

European Office/Europabüro:
St. Michael's House
1 George Yard
London EC3V 9DH
Great Britain/Großbritannien
Tel +44.20.77 43 93 00
Fax +44.20.77 43 93 01

New York Office:
40 Broad Street
New York, NY 10004-2373
Tel +1.212.440.9400
Fax +1.212.440.5260
www.bondmarkets.com

Washington Office:
1399 New York Avenue, NW
Washington, DC 20005-4711
Tel +1.202.434.8400
Fax +1.202.434.8456



La Commission Européenne / Die Europäische Kommission
Marché intérieur Direction générale / Binnenmarkt Generaldirektion
Cortenberghstraat 107
B-1040 Brussels
BELGIE

31. May 2002

RE: European Commission's Revision of the Investment Services Directive

Dear Mr. Mogg,

The Bond Market Association (TBMA) welcomes this opportunity to comment on the second consultation paper of the European Commission (Commission) on the "Revision of the Investment Services Directive" (25. March 2002) and the related summary of responses.

The Bond Market Association is an international trade association representing approximately 200 securities firms and banks active in the global fixed income markets¹. This letter was prepared by TBMA European staff in coordination with TBMA's European E-Commerce Committee. This Committee is comprised of legal and business professionals from a broad cross-section of TBMA's European members with substantial interests in e-commerce developments affecting the European wholesale financial market services and transactions, including issues relating to alternative trading systems (ATS).

TBMA provided extensive comments in our letter of 30. October 2001, on the previous Commission consultation paper published on this subject (24. July 2001). A number of the revised proposals made in the Commission's current consultation paper are welcome, in that they respond to some of our earlier comments. We are particularly pleased that the Commission has decided to abandon its initial considerations in respect of regulatory classification and trade reporting requirements. Nevertheless, the Commission's revised consultation paper still raises a number of general and specific concerns that may endanger the over-arching regulatory objectives of investor protection, market efficiency and the creation of a single financial market.

In addition, TBMA, together with a number of European trade associations, presented a paper to the Commission on 21. May 2002, entitled "*Innovation, Competition, Diversity, Choice: A European Capital Market for the 21st Century*", in which we argue that neither the integrity of European markets nor the interests of investors would be protected if regulators were to propose that all orders in securities be routed to exchanges for execution. It is clear that while exchanges play an important role, investors also seek to use the services of investment firms

¹ More information can be obtained from our website at www.bondmarkets.com.

in executing orders, and it is important that this choice is preserved and that investment firms are not forced to approximate their business models to the business model of exchanges. Any "one size fits all" approach would be catastrophic for the European capital markets, and would be an impractical and retrogressive move which would fail to reflect today's trading environment. Implementing Euronext's proposals would therefore jeopardise the healthy, efficient, and innovative securities market in Europe.

1. Executive Summary

- TBMA is pleased that the Commission has decided to abandon its initial considerations in respect of regulatory classification and trade reporting requirements. Nevertheless, the Commission's revised consultation paper still raises a number of general and specific concerns that may endanger the over-arching regulatory objectives of investor protection, market efficiency and the creation of a single financial market.
- TBMA greatly welcomes the open, public approach taken by the Commission to consult market participants and other experts regarding the proposed revisions to the ISD. The Commission's open hearing in Brussels on 22. April 2002 was particularly very well received.
- TBMA is concerned that the Commission has not indicated in its revised proposals, nor during the Commission's open hearing, that market participants will be given the opportunity to review and comment on the actual proposed ISD Directive before it is presented to the EU Parliament later this year.
- TBMA believes that re-writing significant parts of the ISD is neither necessary nor warranted in order to achieve the intended objectives, and risks introducing detailed and rigid provisions which could impede innovation and the development of efficient markets. To propose greater changes will risk delaying the desired liberalisation and harmonisation of EU regulation as the key issues, which need to be addressed at this stage, will become subsumed in a wider debate on the text of the revisions.
- TBMA welcomes the proposal to adopt the "choice principle" by giving providers of trading services the ability to choose whether to be authorised as a regulated market or an investment firm. The Commission should persist in putting an end to the continuation of concentration rules and Member states should not have the power to ban the creation of new markets.
- TBMA would strongly urge that any detailed transparency rules, whether fixed income or equity markets, which are thought to be necessary for either the protection of investors in particular markets or for market efficiency, should be addressed in level 2, and that these rules should recognise and reflect the differences between markets and market users. This would maintain flexibility to respond to market innovation and change.

