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# **Restoring Investor Confidence in European Capital Markets**

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## **Final Report of the European Investors' Working Group**

**Organised by  
European Capital Markets Institute (ECMI)  
in partnership with  
CFA Institute Centre for Financial Market Integrity**

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## Table of Contents

Preface .....	i
Our Mandate.....	1
Setting the Scene .....	2
Restoring Investor Confidence.....	3
Investor Protection .....	4
Better Transparency.....	7
Market Integrity .....	9
Market Efficiency .....	11
Competitiveness of EU Markets.....	15
Quality of Supervision.....	16
About the European Capital Markets Institute (ECMI) .....	18
About the CFA Institute and the CFA Institute Centre for Financial Market Integrity .....	18

## Preface

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Investors have a longer memory than the sell-side of the market. To regain their trust, intensive work needs to be done in the coming years. The new European Commissioner of the Internal Market, Michel Barnier, will play a pivotal role here. In the area of capital markets, he will need the support of a determined European Parliament, a strong commitment from the Council and Member States, as well as active contributions from the CESR/ESMA, other Level 3 Committees/Authorities and national supervisors. We believe that participants in capital markets share the same goal: to make them as efficient and effective as possible. The ability to collect savings and allocate them to investment, and to allow all participants to defray risk, is at the heart of any successful modern economy. This requires effective regulation that not only mandates common standards, but also promotes accountability, responsibility and transparency, while at the same time encouraging innovation. Effective regulation must not impose undue costs, if markets are to remain efficient and effective. However, we should be conscious that the crisis has been so deep that there is a collective need to go back to the basic principles of financial regulation and supervision.

Whilst the current priority must be to restore financial stability – by identifying, measuring and controlling systemic risks – we believe there is a pressing need to review the supervision and regulation of capital markets in order to restore investor confidence. In this paper, we strongly recommend that each regulation be seen in the context of its role in creating effective capital markets based on the principles outlined above. To reiterate these principles, professional participants must strive to be:

- Responsible: to understand their clients' requirements and interests and act accordingly;
- Accountable: agents will be responsible when they are accountable, and those charged with holding agents to account must be ready, willing and able to do so; and
- Transparent: these conditions can only be met if independent agents have access to and provide relevant information that meets users' needs.

All market participants should agree on these principles, as it is not possible to establish them by regulation alone. As investors, we aim to provide useful support to any future efforts at regulation and to ensure that these efforts translate into the promotion of best practice.

Fabrice Demarigny  
Chairman, EIWG

# Restoring Investor Confidence in European Capital Markets

## Final Report of the European Investors' Working Group

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### Our Mandate

The European Investors' Working Group (EIWG) is composed of retail and institutional investors who commit their resources to invest directly or indirectly (through investment funds) in European capital markets. It is not a formal industry group; those groups may have a different opinion on the issues covered by this report. European capital markets include all securities markets across Europe and related areas. The mandate of the Group is to evaluate, from the investors' perspective, both existing regulation and any reform proposals that are pending or will be proposed at the EU or Member State level in response to the financial crisis. Within the scope of this mandate, EIWG members and supporting staff stand ready to provide the input needed by the European Commission, the European Council and the European Parliament, as well as national regulators and standard-setters.

Mandate

The Group is an independent, non-political body created by the European Capital Markets Institute (ECMI) in partnership with the CFA Institute Centre for Financial Market Integrity (the Centre). The Board of Directors of the ECMI invited Fabrice Demarigny, Member of the Board, to chair this prestigious group.

Independent  
body

Capital markets are efficient if they attract capital and investors and permit an efficient allocation of resources, aimed at boosting economic growth and prosperity. As a result, the integrity of the marketplace and the protection provided to investors are of paramount importance.

Focus on  
capital  
markets

The research and recommendations contained in this report embody the overarching aim of the EIWG to restore investor confidence. We believe this can be achieved by promoting and encouraging an efficient, effective and globally competitive supervisory and regulatory model that offers European capital markets: strong investor protection; robust and coordinated oversight of market participants; strong surveillance and enforcement of marketplace rules and regulations and better transparency. A successful regulatory model must balance competing interests; providing meaningful oversight without needlessly restrictive rules imposing excessive costs on the system.

## Setting the Scene

The financial crisis has had a severe impact on European financial markets. Institutional and retail investors have suffered losses and, most notably, a diffused loss of confidence in the efficient functioning of the market. A general collapse in demand for direct and collective investments occurred. Low interest rates compelled investors, both retail and institutional, to seek returns from alternative sources of investment in order to meet their financial liabilities. The investors' point of view has been too weak over the past ten years, while there has been an intense sell-side input over regulatory actions and new policies. More should be done in order to re-establish trust in European financial markets.

Loss of confidence

Building a safer financial system with better crisis management and a compelling solution for burden-sharing should be the current priority. Fortunately, the progress made towards the Single Market through the EU regulatory agenda has provided some protection against the economic, social and financial disruption of the crisis, though there is much more to be achieved. The Single Market should remain a top political priority. Better harmonisation is fundamental to creating a less vulnerable system where risk management can be efficiently devoted to actual market risks.

