WILMER, CUTLER & PICKERING

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PROPOSALS TO REVISE THE ISD: PRACTICAL IMPLICATIONS FOR FIRMS

European Union ('EU') proposals to revise the Investment Services Directive of 1993 ('ISD') form a 'corner' of its broader 'Financial Services Action Plan' ('FSAP'), which was adopted in May 1999. The FSAP aims to provide a fully integrated pan-EU securities and derivatives market by implementing four large-scale aims: (1) the completion of a single wholesale market; (2) developing open and secure markets for retail financial services; (3) ensuring the continued stability of EU financial markets; and (4) eliminating tax obstacles to financial market integration. A deadline of 2005 has been set for adoption and implementation by member states.

The ISD of 1993 set out the framework for the authorisation and regulation of securities and derivatives firms. It followed earlier Directives relating to banks ('credit institutions' in Euro-parlance) and was intended to give the same pan-European freedoms to investment firms as had already been afforded to banks. Once authorised in a member state, these investment firms theoretically have a 'passport' that allows them to establish branches or provide services into other member states, without the need for local reauthorisation. However, the effect of the Directive has not extended to eliminating requirements for cross-border business to comply with the varying local (and often conflicting) conduct of business rules in each country where customers or counterparties are located.

The mooted revisions to the ISD involve putting in place a common legal framework for integrated securities and derivatives markets. This will be achieved via the so-called 'Lamfalussy' method of rule making, which starts with EU legislation expressed in the form of key framework principles rather than detailed rules (Level 1) which are agreed upon by the European Parliament and the Council. At Level 2, the Commission, after consulting the European Securities Committee, request advice from the European Securities Regulators Committee ('ECSR') on technical implementing measures, which are supposedly the detail to fill out the architecture given at Level 1 to be reached via consultation with market participants, end-users and consumers.

Consultation has recently closed on the Commission's proposed new rules, and our understanding is that it intends to issue its ultimate proposal by the end of this year. However, to date there has been widespread criticism of what is seen to be an overly prescriptive and detailed re-write of the 1993 Directive and whether the proposed time line will be met is now open to doubt. Principal criticisms, and those which this briefing will discuss, are:

- that the regulatory effect on commodities derivatives firms, and particularly their capital requirements, is not commensurate with simply providing such firms with 'passport' in order to facilitate business flows;
- proposed pre- and post-transparency requirements for 'internalised' trading systems appear overly burdensome; and
- the extension of the list of 'core services' to include the giving of investment advice may well catch such non-personalised services as providing analytical material, rather than personalised advice.

Proposals to revise the ISD are focused on bolstering the 'country of origin' principle. This would facilitate cross-border business by simply requiring firms to comply with the rules of the state from which they are operating. However, wholesale market users in particular have raised fundamental concerns over recent Commission proposals, chiefly concerning regulatory classification and market transparency as the Commission has taken the opportunity this round to seek to impose common standards of regulation on certain areas of financial activity such as derivative trading and Alternative Trading Systems ('ATS') which were not within their remit at the time of the last round of regulation.

I. The Effect on Wholesale Markets

Commodity derivatives

A particularly controversial proposal has been the inclusion of the trading of commodity derivatives within the scope of the ISD. This form of business is confined to the wholesale market, by which we mean (for the purposes of this briefing) business to business markets to which consumers or retail customers have no access. Implementation would mean that this business would, for the first time, be subject to licensing requirements regardless of which type of entity is engaged in trading in commodities. This in turn leads to two key issues:

- Capital requirements

  Designating commodity derivatives as an 'investment' product, trading in which requires authorisation, without any distinction between the differing types of firm using these instruments would mean that specialised commodity firms, who only deal with other market professionals, would be subject to the same general regulatory regime (including capital adequacy and solvency ratio requirements) as investment firms. Wholesale market professionals have noted that the contemplated regulatory burden on commodities derivatives firms, in particular the new capital requirements that would apply, is not commensurate with simply providing firms with a 'passport' in order to facilitate business flow.

- Expanding the class of regulated entities significantly by bringing firms previously considered not to be financial services providers within regulation

At present, many institutions not traditionally classed as financial services providers (petrochemical companies, energy companies, sugar and coffee manufacturers etc.) use commodity derivatives for commercial purposes and in particular to hedge out risk, without the requirement to be licensed for the provision of financial services. Market users have strongly suggested, then, that participants who traditionally use commodity derivatives for their own account should not have to be licensed, and that a definition of a professional investor in such instruments should be adopted, facilitating the use of a light-touch regulatory regime on such market participants.

Significant lobbying groups are opposed to this area of proposed legislation and are therefore making approaches to the Commission seeking modification in the areas discussed above.

Regulatory classification and pre- and post-trade transparency

The emergence of new trading systems for securities transactions and the ability of the largest participants in the sector to internalise order flow gave rise to two related and particularly sensitive proposals from the Commission, both of which were ostensibly motivated by the desire to foster investor protection and maintain market integrity. They are the proposed introduction of a mandatory distinction between regulated markets or investment firms, and the prohibiting of investment firms from establishing order execution venues unless authorised as a 'regulated market' (as well as significant additional proposals relating to pre- and post-trade reporting obligations).