- TBMA believes the current proposals relating to ATS are overly prescriptive, which seems to be based on the inappropriate assumption that rules for ATS should be "benchmarked" from rules applicable to regulated markets.
- If the current proposals on ATS are retained, however, the Commission should ensure that its proposals do not impose more stringent measures than those already proposed by CESR on ATS Standards.
- TBMA has identified a number of places in the proposed Annex to the ISD where the proposed text appears to confuse the scope of authorisation requirements (and the scope of the passport) with issues about the content of conduct of business rules.
- TBMA welcomes the specific provision for lighter rules for business conducted with professional investors, as they are able to use their professional judgment to determine the appropriateness of the services provided to them.
- The proposals fail to fully enshrine the country of origin principle. It is vital that any revision to the ISD explicitly states that a Member state cannot impose its own conduct of business rules upon firms carrying out cross-border business with local customers and counterparties.

2. Introductory Remarks

TBMA greatly welcomes the open, public approach taken by the Commission to consult market participants and other experts regarding the proposed revisions to the ISD. The Commission's open hearing in Brussels on 22. April 2002 was particularly very well received. Market participants appreciate the opportunity to participate on practitioner panels, in addition to participating in public consultations whenever the Commission is developing proposals for regulation in the securities markets.

TBMA strongly supports the implementation of measures to create a true, single financial services market in the EU, which is the objective of the European Commission in proposing revisions to the ISD. Furthermore, TBMA supports the broad concepts of the Financial Services Action Plan, and the more specific recommendations made on the European legislative process by the Lamfalussy Group. In this respect, TBMA would like to stress the importance of the specific recommendation of the Lamfalussy Group regarding the appropriate format of EU legislation -- particularly, the distinction between core principles enshrined in foundation legislation (level 1), detailed, legally binding technical implementation measures (level 2) and matters which can be dealt with through informal agreements between supervisors (level 3) -- as this will ensure a more efficient and appropriate regulatory framework for the diverse financial markets within the EU. This approach will provide the flexibility needed to respond to market innovation and structural changes in allowing for differentiated standards to be applied to different markets, and enabling regulators to react to this market development in a more speedily and readily way, without having to wait an inordinate period of time.

In order to achieve the key changes required to liberalise EU markets -- by removing the principle barriers to cross-border business, promoting competition, removing restrictions and providing clarity and market efficiency, with the aim of achieving the public policy objective of establishing a genuine, single financial market by 2005 -- the Commission should propose a revised ISD that merely clarifies and amplifies provisions of the existing ISD and that opens the way for further implementing legislation for matters that might require harmonisation on a European level, as appropriate.

To propose greater changes will risk delaying the desired liberalisation and harmonisation of EU regulation as the key issues, that do need to be addressed at this stage, will likely become subsumed in a wider debate over the text of such revisions. This was also recognised by Mme. Chista Randzio-Plath, *Chairwoman EMAC of the European Parliament*, who was critical of the slow process of the ISD revision and questioned whether these revised proposals were too complex.

For these reasons, TBMA believes that re-writing significant parts of the ISD is neither necessary nor warranted in order to achieve these objectives and risks introducing detailed and rigid provisions which could impede innovation and the development of efficient markets. TBMA would, however, like to make the comment that a number of the proposed revisions to the ISD appear to have been suggested in response to the failure by some member states to implement the ISD properly. The better approach to remedy such issues, would be through level 3 co-operation and particularly level 4 enforcement measures.

TBMA believes that the current ISD represents a sound framework in which the necessary revisions can be built-in to achieve the Commission's and the Lamfalussy Group's key priorities. These key priorities should be to amend the current ISD where necessary, in order to achieve:

- the removal of the ability for host states to impose rules and requirements on cross-border business.
- the complete abolition of the "concentration rule";
- the inclusion of the principle that member states should differentiate in their rules, between the protection required for retail and professional investors and to introduce a "light touch" regime for the latter, based on harmonised measures agreed at level 2; and
- the inclusion of a principle that member states should not be able to impose rules that exceed the measures adopted in the ISD at levels 2 and 3.