Single Market

The Group does not seek to express an opinion on matters of fiscal or monetary policy, but there is a real risk that unsustainable public debts will burden future growth. The coming years will involve difficult choices in demand management before the European economy returns to equilibrium. We do think, however, that policymakers should continue to concentrate their attention on the fact that if public debt sparks uncertainty around the stability of European countries, it will erode investor confidence and raise the cost of investment capital. Safe and stable financial economies are essential to promote investment flows and liquidity in financial markets. In addition, unsustainable public debt and an ever-growing population create a major challenge: providing sustainable pensions to future generations. Future retirement income will increasingly depend on long-term investment performance and diversification. Therefore, it is crucial to preserve the vitality, efficiency, integrity and transparency of capital markets.

Risks of instability

Taking into account the limitations of European rules, investors have an obligation to fulfil their duties as responsible owners, such as the active oversight of the governance and strategies of financial institutions. Investors need to target more resources towards the due-diligence and monitoring of their investments. They should seek to cooperate with other investors to hold issuers to account on matters of governance. More resources should be invested by European institutions too, in order to streamline investors' voting processes, and to promote financial education, assuring more and better protection for retail investors. Most notably, in the last decade retail investors experienced a process of re-intermediation of the capital markets, with potential impact on their accessibility. In effect, widespread diffusion of potentially unfair practices

Investors' responsibility



(such as aggressive commercial practices or rent-seeking bundled products) may have contributed to driving investors out of these markets and reducing long-term performance. Finally, overreliance on ratings, inconsistent quality of advice and the high fragmentation of liquidity may also reduce market efficiency and incentives for investors to inject fresh resources into capital markets.

The European Investors' Working Group acknowledges the efforts of global governments to overhaul the financial system and minimise the impact of the current financial crisis on the global economy. Public and regulatory interventions should bring substantial changes in relevant areas of capital markets that have mostly gone unregulated or have been poorly regulated, without affecting the efficiency of the market (e.g. liquidity). Better and more effective regulation should be the driver of all new regulatory actions in Europe, with greater use of impact assessments and periodic consultation with investors. Supervision and regulation at the European level should not retreat to Member State level. A proportionate approach to regulation should be preferred to a one-size-fits-all approach, in order to fill the gaps in the current regulatory framework.

Financial  
overhaul

The Group is concerned about the lack of uniform implementation and enforcement of European rules, which leaves space for regulatory and supervisory arbitrages. Past regulatory actions left a gaping hole in the process of implementing uniform rules and sanctions across Europe: definitions, deadlines, sanctions and exemptions should be thoroughly harmonised to reduce uncertainty and costs for European investors. Finally, clearer information and specific procedures are necessary to control the real implementation of legislation across Europe. The design of such controls should be placed in the hands of European regulators. The Group welcomes the proposed creation of a single Rulebook across EU Member States and is ready to provide input into the process.

### **Restoring Investor Confidence**

Confidence in European financial markets is the main driver encouraging cross-border retail and institutional investment flows, thus boosting integration. Hence, investors should be encouraged back into the market in order to preserve its efficient functioning and long-term economic and social benefits. The European Investors' Working Group believes in the efficient functioning of financial markets, which provide resources for the prosperity of our economic systems and society. The Group also welcomes initiatives by Member States aimed at promoting the Single Market, as markets and their participants become more Europe-oriented. The paramount role of investors in fuelling resources to these markets should be preserved and further promoted. Therefore, the Group has proposed principles and recommendations to promote investors' confidence.

Restoring  
confidence

Actions pursued in recent years by European institutions with the implementation of the Financial Services Action Plan sought to achieve further integration of European financial markets and to provide markets with a sound and uniform principles-based regulation. These actions were inspired by two ideas: increasing uniformity and quality of regulation; and repairing failures caused by the current financial crisis. At retail and institutional levels, mechanisms to protect investors are still few and fragmented across Member States. We support initiatives to strengthen and harmonise investor protection, provided that the costs and benefits are reconciled with financial market efficiency. We support reforms that promote competition, as long as they increase the welfare of the ultimate investor, without affecting financial stability.

EU agenda

On the one hand, regulators should provide tools to fight behaviours aimed to breach or circumvent the current set of rules through unwanted arbitrage. On the other hand, the design of financial instruments and strategies should be left to the market. The Group desires financial markets that are dynamic and competitive; participant behaviours and efficient conditions to entry and exit should be the target of scrupulous and meditated attention by regulators. Finally, regulators need to solve specific gaps that affect current regulation.

Aims of regulation

**The Group believes that the new EU agenda should primarily focus on restoring investors' confidence.** In order to achieve this overarching goal, six key objectives should be pursued by European institutions:

Six key objectives

1. Investor Protection;
2. Better Transparency;
3. Market Integrity;
4. Market Efficiency;
5. Quality of Supervision and
6. Competitiveness of EU Markets.

The achievement of these objectives is not exclusively subordinated to the production of new regulation, but should include filling regulatory gaps and harmonising regulation and supervision across Europe.

## **Investor Protection**

The financial crisis had a very negative impact on European investors' confidence (both at the institutional and retail level). This led to a reduced participation by retail investors in financial markets and had a negative impact on the amount of direct and collective investments. Investor confidence is an essential component in the efficient functioning of capital markets, and one way to restore it lies in the consolidation of investor protection. Thus, the EIWG believes investor protection should be considered

as one of the pillars for determining the evolution of the European supervisory and regulatory agenda.