While the initial proposals relating to regulated markets have been withdrawn in the face of substantial criticism from the industry, the revised 'orientations' have introduced the concepts of ATS (or as the draft directive defines them 'multilateral system that brings together multiple third party buying and selling interests in financial instruments in a way that forms or results in a contract'), systematic internalisers and incidental internalisers, proposing to subject each to differing levels of regulation.

These proposals have received a mixed reception -- actively applauded by certain exchanges but regarded as unnecessary by certain institutions who assert that, as much of the thrust of the ISD proposals concern this may be adequately assured by properly formulated conduct of business rules. The debate in this area promises to continue.

Wholesale market professionals have been particularly critical of the proposals for the revised ISD to impose widespread pre- and post-trade transparency requirements. In particular, the suggestion that off-exchange transactions should be subject to post-trade transparency obligations has led to a questioning of the usefulness of reporting transactions other than those for which EU regulated markets are the primary trading market and where there is, in fact, market liquidity.

Compulsory pre-trade disclosures raise parallel concerns. For example, there are, of course, serious implications for those seeking to hedge large trades if they are required to first publish that trade. However, the Commission's suggestion that there should be allowances made for deferred reporting of block trades or trades in illiquid securities has been welcomed.

Similarly, the proposal that authorised intermediaries, including ATS who systematically internalise large volumes of client order flows, should be required to conform to transparency obligations in order that their order internalisation does not compromise market efficiency, has also met with resistance. Again, this is on the basis that it is difficult to identify the consumer benefit of pre-

trade disclosure in a market used wholly by professional users.

II. Investment advice

The ISD of 1993 only allows the provision of investment advice a 'passport' if it is carried out in conjunction with a so-called 'core service' of dealing in, managing or arranging investment in securities. Current proposals designate investment advice as a core service eligible for a passport *"where the business of the firm is the provision of impartial and informed personal recommendation to a customer in respect of one or more transaction or investment services relating to financial instruments."*

The aim of this inclusion is undoubtedly to facilitate cross-border advice to retail customers, the actual effect is arguable that firms offering non-personalised advice in the form of, for instance, research reports, would not benefit from a European passport and would, therefore, need to seek a local licence in those jurisdiction where the provision so such generic advice requires a licence.

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For further information contact:

London
4 Carlton Gardens
London, SW1Y 5AA

Simon Firth +44 (20) 7872-1036
sfirth@wilmer.com

James Greig +44 (20) 7872-1040
jgreig@wilmer.com

Alix Prentice +44 (20) 7872-1064
apprentice@wilmer.com

Brussels
Rue de la Loi 15 Westraat
Brussels B-1040

Christian Duvernoy +32 (2) 285-4906
cduvernoy@wilmer.com

Ylenia Ariano +32 (2) 285-4914
yariano@wilmer.com

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Name	Phone	Name	Phone	Name	Phone
James E. Anderson	+1 (202) 663-6180	Ronald J. Greene	+1 (202) 663-6285	Bruce Newman	+1 (212) 230-8835
Philip D. Anker	+1 (202) 663-6613	James Greig	+44 (20) 7872-1040	David Ogden	+1 (202) 663-6440
Ylenia Ariano	+32 (2) 285-4914	Franca Harris Gutierrez	+1 (202) 663-6557	Alix Prentice	+44 (20) 7872-1064
Gregory A. Baer	+1 (202) 663-6859	Stephen R. Heifetz	+1 (202) 663-6558	Matthew P. Previn	+1 (212) 230-8878
Robert G. Bagnall	+1 (202) 663-6974	Kirk Jensen	+1 (202) 663-6182	Victoria E. Schonfeld	+1 (212) 230-8874
Brandon Becker	+1 (202) 663-6979	Satish M. Kini	+1 (202) 663-6482	Marianne K. Smythe	+1 (202) 663-6711
Russell J. Bruemmer	+1 (202) 663-6804	Michael D. Leffel	+1 (202) 663-6784	Daniel H. Squire	+1 (202) 663-6060
J. Beckwith Burr	+1 (202) 663-6695	Christopher R. Lipsett	+1 (212) 230-8880	Natacha D. Steimer	+1 (202) 663-6534
Matthew A. Chambers	+1 (202) 663-6591	David A. Luigs	+1 (202) 663-6451	Todd Stern	+1 (202) 663-6940
David S. Cohen	+1 (202) 663-6925	Martin E. Lybecker	+1 (202) 663-6240	Kerrie Walsh	+44 (20) 7872-1053
Ricardo R. Delfin	+1 (202) 663-6912	James H. Mann	+1 (212) 230-8843	Manley Williams	+1 (202) 663-6595
Christian Duvernoy	+32 (2) 285-4906	David Medine	+1 (202) 663-6220	Soo J. Yim	+1 (202) 663-6958
Simon Firth	+44 (20) 7872-1036	Eric Mogilnicki	+1 (202) 663-6410		