in a short space of time, and the legislative appetite in Europe remains unabated.

However, correcting past mistakes in the eye of the storm, where the outcomes cannot be fully anticipated nor the long term impacts predicted is a process that requires careful forethought and confidence. Less can often be more. Targeted regulatory initiatives, underpinned by sound better regulation principles of pre-consultation and ongoing stakeholder feedback, are of primordial importance.

Europe should move in step with the global consensus, for example by adhering to the guidelines developed at the global level for securities supervision by IOSCO. Mutual recognition with Europe’s key trading partners in targeted areas of financial markets regulation should be the objective. However, within Europe, Cross-border supervisory cooperation must become a reality. Developing a common supervisory culture through the CESR network and reinforcing its capacity to act in the common European interest on the key issues are particularly important.

Now is the right time to rebalance the discussion away from suspicion and fear towards understanding and appreciation: well articulated legislation on Alternative Investment Fund Managers can make funding easier and cheaper for firms in the non-financial sector, making saving for investors more efficient, more flexible and more tailed to individual needs. First time home buyers taking out fixed rate mortgages rely on derivative instruments traded bilaterally in the “over the counter markets” to enable that choice. Short selling is legitimately used to hedge exposure and improve risk management practices.
More appropriate information to investors is but one priority area that the public and private spheres have in common. In the discussion on the Commission’s proposal for pre-contractual product disclosures for packaged investment products keep in mind the different products’ characteristics, avoid over-simplification, and retain necessary degree of flexibility to adequately explain product functioning and risk and reward profile.

However, all of the above developments are only possible if Europe creates the conditions for safe, competitive and efficient post trading infrastructures to clear and settle trades. Development of integrated pan-European post trading infrastructure must continue.

The European Banking Federation put its resources at the full disposal of European policy officials and law makers to ensure that consensual outcomes return to be the norm. The balance that is still to be struck between protection and openness, prescription and flexibility, must work for the banks, just like it must work for Europe’s citizens, and in equal measure, as Europe seeks to reassert and rebuild itself after some of the severest challenges it is ever likely to encounter.
## Annex I – Objectives and Selected Initiatives of the Financial Services Action Plan and Selected Recommendations of the de Larosière group


<table>
<thead>
<tr>
<th>FSAP Objectives</th>
<th>FSAP Initiatives</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strategic objective 1: A single EU wholesale market</strong></td>
<td></td>
</tr>
</tbody>
</table>
| Raising capital on an EU-wide basis | ● Prospectus Directive (Directive 2003/71/EC “on the prospectus to be published when securities are offered to the public or admitted to trading“)  
● Transparency Directive (Directive 2004/109/EC “on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market“) |
| Financial reporting – single set of financial statements for listed companies | ● **4th and 7th Company Law Directives** (Directive 2001/65/EC “as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions and insurance undertakings“)  
● **IAS Regulation** (Commission Regulation EC 1606/2002 “on the application of international accounting standards“) |
<table>
<thead>
<tr>
<th>Common rules for collateral - containing systematic risk in securities settlement</th>
</tr>
</thead>
<tbody>
<tr>
<td>● <strong>Settlement Finality Directive</strong> (implementation of Directive 98/26/EC “on settlement finality in payment and securities settlement systems”)</td>
</tr>
<tr>
<td>● <strong>Clearing &amp; Settlement Communication</strong> (COM 2004/312 “on Clearing and Settlement in the European Union” – not part of the original FSAP)</td>
</tr>
<tr>
<td>● <strong>Financial Collateral Directive</strong> (Directive 2002/47/EC “on financial collateral arrangements”)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>A secure and transparent environment for cross-border restructuring</th>
</tr>
</thead>
<tbody>
<tr>
<td>● <strong>Takeover Bid Directive</strong> (implementation of Directive 98/26/EC “on settlement finality in payment and securities settlement systems”)</td>
</tr>
<tr>
<td>● <strong>SE Regulation</strong> (Regulation (EC)2157/2001 “on the statute for a European company” and Directive 2001/86/EC “on the involvement of employees”)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>A single market which works for investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>● <strong>UCITS III</strong> (Directive 2001/107/EC “on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with a view to regulating management companies and simplified prospectuses” – revised in 2008 (UCITS IV)</td>
</tr>
<tr>
<td>● <strong>IORP Directive</strong> (Directive 2003/41/EC “on the activities and supervision of institutions for occupational retirement provision”)</td>
</tr>
</tbody>
</table>