- Recent developments in financial markets have highlighted how the sale of financial products to retail consumers has been influenced by unbalanced fee structures and compensation mechanisms. In some cases, such compensation mechanisms compromise the ability of investment advisors to uphold the primacy of customers’ interests. These professionals owe a fiduciary duty to their clients. The sale of financial products should be based on a thorough assessment of customers’ investment goals, objectives, risk profile and material constraints.

Sale of financial products
- In this context, the EIWG welcomes the developments within the AIFM and MiFID Directives in relation to business conduct standards, and we hope to see these provisions extended to investment products that are not currently covered by these standards. In particular, the requirement that “managers of alternative investment funds [should] act with honesty, fairness, and with the best interests of investors in mind” is a step in the right direction. In addition, there should be a similar extension of the scope of the conflict of interest rules under MiFID.

Business conduct standards
- The lack of effective implementation of best execution duties is another important source of concern and should be properly addressed in order to protect investors’ interests at institutional and retail levels. This problem is exacerbated by a fragmented trading landscape, which must be supported by consolidated data solutions.

Best execution
- It is particularly hard for retail investors to understand the suitability of an investment product before purchase and to critically evaluate its performance. Moreover, retail investors often lack the experience or the familiarity with legal issues needed to identify mis-selling practices (e.g. hidden costs). In this context, we feel more needs to be done at Member State level to improve financial literacy and fight mis-selling practices. In conjunction with investment in financial literacy, we also suggest the creation of a ‘unit’ within the future European Securities and Markets Authority (hereafter, ESMA), with responsibility for proactively monitoring the selling practices of financial intermediaries for the distribution of all substitutable retail investment products. However, the Group believes that proactive monitoring alone is not sufficient. Stronger enforcement – through targeted penalties and sanctions – must be pursued throughout the EU on a consistent basis.

Retail investors  
ESMA ‘unit’
- Harmonised resolution and settlement procedures (through private enforcement, e.g. collective redress schemes), as well as more dissuasive sanctions for financial institutions engaging in improper practices, should be taken into account. Private enforcement aims to protect the interests of small investors, who otherwise would not get

Private enforcement

the same level of protection through public enforcement, promoting a general loss of confidence in capital markets.

- The Group urges the harmonisation of investor protection rules around investment products, independently from the channel of distribution. The priority should be to avoid a race to the bottom between Member States in the standards of investor protection. The current regulatory patchwork of UCITS, MiFID and the IMD implies that customers experience different levels of disclosure and protection based on categories of products, even when they meet the same financial needs. Such an inconsistency should call for homogeneous disclosure requirements in tandem with uniform rules on the conduct of business. This would benefit retail investors and have positive spill-over effects on the market as a whole through the increase in competition among suppliers. Distribution channels
- In this respect, the EIWG welcomes the Packaged Retail Investment Products (hereinafter, PRIPs) proposal of the European Commission. However, we believe that the target of the project should be more comprehensive. PRIPs should cover all ‘substitutable’ investment products, and not only packaged products whose primary function is capital appreciation, as outlined in the proposal. Retail investors do not have enough incentives or capabilities to assess whether their products are ‘packaged’ or not, as long as they are substitutable investment products. All investment schemes try to achieve two goals: a return of capital and a return on capital. The policies on substitutable products should be framed with these goals in mind. Extending PRIPs
- Concerning the proper mechanisms of disclosure for retail investors, we feel that the work that has been done so far in the context of CESR and the Key Information Document (KID) should be considered as a benchmark for the disclosure of information across all PRIPs. This solution is practical to implement as all investment products can be easily described in terms of expected risk, return, fees, objectives, investment policy, and past performance. This would enable more comparability and make it easier for retail investors to improve their general understanding of marketed products. Disclosure Mechanisms
- We are concerned about the lack of investor oversight of financial firms and mainstream issuers, both in terms of weak representation and the insufficient level of financial competency amongst corporate boards. Good corporate governance practices, intended as the system of internal controls and procedures by which individual companies’ risks and strategies are managed, are essential in order to strike a balance between the influence of corporate insiders and external shareholders whilst upholding the primacy of shareholder interests. In parallel with what happens in the US market, shareholders should be able to vote electronically. Investors’ rights to have an accountable, predominantly independent and competent board of directors should become the general practice. Without question, the Corporate governance

current financial crisis exposed the inability of independent directors to exert sufficient control over the Board of financial institutions.

- Shareholders within the EU currently do not face homogenous corporate governance rules. Some Member States have effective shareowner bases, which can fully exercise their powers at general meetings. In other Member States, shareholders are less engaged, even when they have, in theory, legal grounds to influence the management of the issuing company. The Group believes that a balanced approach should apply; shareholders should be more engaged with corporate boards and have adequate means to express their views and exercise their rights without affecting the regular and efficient management of the company. Calling for centralisation of corporate governance law at the EU level may be too onerous for companies, as it could not take into account the economic and cultural differences within Europe. We believe, instead, that promoting a culture of sharing best practices would act as a catalyst for better governance across the European Union.

