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31 January 2003

Dear Mr White

Consultation Paper 153: Alternative Trading Systems

The International Swaps and Derivatives Association is an international organisation whose members include more than 600 of the world's largest commercial, universal and investment banks as well as other companies and institutions with extensive activities in the area of swaps and other individually negotiated derivatives transactions. Additional information on ISDA can be found at our website (www.isda.org).

We welcome the opportunity to comment on CP153, having previously submitted detailed comments to CESR on its two rounds of consultation relating to its Standards for Alternative Trading Systems. While a number of points we make in this letter will be of general importance, we will focus particularly on the impact on the OTC derivatives markets. We have had the opportunity of seeing the submissions by APCIMS, the Bond Market Association, the International Securities Market Association and the London Investment Banking Association, which we generally support.

FSA Objectives

CESR has, of course, done a great deal of work already in relation to appropriate standards for regulation of alternative trading systems, culminating in its July 2002 Standards. In commenting on CESR's proposals, ISDA, in common with many other respondents, argued that CESR had failed to explain the policy objectives behind the proposed Standards in a satisfactory way and had offered no evidence in support of the need for users of ATs to have additional protections or to show how trading systems threaten the integrity of the market. Indeed, in its paper of 14 January 2002, CESR acknowledged that the European market place had not developed in the way it was anticipated when CESR began its ATS work and that the impact of ATs in Europe was still limited, particularly in the trading of equities and, by implication, even more so in the case of OTC derivatives. CESR was therefore anticipating a theoretical

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problem rather than responding to an existing one. ISDA did not agree with CESR's approach and we remain of the view that it is not necessary or desirable to impose burdensome new requirements on operators of multilateral ATSS, particularly where an ATS is not attracting a significant proportion of the market in the relevant instrument.

We appreciate that, in making its proposals, FSA is responding to CESR's expectations that members will introduce its Standards into their domestic law. Nevertheless the FSA must still apply the usual tests for any measure it introduces, including the matters to which it must have regard as set out in Section 2 of the Financial Services and Markets Act 2000. In particular, that section requires FSA to have regard to the proportionality of the measure to the benefits to be achieved. ISDA is strongly of the view that FSA has not demonstrated that the risks to its market confidence objective set out in brief in paragraph 2.5 of the paper or the risks to consumer protection set out in paragraph 2.6 are either imminent or likely across the broad range of investments to which it is proposed to apply the new rules. No evidence has been provided of current problems arising in any of the areas outlined in these two paragraphs.

Furthermore, in paragraph 2.3 the FSA acknowledges that, in many areas of the financial markets, ATSS play a very minor role and certainly do not attract significant liquidity or provide benchmark pricing. That is certainly true of the financial derivative markets generally. In the light of this and in the absence of any evidence of imminent risks to either the market confidence objective or consumer protection or of any existing problems in these areas, it is difficult to conclude that the proportionality requirement of FSMA could be satisfied by the proposed rules. This is compounded by what we believe to be excessively optimistic cost assumptions in the cost-benefit analysis (see below). We would therefore strongly urge the FSA to revise their proposals to tailor them much more specifically to those ATSS which attract a significant proportion of the trading liquidity in particular types of financial instrument or which provide benchmark prices for retail participants in particular. Furthermore, we do not believe that it is generally appropriate to apply burdensome new requirements on ATSS which provide execution facilities exclusively for professional investors.

Cost-Benefit Analysis

We have not carried out a detailed cost-benefit analysis of our own. Indeed, an accurate one is very difficult to do in view of the lack of certainty provided by the proposed rules as to, for example, how extensive would be the required publication of trading information or how this would be carried out and how much monitoring would be required by operators of ATSS. FSA's paper gives no real guidance on the extent to which it plans to impose such requirements in individual cases. Nevertheless, we believe that the estimated costs are excessively optimistic in the light of experience on the part of those who have been involved in operating ATSS in the past. Many of the cost assumptions are based on assumed per-diem rates for both in-house and external contractors. The rates for external contractors look particularly unrealistic in view of the fact that work of this kind inevitably often has to be done by very experienced professionals. Some have suggested to us that the estimated costs are only a tiny fraction of the likely costs, depending of course on how the rules were implemented.

Thus, to the extent that FSA's views on the proportionality of the proposed rules were influenced by the allegedly relatively low cost of implementation, we believe that those conclusions are open to challenge. Similarly, since we believe that the risks that the FSA is seeking to address are themselves more theoretical than real, we believe that the benefit component of the equation is also open to challenge.

Timing

The FSA proposes to introduce the new rules early in May of this year, notwithstanding that the proposed new ISD regime has not been settled. The FSA appears sanguine about the prospect of ensuring that the FSA rules will be consistent with the ISD in its eventual outcome. We do not share FSA's optimism. It seems to us that the measures proposed in the ISD differ quite substantially from those proposed by the FSA in many areas, not least in the limitation of proposed pre-trade transparency rules to ATSs operating in the cash equity markets. Quite apart from the fact that we do not think it helpful for the FSA to burden the UK industry with super-equivalent rules, we think that there is a significant risk that the eventual provisions of the ISD will require change to the FSA rules which may entail double implementation risks, and associated costs, for firms.

Contrary to FSA's assertion, we see no evidence of CESR members actively implementing the proposed ATS Standards and we therefore urge FSA to refrain from doing so at this stage.