In contrast to the Commission's previous consultation paper on the ISD, TBMA recognises that the Commission has proposed to abandon or simplify some of its initial detailed proposals, thereby permitting detailed legislation to be adopted in accordance with the comitology procedure. However, we note that the Commission has not been fully consistent in its approach toward the different types of platforms and instruments. This is particularly true in respect of ATS and equities (see further comments below).

As mentioned in our previous letter, TBMA would stress the importance of co-ordination between the Commission and the Committee of European Securities Regulators (CESR) in the development of level 2 and level 3 measures for conduct of business, customer classification and other detailed standards, and in particular, those that will apply to investment firm operators of electronic trading systems. TBMA also considers it vital for the development of effective regulation in the EU that there be extensive consultation on level 2 and 3 level measures. This will help ensure that the final measures provide for effective regulation, reflecting the different structures and products of the EU markets. TBMA hopes to be given the opportunity to comment on any further proposals for the revision of the ISD arising out of this consultation at the levels 2 and 3.

In this regard, we are concerned that the Commission has not indicated in its revised proposals, nor during the Commission's open hearing, that market participants will be given the opportunity to review and comment on the actual proposed ISD Directive before it is presented to the EU Parliament later this year. It is important for market participants to review and comment on EU proposals, at a predetermined regulatory stage, before being adopted by the Council. At the very least, TBMA would encourage the Commission to consult market participants again on key sections of the current ISD consultation paper, before finalising its legislative proposal.

TBMA has not sought to comment on all of the proposals outlined in the Working Document, but has focused on those proposals that affect its members' activities in the global fixed income markets. The comments made are consistent with or supplement, TBMA's responses to previous consultation papers, including FESCO's/CESR's consultations on customer categorisation, harmonised standards and rules for conduct of business² and the regulation of ATS³.

3. Regulatory Classifications

TBMA welcomes a number of the revised proposals made in the Commission's current consultation paper as they respond to some of our earlier concerns and comments. We are particularly pleased that the Commission has decided to abandon its initial consideration in respect of regulatory classification, and has chosen to preserve the existing duality between "regulated markets" and authorised intermediaries.

² TBMA comment letter to FESCO dated 11. May 2001 responding to the FESCO February 2001 consultative paper on "Standards and Rules for Harmonizing Core Conduct of Business Rules for Investor Protection".

³ TBMA comment letters, 3. September 2001 and 18. March 2002, to FESCO's/CESR's consultation papers on "Proposed Standards for Alternative Trading Systems" (11. June 2001/14. January 2002), and TBMA comment letter, sent to the Commission 20. December 2000, regarding "The regulation of Alternative Trading Systems in Europe", a paper issued by FESCO for the EU Commission.

TBMA clearly believes that the earlier proposals, to establish a new category of "organised market" and to differentiate between a "regulated market" and a "nationally regulated market" would, if implemented, create new barriers to business, which would be wholly inappropriate in the context of the global fixed income markets. This is particularly true for the fixed income market, as the vast majority of the fixed income market is principally a professional OTC market, where fixed income securities are customarily traded via brokers or bilaterally on an OTC basis and not on regulated markets. Furthermore, the greater nominal value of fixed income securities, the relatively low underlying volatility, the array of issuers and product diversity, have militated against the development of a centralised auction market model for the trading of fixed income securities. Accordingly, in TBMA's view, the organised market proposals would have inhibited the development of the fixed income market and would have had potentially serious and unforeseen consequences for the efficiency of the fixed income markets⁴.

TBMA also welcomes the proposal to entrench the "choice principle" by giving providers of trading services the ability to choose whether to be authorised as a regulated market or an investment firm. The Commission should persist in putting an end to the continuation of concentration rules and Member states should not have the power to ban the creation of new markets.

4. Trade and Transaction Reporting

TBMA is also pleased that the Commission has substantially revised its transparency requirements for investment firms active in the fixed income market, as they would have had unforeseen adverse consequences to the fixed income market and would have had serious impact on the liquidity and efficiency of European capital markets, and thereby on the European economy as a whole. Furthermore, TBMA is pleased that the Commission has acknowledged that there should be an ability to defer publication of large trades.

TBMA supports the principle of transparency, any transparency measures which are to be imposed must take into account the different markets in terms of their structure, instruments and users. A "one size fits all" is not appropriate.