Balanced  
framework

## Better Transparency

The European Investors' Working Group believes that certain areas of financial markets would benefit from better transparency. In general, we believe material information should be more easily accessible to investors and should be readily available to regulators and financial authorities. A periodic flow of valuable and relevant information should be assured.

- More and better transparency may represent an alternative policy tool to more invasive and inefficient regulatory solutions. For instance, the regulation of short-selling can be approached in a completely different way than by banning its use. In effect, a two-tier system based upon public disclosure of aggregate data and confidential disclosure to regulators of single positions can improve market efficiency and risk management without affecting market integrity. Named disclosure would make investors less willing to sell short, thereby impairing price determination and creating negative spill-over effects on the market as a whole. Short-selling provides investors with hedging options and helps to align market values with fundamentals. It contributes to the dynamics of the markets by acting as a restraint on asset bubbles and offering price support when these bubbles collapse. Finally, it conveys useful risk management information that is of benefit to investors; and also in the case of systemically important stocks, to prudential supervisors.

Transparency  
of short  
selling

In the context of short selling regulation, we believe that flagging preserves the benefits of anonymity while providing useful real time information. Flagging narrows the opportunity for abusive behaviour stemming from rumours of alleged shorting activity intended to falsely undermine confidence in a security or a market. It would also eliminate the problem of aggregation, already incurred

when calculating positions under the Transparency Directive. This would also alleviate the costs associated with disclosure, in particular for those actors operating in multiple EU jurisdictions. Finally, there should be symmetry on disclosure thresholds of significant long and short positions, as intentions to manipulate prices may occur to the same degree in long or short positions.

- Transparency for financial stability and market integrity. The Group believes that investors need continuous and timely disclosure of material and price-sensitive information, without undue exclusion. For instance, liquidity support to financial institutions by the lender of last resort should be fully disclosed in order to reduce information leakage and impaired price formation. If more time is needed to disclose information, European markets should together opt to suspend trading of that security in order to avoid uncertainty and information leakage.

Financial  
stability

Initiatives that provide additional scope for firms to delay public disclosure of inside information – regardless of the best intentions of those initiatives – set dangerous precedents in the context of the market abuse regime. MAD only permits this activity provided that “such omission would not mislead the public”. The EIWG believes that such a statement is ambiguous and may generate inefficient outcomes for final investors.

Market  
integrity

- Disclosure of regulatory information. The creation of an electronic and single system of thresholds notification under the Transparency Directive would reduce the burden and compliance duties for firms and small investors, making the process smoother and less expensive. It makes sense for listed companies and investors that face a single EU market to deal with a single reporting system as well. The aim should be the creation of a uniform market data collection facility, to collect, store, and share all information with regulators, which can in turn provide the data to market participants and investors. The provisions included in the Regulations creating the new EU Authorities should be more ambitious in this respect.

Regulatory  
information

- Regarding trading data, central access at the EU level for OTC and regulated market data (through industry or policy-led consolidated solutions) would eliminate the need for complicated legal structures directing cooperation among regulators, and would promote the standardisation of format for data collection and distribution. Central access would also make collection, submission, and review of relevant market data easier for regulators and would provide investors with a single place to go for vital real-time trading information. Quality of reporting would be improved as well. This would also eliminate a two-tier system in which more sophisticated investors enjoy a comparative advantage, given their resources and capabilities, over less sophisticated/domestic focused investors.

Trading data

Better transparency can translate into increased market efficiency and reduced costs for companies. For instance, the Prospectus Directive has led to the production of heavy share prospectus documents, which are costly to produce and distribute. Their purpose seems only to protect the issuer from regulatory liability, rather than act as a source of illumination for the investor. The Group welcomes the current proposal to amend the Prospectus Directive, thereby introducing the idea of a measured prospectus proportionate to the budgets of small and mid-cap issuers seeking access to capital from the public markets. The objective should be to utilise, to the full extent, the maximum harmonisation aim of the Directive, in order to obtain shorter and more meaningful prospectuses that investors can thoroughly understand. In addition, the shorter version format and contents should be inspired by the 'KID' approach used for investment funds, and also included in the 'PRIPs' scope (see below).

Prospectus

- A two-tier system of information disclosure should be taken into account to increase the efficiency and efficacy of pre-contractual information. First, a specific document of selected readable and readily understandable information should be made available to retail investors. The Group welcomes the current initiatives to introduce a Key Information Document (KID) for investors, especially if it is extended to all investment products besides funds (UCITS). Second, the EIWG reaffirms the usefulness of a broader prospectus, where valuable and detailed information is contained. The difficulty of evaluating every specific aspect, however, may also affect professional investors, so the availability of a short and simple document would be of general importance.
- Lastly, the EIWG is convinced that IFRS accounting standards should be informative and reflect economic reality. Accounting standards should reflect real business practice. They should therefore mainly be used to increase transparency and disclosure for final investors, as well as being conceived to reflect diverse businesses and investment horizons in a neutral manner.

Pre-contractual information

IFRS

## Market Integrity

The integrity of the financial markets is of utmost importance in order to restore and retain investor confidence. Material components of the current crisis were failures in due diligence and ethical conduct, driven by flawed incentives. The crisis could possibly have been avoided and very probably reduced in magnitude if more market participants had observed an ethical code of conduct. Such ethical conduct is fundamental to protect investors from misaligned incentive structures and short-term behaviour.