**Strategic objective 2: Open and secure retail markets**

<table>
<thead>
<tr>
<th>Open and secure retail markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>● <strong>Distance Marketing Directive</strong> (Directive 2002/65/EC “concerning the distance marketing of consumer financial services”)</td>
</tr>
<tr>
<td>● <strong>E-Commerce and financial services Communication</strong> (COM (2001)66)</td>
</tr>
<tr>
<td>● <strong>Recommendation on information provision for mortgage credit</strong> (Recommendation 2001/193 “on pre-contractual information to be given to consumers by lenders offering home loans”</td>
</tr>
<tr>
<td>● <strong>Insurance Mediation Directive</strong> (Directive 2002/92/EC “on insurance mediation”)</td>
</tr>
<tr>
<td>● <strong>Cross-border Payments Regulation</strong> (Regulation 2560/2001 “on cross-border payments in Euro” – not part of the original FSAP)</td>
</tr>
</tbody>
</table>
### Strategic objective 3: State-of-the-art prudential rules and supervision

| State-of-the-art prudential rules and supervision | • **Winding-up Directives** (Directives 2001/17/EC and 2001/24/EC “on the reorganisation and winding-up of insurance undertakings” and “on the reorganisation and winding-up of credit institutions”)

|  | • **E-Money Directive** (Directive 2000/46/EC “on the taking up, pursuit of and prudential supervision of the business of electronic money institutions”)

|  | • **2nd Money Laundering Directive** (Directive 2001/97/EC “on prevention of the use of the financial system for the purpose of money laundering”)

|  | • **Recommendation on disclosure of financial instruments** (Recommendation 2000/408 “concerning disclosure of information on financial instruments and other items complementing the disclosure required (...) on the annual accounts and consolidated accounts of banks and other financial institutions”)

|  | • **Capital Requirements Directive** (Directive 2006/48/EC “relating to the taking up and pursuit of the business of credit institutions” and Directive 2006/49/EC “on the capital adequacy of investment firms and credit institutions”)

|  | • **Insurance solvency Directives** (Directives 2002/83/EC “concerning life assurance” and 2002/13/EC “as regards the solvency margin requirements for non-life insurance undertakings”)

|  | • **Financial Conglomerates Directive** (Directive 2002/87/EC “on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate”)

|  | • **CESR Decision** (Decision 2001/528/EC establishing the Committee of European Securities Regulators)

### Strategic objective 4: Wider conditions for an optimal single financial market

| Wider conditions for an optimal single financial market | • **Savings Tax Directive** (Directive 2003/48/EC “on taxation of savings income in the form of interest payments”)

|  | • **Corporate Governance Action Plan** (Communication COM(2003)284 “on modernising company law and enhancing corporate governance in the European Union”)

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53
Annex II – Intermediation in the Capital Markets