Accordingly, as mentioned in our previous letter, TBMA considers that it would be wholly inappropriate to impose at level 1, trade reporting requirements that cut across such market-induced transparency structures as they have developed for different markets and instruments. Any detailed transparency rules, whether fixed income or equity markets, which are thought to be necessary for either the protection of investors in particular markets or for market efficiency, should be addressed in level 2, and that these rules should recognise and reflect the differences between markets and market users. This would maintain flexibility to respond to market innovation and change.

An integrated European capital market should not be thought of as a single monolithic entity with a single structure and a single set of standards applied to it. European markets have

⁴ See TBMA's comment letter to the Commission dated 30. October 2001 on the previous Commission

evolved due to competition from both EU and non-EU markets, and in all likelihood will continue to do so.

Markets develop and evolve in many different directions to cater in the most efficient way for a range of permutations of financial instruments, investors, and investment strategies, each of which evolves competitively to meet new user needs more efficiently and cost-effectively. Different markets therefore find different balances between the factors of ‘market efficiency’. The difference in existing levels of transparency for various financial instruments is due in part to the relative importance of a centralised price formation process for the respective instrument (an illiquid fixed income product, for example, might usually be priced having regard to certain benchmark parameters, and not with regard to trading in that particular instrument) and the effect of immediate trade publication on liquidity.

It would be a highly complex undertaking to set the right level of transparency for a given market, particularly at level 1. However, more importantly, the interplay of capital markets itself is best able to deliver optimal solutions, through the commercial resale of trading data, the conditions of membership in certain trading venues or through other market-induced mechanisms.

To briefly illustrate this; the fixed income market is predominantly a primary market, in which bonds typically have a finite maturity and are held from issue to maturity. Secondary trading is mainly between dealers or as part of a wholesale market – as a feed to the institutional investors, as a means of funding or, to give the dealers low underlying risk exposure to interest rates. Therefore, Investors provide little or no ‘natural’ day-to-day liquidity to the market. The fixed income market is dominated by institutional rather than retail investors, where the retail investment in bonds is generally intermediated by institutions via UCITS and pension funds. Institutional investors have significant knowledge of the instruments and will “shop around” to ascertain the prices that are being offered by dealers in the required size. The equity market, on the other hand, is predominantly dominated by secondary trading with new issues occurring on a relatively rare basis. Investors derive profit mainly from capital gain by buying and selling, with dividends contributing to a small proportion of a portfolio’s profits. The differing and constantly changing views of investors, and their willingness to act on their views, provides ‘natural’ day-to-day liquidity. The main need of investors with fixed income portfolios, is to be able to reinvest the proceeds of maturing bond issues with issuers similarly in need to replace the funds which they return to investors on maturing issues, by raising capital with new issues. The main function of intermediaries is to match these needs.

A substantial proportion of transactions in fixed-income markets are entered into in order to provide low-cost funding for dealers and secured lending for institutional investors (repurchase or “repo” transactions). Because of the purpose of these deals, the prices are likely to differ from, and be irrelevant to, market participants who are making investment portfolio decisions. Instead they reflect the cost of funding (ie a “lending” rate) rather than the intrinsic value of the underlying Securities. In these circumstances, publication of prices could be actively misleading to the market.

Therefore, for dealers in the fixed income market, transparency requirements may have unforeseen adverse consequences, in that the premature publication of trades, represents a higher risk to the dealer, as there is less time to hedge the exposure.

Moreover, as already mentioned, fixed income markets are “over the counter” markets and generally global in nature. Trading takes place in many different venues outside the EU, as trading books are “passed” around the globe with the sun. Imposing transparency requirements on one geographic segment of the market, may achieve relatively little for the efficiency of the price formation process overall. For example, mandating trade reporting and publication by dealers in the EU, in relation to a particular bond that trades largely outside the EU, would be of no benefit to the market as a whole nor would it address the Commission’s underlying regulatory concerns.

Any regulatory proposal for transparency requirements, should therefore take into account all factors related to the various platforms and instruments, and ensure that any regulatory intervention does not distort competition by through giving a regulated market control of all information flow relating to OTC trading in the markets, particularly for fixed income securities traded on a regulated market. Given that regulated markets are increasingly run as commercial entities and it is likely that they will seek to exploit the commercial advantage given to them by this proposal, it would distort competition between regulated markets and other trading mechanisms.