- Hence, the Group urges the adoption of market initiatives aimed at encouraging ethical practices between market participants and professionals. Without their wide adoption, we support mandatory requirements to act honestly, with due skill, care and diligence and

Market initiatives

in the best interest of investors.

- It is also vital that conflicts of interest are duly addressed. Avoiding conflicts of interest or even the perception of conflicts of interest is necessary to provide investors with the confidence they need to commit capital. Whenever potential conflicts of interest arise, they must be fully disclosed to investors prior to entering into any contractual agreements or commercial relationships, as well as on an ongoing basis once such a relationship has been established. In this way, investors can make their own judgement as to whether the conflict is severe enough to alter their investment behaviour. Conflicts of interest, under MiFID, may need to be re-assessed to determine whether these protections are adequate. Conflicts of interest
- The centrepiece of market integrity in the European Union is the Market Abuse Directive (MAD). It covers all financial instruments traded on a regulated market regardless of where the actual transaction takes place. However, financial instruments that are solely admitted to trading on an exchange-regulated alternative market (such as AIM, Alternext, Expandi) or that are solely traded over-the-counter may fall outside the scope of MAD. The current regulation might make it difficult to keep track of which financial instruments are covered by market integrity rules and which are not. This is especially true for retail investors, who might invest in instruments admitted to trading on the markets not covered by MAD, whilst not being aware of potentially different market integrity rules. If no action has been taken at national level, there could be a regulatory gap. A proportionate extension of the key provisions of MAD to exchange-regulated alternative markets and OTC markets, therefore, must be a priority at Member State level. Furthermore, to increase investor protection on these venues, existing surveillance mechanisms enforced by all platforms trading financial instruments should be tested and validated by supervisory authorities. MAD...  
...and its extension
- During the financial crisis, one Member State introduced a rule to explicitly permit delaying the disclosure of emergency Central Bank support to a financial institution. The Group believes that this activity should not be extended to the provisions of the MAD in future revisions. This kind of material information should not be kept confidential, as it is prejudicial to the interests of investors and savers. Non-disclosure may cause information leakage and impaired price formation to the detriment of final investors. Specifically, such practices hinder the ability of market participants to accurately assess the fair value of holdings in financial institutions, since their decision-making must be based on incomplete information. More pertinently, investors may make decisions that they would otherwise not have made if the liquidity support had been disclosed. Such non-disclosure over many months undermines investor confidence and damages trust in the Central Bank support



accuracy and validity of corporate information and related financial disclosures. This has the potential to exacerbate market instability. The circumstances that lead to the events where emergency liquidity support is required – namely, where deteriorating liquidity threatens a financial institution’s solvency – may be avoided in future through macroprudential supervision, rather than through reducing the transparency of the markets. Information on financial rescue operations should always be divulged on a timely basis. In the run-up to such an event, where all other preventative actions have proven ineffective, trading should be suspended until the situation is stabilised and resumed after ‘complete’ public disclosure. Suppression of material market information gives an unfair advantage to certain market players and harms investor confidence. Other measures, such as common European rules to suspend trading across markets, may be more efficient in case of information with a high market price impact.

Trading suspension

- One of the main weaknesses of MAD is the lack of harmonisation in national implementation. Within Europe, there is inconsistent application of the directive, its enforcement and penalties. This undermines the efficacy of a single market and may be harmful for its integrity. It is inequitable that under competition law a firm can be fined up to 10% of its turnover for malpractice, while sanctions for firms manipulating the market are considerably smaller and not sufficiently persuasive.

Lack of harmonisation

## Market Efficiency

The efficient functioning of financial markets allows easier and cheaper access to capital for firms, in order to boost employment and growth. Investors play a crucial role in promoting efficiency, through the provision of liquidity that can be fuelled towards welfare-increasing activities. Investment alternatives, easy access to capital and investor protection may stimulate market efficiency and provide more opportunities to increase social welfare.

The EIWG recommends actions in several areas in order to promote market efficiency for European financial markets.

- The fragmented framework of marketing rules for investment products across Europe poses a threat to the interests of retail and institutional investors. Under the current set of rules, the costs of marketing products across Europe place an unnecessarily high burden on product providers, which in turn is passed on to investors. This creates inefficient outcomes as investors experience diminished returns net of costs and expenses.
- Specifically on equity markets, where more than anywhere else retail and institutional interests converge, liquidity fragmentation, sub-optimal pre- and post-trade transparency and misreporting may potentially affect price formation and price discovery. Firstly,

Marketing rules

Price formation and discovery

the current market structure, with over-the-counter, dark and lit alternative trading platforms all competing for liquidity may pose a threat to market efficiency if competing on uneven terms hampers price formation. That said, proof of inefficient price formation due to fragmentation has not been clearly highlighted due to the impact of the crisis on trading and more should be done to increase understanding of liquidity formation in financial markets. On the other hand, a fragmented trading landscape is affecting transparency. In particular, the absence of standardised data collection and insufficient access to consolidated quote and trade data have made it difficult for investors to obtain an accurate and complete picture of prices and trading interest across European markets. Consolidated tape and/or quote solutions - industry or policy-led - should be examined and addressed to meet investors' transparency needs. In addition, access to new advanced technologies (e.g. high-frequency and algorithmic trading systems), along with smart order routing technology, can be too costly. This raises the concern that many investors (such as retail investors) cannot benefit from these services because such advanced technology-driven trading creates a two-tier market. In fact, there is a risk that the use of these technologies provides advantages to a limited number of market participants.