Diagram showing the relationship between central bank, banks A, B, C, and D, and the wholesale and retail markets. The diagram illustrates how banks intermediating in the capital markets operate and interact with each other and with the central bank, focusing on the role of swap deals in managing risks and facilitating transactions.
<table>
<thead>
<tr>
<th>Keyword</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alternative investment funds</td>
<td>22; 35; 36; 37; 46; 49</td>
</tr>
<tr>
<td>Better regulation</td>
<td>2; 3; 9; 11; 12; 13; 49</td>
</tr>
<tr>
<td>Central Counterparty clearing, CCP</td>
<td>22; 26; 28; 30</td>
</tr>
<tr>
<td>Committee for European Insurance and Pension Supervisors, CEIOPS</td>
<td>5; 6; 34</td>
</tr>
<tr>
<td>Committee of European Banking Supervisors, CEBS</td>
<td>5; 6; 34</td>
</tr>
<tr>
<td>Committee of European Securities Regulators, CESR</td>
<td>2; 5; 6; 14; 15; 16; 22; 24; 25; 28; 34; 37; 40; 43; 49; 53</td>
</tr>
<tr>
<td>Conduct of business</td>
<td>12; 14; 15; 23; 42; 43</td>
</tr>
<tr>
<td>Council</td>
<td>5; 6; 18; 19; 31; 33; 34</td>
</tr>
<tr>
<td>Credit default swaps, CDS</td>
<td>22; 29; 30</td>
</tr>
<tr>
<td>Credit rating agencies</td>
<td>30; 31; 33; 34</td>
</tr>
<tr>
<td>De Larosière</td>
<td>7; 50</td>
</tr>
<tr>
<td>Derivatives</td>
<td>5; 22; 25; 26; 28; 29; 30; 32; 34; 36; 51</td>
</tr>
<tr>
<td>ESCB-CESR Recommendations</td>
<td>22</td>
</tr>
<tr>
<td>(European) Parliament</td>
<td>5; 6; 7; 18; 19; 21; 31; 32; 33; 34; 38</td>
</tr>
<tr>
<td>Financial crisis</td>
<td>2; 4; 7; 8; 9; 10; 12; 15; 16; 24; 25; 31; 32; 33; 36; 37; 38; 49</td>
</tr>
<tr>
<td>Financial literacy</td>
<td>45</td>
</tr>
<tr>
<td>Financial integration</td>
<td>4; 7; 8; 10; 15</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>36; 37</td>
</tr>
<tr>
<td>International Organization of Securities Commissions, IOSCO</td>
<td>2; 14; 15; 16; 34; 40; 49</td>
</tr>
<tr>
<td>Investment Funds</td>
<td>5; 18; 22; 35; 42; 45; 46; 47</td>
</tr>
<tr>
<td>Investment Services Directive, ISD</td>
<td>4; 22; 23; 25; 29; 39; 40</td>
</tr>
<tr>
<td>Financial Services Action Plan</td>
<td>2; 3; 4; 11; 51</td>
</tr>
</tbody>
</table>
## Annex III – Index of keywords

<table>
<thead>
<tr>
<th>Keyword</th>
<th>Page Numbers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lamfalussy</td>
<td>5; 6; 14; 19; 34</td>
</tr>
<tr>
<td>Market Abuse Directive, MAD</td>
<td>4; 7; 12; 18; 21; 22; 30; 33; 34; 35; 37; 38; 43; 44; 51</td>
</tr>
<tr>
<td>Markets in Financial Instruments Directive, MiFID</td>
<td>7; 12; 14; 15; 19; 22; 23; 24; 25; 26; 27; 35; 42; 43; 44; 46; 48; 51</td>
</tr>
<tr>
<td>Multi-lateral Trading Facilities, MTFs</td>
<td>23; 24; 26; 35</td>
</tr>
<tr>
<td>Over The Counter markets, OTC</td>
<td>2; 9; 22; 24; 25; 29; 30; 49</td>
</tr>
<tr>
<td>Pensions</td>
<td>5</td>
</tr>
<tr>
<td>Post trading</td>
<td>2; 22; 26; 27; 28; 50</td>
</tr>
<tr>
<td>Private equity</td>
<td>18; 20; 21; 22; 32</td>
</tr>
<tr>
<td>Prospectus Directive</td>
<td>7; 18; 19; 22; 31; 46; 51</td>
</tr>
<tr>
<td>Prudential supervision</td>
<td>5; 14; 15; 53</td>
</tr>
<tr>
<td>Retail markets</td>
<td>4; 43; 46; 52</td>
</tr>
<tr>
<td>Single Market</td>
<td>3; 4; 7; 10; 18; 22; 45; 52</td>
</tr>
<tr>
<td>Supervision</td>
<td>2; 3; 4; 5; 7; 11; 12; 14; 15; 22; 34; 35; 42; 49; 52; 53</td>
</tr>
<tr>
<td>Transparency Directive</td>
<td>19; 31; 32; 34; 37 51</td>
</tr>
<tr>
<td>Undertakings for Collective Investments in Transferable Securities, UCITS</td>
<td>18; 21; 22; 38; 45; 46; 47; 52</td>
</tr>
<tr>
<td>Wholesale markets</td>
<td>31</td>
</tr>
</tbody>
</table>
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