On another note, many of the Commission’s proposals on ATS and market transparency appear to be driven by concerns of market fragmentation and internalisation of order flow, and the perceived impairment to the price formation process.

Fragmentation and internalisation are merely disparaging ways of describing the development of innovative and competitive ways of conducting business. However, it should not be forgotten that these alternative means of doing business have developed by responding to the demand of market users. They directly benefit market users, including investors and issuers, by providing additional liquidity, choice, competition, better prices, lower costs, and reduced volatility, which also indirectly places pressure on regulated exchanges to improve the quality of the service which they offer.

Finally, TBMA sees no justification for imposing different reporting requirements on systematic internalisers, incidental internalisers and ATS. These should have the same choice of trade reporting routes. Forcing intermediaries to report transactions to the “most liquid or leading” regulated market, would tend to reinforce a regulated market monopoly. Instead, the market should be left to find its own commercial solutions, rather than being forced down any particular route by regulation. If adopted, however, the Commission should expressly exempt fixed income markets from the scope of these requirements.

4.1 Trade Reporting

The revised Working Document proposes to require investment firms -- which conclude transactions outside the rules and systems of a regulated market -- when dealing with counterparties on their own accounts or on behalf of clients, or which internally match client orders on an incidental basis, to report equity transactions to a “regulated market” of which they are a member and where that instrument is admitted for trading. Furthermore, the revised Working Document proposes that authorised intermediaries engaged in systematic order- internalisation, shall either (i) report details of completed transactions to the most liquid or leading “regulated market” for trading in the equity instrument in question; or (ii). operate proprietary arrangements for disclosing details of all transactions which it executes internally.

Although TBMA will not comment specifically in respect of the current approach taken on the trade reporting obligations for OTC transactions in equities, we would certainly not support a similar approach to be taken as an extension of these obligations to fixed income market, for reasons articulated in this and in previous letters.

Whereas TBMA is pleased that the Commission has revised its previous proposal requiring all investment firms to report all “off-exchange” transactions to a reference market for immediate publication, we believe the Commission should only focus on core principles in the proposed ISD and refrain from implementing specific detailed provisions in respect of certain instruments and platforms. Particularly, proposing additional and specific trade transparency requirements for ATS dealing in fixed income, is wholly unnecessary and undesirable and could have serious unforeseen consequences. As mentioned above, inappropriate trade reporting requirements could have a serious impact on the liquidity and efficiency of European capital markets and thereby on the European economy as a whole.

Today, across Europe, the level of transparency in different markets is mainly determined by voluntary arrangements such as through the sale of trading data, membership in exchanges and other trading venues, or through other private-law agreements, and not by regulatory or governmental bodies. Indeed, the existence of services such as TRAX, and the evolution of the new bond trading platforms, have made a positive impact on the transparency in the markets. Regulatory intervention could in many Member states, result in duplicate reporting given that many market participants already report to TRAX or relevant exchanges. Whereas this duplicative reporting is not only unnecessary and unwarranted, it is also a costly measure which eventually trickles down to the retail customer. Thus, any regulatory intervention to correct imbalances in those voluntary environments, in the interests of public policy objectives and market integrity within the market concerned, needs to be specifically tailored at level 2. Besides, in today’s economic environment, information has become more readily available as a result of the economic value that is often attached to it. Consequently, any information not published is generally speaking of little use to market participants.

4.2 Pre-trade transparency

TBMA considers that it is wholly inappropriate and distorts competition to single out particular intermediaries, including ATS, for additional pre-trade transparency requirements merely because of the way in which they provide services to the market. In particular, TBMA considers that the mere fact that a firm uses non-discretionary rules is not sufficient justification for the imposition of requirements of this kind.

As already mentioned, the market already provides mechanisms for an improved consolidation of information and level of transparency as a result of the technology and changing economic environment. In fact, prices have become more readily accessible to market professionals, who now access prices in a number of ways that were unavailable to them before, such as (i) through prices formed as a result of trading on multilateral trading systems, which create price transparent pools of liquidity; (ii) through dealers; or (iii) systems which are designed to provide price information or access price sources.