In addition, fragmented and inconsistent application of waivers has created problems for pre-trade transparency. Finally, misreporting of trades and low quality post-trade transparency may affect price formation and discovery. This can further impact on the ability to achieve and measure best execution for investors. In effect, best execution is poorly implemented in Europe for retail and institutional investors. Poor quality trade reporting (misreporting and double counting) and limited ability of investors to process huge and complex information creates a problem for the mechanisms of price discovery. The difficulties in the data access and high costs of data highlight the need for improvements in the provision of consolidated data. Ultimately, such solutions are necessary to improve the quality of execution and facilitate a competitive market between trading venues.

Waivers and  
best execution

- The graph on the next page shows the results of two years of MiFID implementation. The solid outside pentagon is the ideal market infrastructure, as conceived by the legal text in 2007. The dashed line shows the environment prevailing before MiFID (ISD<sup>1</sup>). The dotted line, instead, represents the current market environment. We can thus identify several aspects:
  - MiFID has fragmented the market and created new trading venues, introducing competition between market

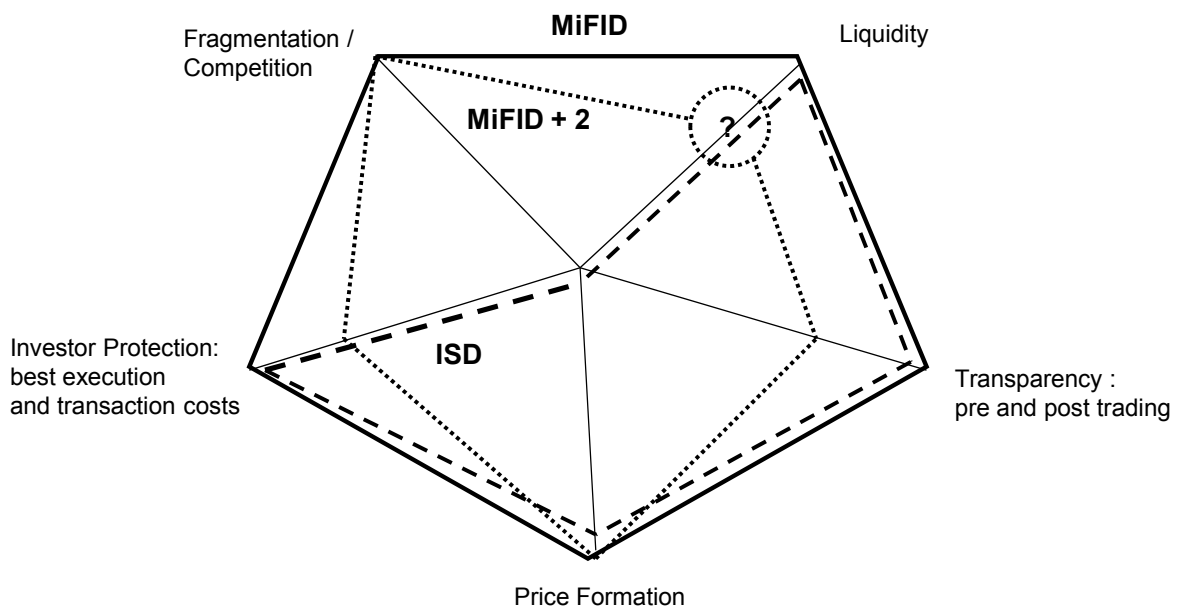
MiFID

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<sup>1</sup> Investment Services Directive, N. 93/22/EEC.

- infrastructures;
- Taking into account all trading venues, overall liquidity has increased post-MiFID, though this may not have benefitted end-investors who do not often have direct access to these new platforms. However, liquidity has been fragmented, thereby diminishing the market share of pre-MiFID trading platforms. Trading has been concentrated on 'blue chips', leaving small and mid-cap securities with even lower liquidity than they traditionally have, thereby reducing efficient investor choice;
  - Fragmentation, enhanced by new high-frequency systems, may have negative effects on transparency. Most notably, some market players have exempted themselves from transparency rules. There is poor access to consolidated pre- and post-trade market data, as well as insufficient standardisation of data, especially for OTC data. This impedes consolidation and the disclosure of high-quality data;
  - Promoting instantaneous efficient arbitrage between trading venues, through smart order routing, creates the economic condition for a satisfactory price formation mechanism;
  - Best execution, which is not based exclusively on price in the EU, is not functioning optimally. In effect, costs of access to multiple trading venues and to consolidated market data have offset the benefits of competition on trading fees for final investors.