Given that many mechanisms already exist in the fixed income markets, through which investors can make their open trading interest known to the wide market if they so wish, TBMA urges the Commission not to force OTC markets to adopt the market models of exchanges (which are very useful and important trading venues for parts of the trading interests, especially for very liquid instruments). Restricting the choice of investors to deal privately without making such a disclosure will not serve any of the proposed recognised goals of sound securities regulation.

On a similar note, TBMA clearly believes that if the Commission were to propose pre-trade transparency requirements on so-called systematic internalisers, this would, in practice, re-introduce a form of concentration rule, which we strongly oppose.

5. ATS rules

TBMA believes the current proposals relating to ATS are overly prescriptive, which seems to be based on the inappropriate assumption that rules for ATS should be "benchmarked" from rules applicable to regulated markets.

TBMA would reject the Commission's underlying assumption that simply because an ATS might appear to provide an equivalent service to regulated markets it should therefore be subjected to "equivalent" system management and transparency obligations. Regulated markets benefit from a number of special privileges which are not available to authorised investment firms. In addition, many (if not all) regulated markets are so integral to the markets in which they operate as to justifying additional regulation. We do not believe that any so-called "alternative" trading systems have such a market position. Trading in fixed income securities is conducted bilaterally, by telephone or increasingly through electronic trading systems, which have developed as an alternative option and more efficient means of meeting market demand rather than as an alternative to existing and identifiable regulated markets.

The development of electronic trading systems for fixed income securities has been a positive market evolution and is naturally leading to the formation of new pools of liquidity and price transparency within those pools. Order driven systems also provide order depth, and thus transparency in a market that had, before the evolution of such systems, been largely opaque. In this context, we continue to believe that regulation should take account of these positive developments and must neither inhibit the growth of new trading systems nor impose undue burdens on the development of existing ones. To impose such burdens would inhibit the growth of these beneficial systems and impose economic burdens on the existing systems that will increase inefficiency in these markets.

As we have suggested in our previous submissions to CESR, we consider that tests which focus on the functions performed by a particular operator or system, are artificial and do not respond to any particular legitimate regulatory objective. We continue to believe that the appropriate approach is to focus any regulatory attention on those "core systems" which have become so integral to the operating of a wider market, that they can truly be said to be part of the market infrastructure. It would therefore be appropriate to direct regulatory requirements designed to ensure systemic stability at operators of systems of this kind. On the other hand, we do not consider it appropriate to single out particular market participants to impose additional transparency or surveillance requirements, merely because they happen to operate an automated system which functions in a particular way.

To include standards for ATS, at the level of detail which the Commission proposes, is not appropriate, as the Directive will not be able to adapt to evolving markets. Most of these issues should be dealt with at level 2. However, we believe that any regulation at level 2 should be subject to some high-level constraints in the ISD itself, to ensure that the detailed provisions provides for a well defined balance of transparency with liquidity, competition, and other factors of high quality markets, so that investors' and issuers' interests are served in the best way possible.

If the current proposals on ATS are retained, however, the Commission should ensure that its proposals do not impose more stringent measures than those already proposed by CESR on ATS Standards.

In the Commission's "revised orientation", an ATS is defined as a multilateral system that brings together multiple third party buying and selling interests in financial instruments – in the system and in accordance to non-discriminatory rules set by the operator – in a way that forms, or results in a contract, irrespective of whether countervailing orders are matched directly with each other or indirectly through intercession of the investment firm, as riskless counterparty to both sides of the transaction.

It is unclear what is intended by the use of the term "system", even though this appears to be a central part of the definition. For example, a telephone (voice) broker might direct its personnel to operate in a "systematic" way of conducting their business (possibly even by reference to non-discretionary rules). Indeed, it seems that the definition is not intended to operate in a technology-neutral manner and is really intended only to apply to processes involving the use of computers, in which case, it should be made clear (at the very least) that it is restricted to fully automated systems.

Furthermore, it is unclear whether the definition covers a system which merely routes orders to regulated markets, market makers or brokers for execution. This may depend on the question of whether the buying/selling interests are brought together "in the system" (which may be difficult to answer in the case of a series of interconnected computer systems). There can be no justification for imposing additional regulation on systems which merely route orders to regulated markets or market makers. The adopted standards should at a minimum, exempt order routing systems from the scope of the standards.

Lastly, it should be made clear that the definition of qualifying system is limited to systems which operate according to "published" non-discretionary rules. The fact that a broker or dealer automates its internal decision making process, should not itself be the basis for additional regulation.

6. Scope of Activities for Authorised Intermediaries

According to the Commission's 'revised orientations', the revised ISD shall apply to all investment firms, meaning any legal person, the regular occupation or business of which is the provision of investment services or the undertaking of investment activities set out in section A of the Annex to the ISD.

TBMA believes there is little merit in the proposals to restructure the current definition of an investment firm or the Annex to the ISD.

The changes are also likely to be of minimal effect in so far as they attempt to narrow the scope of authorisation requirements, as Member states are likely to retain the authorisation requirements imposed in compliance with the current ISD. In fact, narrowing the scope of the Annex is only likely to narrow the scope of the passport in a number of ways which would be damaging to those providing electronic trading services.

TBMA is particularly concerned about paragraphs (a)(1) and (b)(1) of the proposed Annex. The proposal in paragraph (a)(1) is limited to the reception and transmission of orders to be transmitted to licensed firms (and applies only where the firm owes contractual obligations to investors). In addition, it seems that the current 13th recital to the ISD would no longer apply, whereby authorised firms would no longer have the benefit of the passport when they arrange transactions between two investors. Member states should already have in place licensing requirements meeting the wider requirements of the existing ISD. Thus, unless all Member states are willing to cut back on the scope of their own authorisation requirements, the only effect of the change will be to restrict the extent to which firms have the benefit of the passport for arranging transactions. This could have a major impact on intermediaries, which may then require "top-up" licences in other Member states to do business which is currently within the scope of the passport. TBMA can see no advantage in seeking to cut back the scope of Section A of the Annex in this way (and if these amendments were made it would be necessary to expand the scope of non-core services to cover arranging activities carried on by investment firms).

We are also concerned about paragraph (b)(1), regarding dealing on own account. There is a risk that this would effectively impose licensing requirements on "customers" of the market, who engage in active trading. We do not think that there is anything to be gained from attempting to restructure the way that the current ISD addresses these issues. It would be better to preserve the current position where the authorisation requirements apply to a person the regular occupation or business of which is the provision of investment services for third parties on a professional basis.

Furthermore, the proposals with respect to "investment advice" would restrict the passport to personalised advice (i.e. advice which includes a personal recommendation). Under the current ISD, investment firms who provide other services have the benefit of the passport for all kinds of investment advice (personalised or otherwise). This is important because at least some Member states do impose licensing requirements on non-personalised advice e.g. the issue of research. Again, narrowing the passport in this way would likely result in barriers to cross-border business. On the other hand, TBMA does not believe that it would be appropriate to extend Section A to cover all kinds of investment advice (the application of mandatory authorisation requirements to non-personalised advice raises a number of more difficult issues that might have to be addressed e.g. the position of journalists). Therefore, if Section A is to apply to personalised advice it will be necessary to retain other kinds of advice as a non-core service.

There are a number of places in the proposed Annex where the proposed text appears to confuse the scope of authorisation requirements (and the scope of the passport) with issues about the content of conduct of business rules. For example:

- It is clearly inappropriate to suggest that authorisation requirements should only apply to those who provide "impartial and informed" investment advice. On the other hand, conduct of business rules may, for example, seek to address any conflicts that an advisor may have.
- Similarly, it is clearly inappropriate to suggest that a person should be able to avoid licensing requirements by merely passing on orders to an unlicensed firm for execution. On the other hand, it may be legitimate for conduct of business rules to require that an intermediary does not pass on an order for execution to an entity which the intermediary knows to be carrying on business in breach of local licensing requirements.
- Likewise, it is inappropriate to suggest that licensing requirements should only to a person engaged in dealing for account if it deals with "eligible counterparties" (implying that licensing requirements do not apply when the same activity is conducted with retail investors). On the other hand, it is clearly appropriate to prescribe that an authorised firm which deals with eligible counterparties should be subject to very limited conduct of business rules.

As already mentioned, TBMA does not see the need to enshrine a definition of an ATS as a core service. The activities of a qualifying ATS should already be covered by the other investment activities, as set out in section A of the Annex to the Commission's "revised orientations". However, it needs to be made clear to all Member states, through a recital or other-

wise, that the provision of trading services whether through multilateral or bilateral trading platforms is within the scope of the ISD passport.