**Figure 1. MiFID and Equity Markets**



- Competition in the post-MiFID environment is, for some areas, still limited to a superficial price war. In effect, many alternative trading platforms are not investing enough to create the infrastructure

Price war

necessary to provide a real alternative to stock exchanges. More investment in technology and infrastructure is essential to create a widely-recognised resilient venue that can efficiently substitute the incumbents in price formation. The Group firmly believes that more should be done to push further investment in technology and infrastructure to increase competition, not only on price but on the feasibility of alternative infrastructures, to stand alone as real independent and profitable liquidity platforms. However, this should be induced without interfering with the business models and commercial decisions of players.

- The endorsement by European regulators to extend MiFID to non-equity markets (e.g. OTC derivatives and bond markets), especially for transparency and business conduct standards, is in principle welcomed. The way in which this is implemented should be carefully assessed, as markets and financial products differ significantly across asset classes. Markets are different in the way products are executed, then cleared and finally settled.

MiFID extension
- The increased competition in the post-trading sector, unleashed by the competition between trading venues in the upstream market, due to MiFID, has begun to lower barriers to market entry and to reduce transaction costs. However, costs are still relatively high compared to the USA. The Group welcomes the initiative of the European Commission to draft a comprehensive legal framework for clearing and settlement across asset classes. Centralised solutions for clearing and settlement, also for off-exchange instruments, may strengthen post-trading infrastructure. However, risks should be carefully examined and supervision strongly pursued, as risk will be transferred and mitigated but concentrated into few infrastructures. In order to be efficient, centralised clearing and settlement arrangements should be conditioned to the specific characteristics of the product in question, taking into consideration factors such as liquidity, availability of prices, and external risks. In relation to over-the-counter derivatives, not all standardised products can be centrally cleared, and bilateral clearing cannot be simply removed or excessively burdened by stricter requirements for non-financial companies that require customised derivatives for hedging purposes.

Post-trading
- The informational role of third-parties is essential for the smooth and efficient functioning of financial markets. Neutral and independent market information can help to minimise the incidence of adverse selection and moral hazard that structurally affect capital markets. Restoring confidence in the quality, reliability, and independence of credit ratings should be a priority for European regulators. The Group welcomes the new regulation on Credit Rating Agencies, which will bring more efficient methodologies and mechanisms to their operations. Finally, an excessive use of ratings may create pro-cyclical effects on the business of regulated financial institutions. Therefore, the Group

Ratings and regulation

believes that regulators should be more selective in the use of ratings for regulatory purposes. Credit ratings are a useful tool to supplement investors' analysis of the credit quality of a given financial instrument, but issued ratings should not be promoted as a substitute for thorough due diligence.

## Competitiveness of EU Markets

The European Investors' Working Group acknowledges the importance of the global competitiveness of an integrated EU market. Financial markets are global and, in the Group's view, it is crucial that the competitiveness of our markets is not damaged by the regulatory response to the crisis. Competitiveness means more opportunities to diversify portfolios and to attract investment into our economies, as well as a decrease in transaction costs. The Group welcomes the increased coordination at G20 level when it comes to key regulatory and supervisory policy choices. However, implementation will remain at regional or national level, and this will happen with a different speed and intensity in different jurisdictions. The European Commission should carefully monitor the way in which the G-20 conclusions are globally implemented, in order to ensure that the competitiveness of the Single Market is not undermined. Therefore, the Group recommends actions against regulatory and supervisory arbitrages.

- Compensation schemes in Europe should be designed in order to strike the right balance between two targets: reduction of moral hazard and coherence with the long-term sustainable targets of the firm on the one side; and the offer of competitive compensation schemes aimed at keeping talent in Europe on the other.

Compensation schemes
- Regulatory and supervisory arbitrages are sources of instability and concern, especially for institutional investors. As such, these issues should be avoided whenever possible, as they promote a 'race to the bottom' for the quality of regulatory standards. Consistent regulatory action and international cooperation may together avoid such an inefficient outcome. Member States should avoid unjustified gold-plating and national financial authorities should cooperate much more in supervising our financial markets. The Group is concerned about how European regulations have been implemented at Member State level.

Regulatory and supervisory arbitrages
- Transatlantic dialogue should lead to a parallel implementation of a key set of regulatory standards (in particular, prudential capital requirements, which will be designed by the Basel Committee, and IFRS standards). Convergence around a specific set of standards will be achievable provided that leading economies, such as the US, accept such a uniform framework. The Group is concerned about partial convergence, which does not include relevant markets.

Convergence of standards
- The fact that EU directives apply equally to major listed companies and small or mid-capitalised companies has created a dissuasive listing environment for small and mid-cap companies. Despite the original intention of meeting their needs by creating exchange-regulated markets based on national law and exemptions from all

Small and mid- cap

major FSAP rules, it seems that the EU pool of liquidity is scarcely financing companies that represent the future economy (e.g. start-up companies, where innovation and new ideas are frequently cultivated). As in the US, the EU should adapt listing requirements in order to favour access to small and medium size issuers to regulated markets and exchange-regulated markets.

- The European supervisory system should permit a company-level passport for cross-border European groups. In the path laid out by the European passport, such a system would enable free allocation of internal control/risk management functions in European centres of expertise, thereby not requiring duplication at a local level on a legal entity basis.