The proposals fail to redress the imbalance between the scope of the passport conferred by the ISD and the Consolidated Banking Directive, in particular with regard to "unconnected" foreign exchange services. There should be no requirement for foreign exchange services to be connected to the provision of investment services. Conversely, the proposals should also address other imbalances where the Consolidated Banking Directive might be thought to provide a narrower passport than the ISD (e.g. in relation to the reception and transmission of orders).

7. Investment Firm Regime

TBMA welcomes the specific provision for lighter rules for business conducted with professional investors, as they are able to use their professional judgment to determine the appropriateness of the services provided to them.

However, the proposals for new organisational and conduct of business rules fail to respect Lamfalussy principles, as they set out overly detailed rules. The eventual text should set out high level principles which provide a framework within which level 2 decisions can be taken.

In particular, the proposals on 'conflict of interest' are far too prescriptive. They should be restricted to a general statement of principles, and provide for detailed regulation to be adopted in accordance with the comitology procedure. These proposals also need to address the issues regarding the allocation of responsibility between competent authorities: the primary responsibility for organisational requirements should fall to the home state authorities.

In addition, it is wholly inappropriate to suggest that internalisation presents insuperable conflicts of interest that cannot be addressed by a combination of disclosure and other normal conduct of business requirements, such as best execution requirements. In particular, it is wholly unrealistic to suggest that firms should create Chinese walls to separate aspects of own account trading activity from one another.

In addition, the proposals fail to fully enshrine the country of origin principle. It is vital that any revision to the ISD explicitly states that a Member state may not impose its own conduct of business rules upon firms carrying out cross-border business with local customers and counterparties. Like the e-commerce directive, the revised ISD should prohibit other member states imposing restrictions on cross-border services provided by a firm established in another member state, where those restrictions are of a kind falling within the field coordinated by the revised Directive.

8. Concluding Remarks

TBMA strongly supports the implementation of measures to create a true, single financial services market in the EU, which is the objective of the European Commission in proposing

revisions to the ISD. Furthermore, TBMA supports the broad concepts of the Financial Services Action Plan, and the more specific recommendations made on the European legislative process by the Lamfalussy Group.

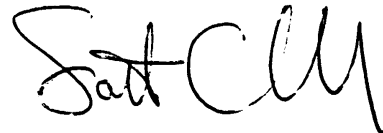
However, TBMA continues to believe that the Commission has proposed an ISD that is unnecessarily too detailed and overly prescriptive. TBMA believes that the current ISD represents a sound framework in which the necessary revisions can be built-in to achieve the Commission's and the Lamfalussy Group's key priorities. To propose a more detailed and rigid revision risks impeding innovation and the development of efficient markets.

TBMA hopes the Commission substantially agrees with TBMA's concerns, as articulated in this letter, and hopes to be given the opportunity to comment further when the proposed directive has been drafted.

Yours sincerely,



Dr. Matthias Bock
Chair, TBMA European E-Commerce Committee
Goldman Sachs International



Dr. Scott Rankin
Executive Director, TBMA European Office
and Vice President
The Bond Market Association

cc:

David Wright, *Director*, Financial Markets, DG Internal Markets, European Commission
Dr. Alexander Schaub, *Director General* for Competition, EC Commission
Arthur Docters van Leeuwen, *Chair of CESR, Chairman*, Stichting Toezicht Effectenverkeer
F. Demarigny, *Secretary General*, Committee of European Securities Regulators
Niall Bohan, *Administrator*, European Commission, Internal Market Directorate-General
Nickolaus Böhmcke, *Secretary General*, European Banking Federation
Howard Davies, *Chairman*, Financial Services Authority
Eddy Wymeersch, *Chairman*, Commission Bancaire et Financiere
Blas Calzada, *Chairman*, Comisión Nacional del Mercado de Valores
Michel Prada, *Chairman*, Commission des Operations de Bourse
Luigi Spanventa, *Chairman*, Commissione Nazionale per le Società e la Borsa
Joseph W. Sack, *Senior Vice President*, The Bond Market Association
Paul Saltzman, *Executive Vice President & General Counsel*, The Bond Market Association
Members of TBMA European E-Commerce Committee