Company Law  
and  
Governance

## Quality of Supervision

The European Investors' Working Group welcomes the current legislative reform for a new supervisory architecture of European financial markets.

- The Group believes in the introduction of a pan-European supervisory structure, with adequate powers to support and encourage the development of a single market in financial services. It is fundamental for investors that Member States do not retreat at national level, but that they work for international solutions that allow more peer review and collegiality of decisions.
- Within the new supervisory structure, the EIWG believes there should be room for a greater involvement of retail and institutional investors in the process of definition and implementation of financial regulation. This could happen, for instance, through the definition of a minimum number of investors' representatives within the market participants committees that have already been defined (such as the Securities and Markets Stakeholder Group within ESMA).
- The institutional framework for the interaction between the European Systemic Risk Board (ESRB) and the European System of Financial Supervisors (ESFS) should be clearer. Guidelines are needed to establish when micro and macro supervisory levels should intervene and promote actions on the same issue at the respective lower or upper stage of supervision. The scope of each authority should be more clearly specified.
- The new system, especially for what concerns the ESFS, should be truly European in scope if we want to avoid a balkanisation of EU financial markets and prevent future threats to the Single Market in such a crucial area. It is in this context that the EIWG believes that veto positions should no longer be allowed. With the appropriate safeguards for Member States' fiscal sovereignty, we believe that majority voting should become the rule for the approval of final

Scope and  
functions

More investor  
involvement

ESRB and  
ESFS

Majority vote

binding decisions. Simple majority rule within the new Authorities should be promoted for most decisions if these bodies want to exercise meaningful supervisory and regulatory powers. Otherwise, no significant progress will have been achieved since the creation of the level 3 Lamfalussy committees.

- The Group is firmly convinced that a set of binding standards is fundamental to the implementation of current regulation and the future Rulebook. The only relevant exceptions should be those relating to fundamental differences in legal systems. Instead, gold-plating solutions should be always considered as a threat to a European integrated market and detrimental to the interests of retail and institutional investors. Moreover, a level playing field could potentially unleash beneficial competition between alternative investments across European national markets, lowering transaction costs and improving investment choice for final investors. Binding standards
- The patchy and uncoordinated responses to the collapse of Lehman Brothers have definitely proven that a Single EU Market also needs single emergency procedures. Such procedures (e.g. harmonised rules for the immediate suspension of trading of listed shares across platforms) should be one of the tools in the hands of the new European Securities Markets Authority (ESMA). This is crucial if we want to protect financial stability throughout the EU in the event of a sudden default, for example. This is why the EIWG welcomes the provisions suggested by the Commission in the case of “developments which may seriously jeopardise the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system”. Emergency procedures
- Finally, the EIWG considers the new Authorities’ independence to be of paramount importance for the supervision of our markets. Such independence should be granted not only to the key officials and to the staff, but also to the three new legal authorities as a whole. The Group acknowledges the legal limits set by European case law (Meroni case<sup>2</sup>), which – as defined by the Treaty – limits the possibility to delegate to independent bodies rule-making powers that the Commission itself does not possess. The case also stated that the Commission should retain oversight of these bodies and it will be responsible for the manner in which they are performed. With this in mind, we still believe in the possibility to set up a system that would *de facto* make such independence more likely. We acknowledge the need of the Commission, which maintains the monopoly over legal initiative, to be the formal rule-maker. At the same time, given the Commission’s presence within the Authorities, any proposal would not come as a surprise. Independence

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<sup>2</sup> Case 9/56 Meroni v. High Authority [1957-8] ECR 133

## **About the European Capital Markets Institute (ECMI)**

The European Capital Markets Institute (ECMI) was established as an independent non-profit organisation in October 1993. ECMI's membership base comprises financial services firms, stock exchanges, regulatory bodies, university institutes and many leading institutions. Since January 2006, ECMI's activities and research programme have been managed and staffed by the Centre for European Policy Studies (CEPS), a highly reputed, independent think tank based in Brussels.

The principal objective of ECMI is therefore to provide a forum in which market participants, investors, policy-makers and academics alike can exchange ideas and opinions concerning the efficiency, stability, liquidity, integrity, fairness and competitiveness of European capital markets and discuss the latest market trends. In effect, ECMI regularly produces publications for its members: quarterly newsletters, annual reports, a statistical package, regular commentary and research papers, as well as occasional workshops and conferences. ECMI also advises European regulators on policy-related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the subject. More info at [www.eurocapitalmarkets.org](http://www.eurocapitalmarkets.org) or [www.ceps.eu](http://www.ceps.eu).

## **About the CFA Institute and the CFA Institute Centre for Financial Market Integrity**

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 100,000 members, who include the world's 84,447 CFA charterholders, in 133 countries and territories, as well as 136 affiliated professional societies in 57 countries and territories.

The CFA Institute Centre develops timely, practical solutions to global capital market issues. Established in 2004, the CFA Institute Centre builds upon the CFA Institute mission to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence. It carries forward the organization's 60-year history of standards and advocacy work, especially its Code of Ethics and Standards of Professional Conduct for the investment profession. More information may be found at [www.cfainstitute.org](http://www.cfainstitute.org) or [www.cfainstitute.org/centre](http://www.cfainstitute.org/centre).