A further aspect of timing is the proposed transitional period between adoption and implementation of the rules. FSA proposes three months. We believe this is far too short and that many of the rules may require lengthy transitional periods, particularly those requiring IT changes such as the transparency obligations.

Lack of Regulatory Transparency

We believe that it is essential that any rules proposed by the FSA should provide regulated firms with a clear picture of the requirements being imposed upon them. The "rules" (including the evidential rules) proposed in the Paper appear to us to be almost completely lacking in transparency of this kind. The main provisions depend for their effect on the requirements for firms to have "appropriate arrangements" for various purposes or, in one case, on a requirement to monitor "adequately". While these terms are defined, their definitions are so vague and general that it is impossible to glean from them what will be the standards applicable to an ATS operator in a particular case. In effect, an operator will be wholly dependent on obtaining individualised guidance from the FSA as to what the "rules" mean in the context of his particular circumstances. If the FSA is to impose these requirements through the use of rules, it is essential that the FSA fleshes out its requirements in more detail, at the very least by providing more extensive guidance as to the applicable requirements and the circumstances in which firms will be taken to have complied with the requirements in a way that enables firms to predict in advance (with reasonable certainty) what the rules will mean in particular cases. Without this, we believe that the proposed rules are fundamentally flawed.

Rules or Part IV Permission Requirements?

We have considered carefully whether it would be preferable to implement these new measures as rules or as requirements applying to ATS operators' Part IV permissions under Section 43, 44 and 45. We have concluded that the latter is preferable for a number of reasons. The first, and most important, is that implementing by means of Part IV permission requirements will be much more flexible, allowing the FSA to tailor the precise requirements to the risks posed by any particular ATS. It would enable the FSA, for example, to apply few, if any, requirements to an ATS operating in the OTC derivatives market involving purely market counterparties or intermediate customers and posing little regulatory risk.

A second benefit of adopting this route would be that it would avoid tying the FSA's hands if the ISD were to require changes to the UK regime, since it would potentially be simpler to make effective changes to the UK regime by way of changes to the Part IV permission requirements.

A third benefit of this method, albeit one not perhaps immediately attractive to the FSA, is that it would give firms greater certainty as to the requirements applicable to their particular ATS and therefore some remedy against the FSA if it were to attempt to impose broader requirements after the event. This is a particular benefit in the light of our concerns expressed above about the complete lack of regulatory transparency achieved by the proposed measures.

Detailed comments on proposed rules

Our comments below, while directed to the proposed rules, are equally applicable to the proposed alternative requirements on Part IV permissions.

1. COB 4.2.17.E

The level of detail required to be contained in a firm's terms of business is quite inappropriate. The terms of business will often not be the appropriate location for much of the information in any event. This would be particularly the case for items (1), (2), (6) and (8). Firms should be permitted to convey this information by alternative means. Item (8) is, in our view, an unwarranted requirement. It imposes an unnecessary burden on ATS operators. It should be for the users to determine whether they have sufficient information or where to obtain that information, particularly where they are market counterparties or intermediate customers (see further our comments below on MAR 5.4.15R)

In addition, items (4) and (9) in our view impose unacceptable obligations on the operator of an ATS. It should not be for the ATS operator to be the guardian of the customer's duty to report transactions to a regulatory authority. It should be for the customer to ascertain his own obligations, particularly where that customer is likely to be either a market counterparty or an intermediate customer. Furthermore, the burden on the operator may well be substantial in view of the requirement to investigate reporting obligations under all applicable laws. In the case of item (9), it will often be difficult to ascertain whether an investment traded on the ATS does or does not at any precise moment fall within the market abuse regime. No doubt some operators of ATSs will work on the assumption that investments traded on the ATS will potentially be subject to the market abuse regime regardless of whether they in fact are in any particular case. They would not expect to differentiate between investments in terms of the way they operate the system or monitor transactions. Participants in the ATS should themselves have responsibility for ascertaining whether the market abuse regime applies.

2. MAR 5.4.1R

As a general point, we believe that it is essential that all requirements to have "arrangements" in the proposed rules should be requirements to have "appropriate arrangements". It is not sufficient that the appropriateness requirement should be introduced in the evidential provisions: it is after all the rule that imposes the obligation.

As indicated above, we believe that the reference in 5.4.2E and elsewhere to "appropriate arrangements" gives inadequate guidance as to the nature of the obligation upon an ATS operator and will effectively require individual agreement with each operator. It seems to us that there will also be cases, perhaps quite frequent ones, where it will be inappropriate to apply any requirements at all. It should therefore be made clear, perhaps by guidance, that "appropriate arrangements" may include "no arrangements".

We are unclear how MAR 5.4.2E (1)(b) will apply to a bulletin board system, where no deals are concluded in the system, or to an auction system that may result in a number of different price outcomes.

3. **MAR 5.4.5R**

The effect of applying this paragraph to investments traded on an ATS only if they are traded on a market is to create a situation where it is the market's decision to introduce trading in a particular instrument which will determine whether publication requirements will be triggered for an ATS trading the same instrument. This would apply regardless of whether there was any liquidity in the relevant instrument on the market. Indeed, in an extreme situation, it might require an ATS to introduce publication of trading information even where virtually all the trading interest was on the ATS rather than on the market. This is unacceptable. At the very least, ATSS should only be required to publish information of this kind where trading on the market in question represents a significant proportion of overall trading in the instrument in question.

This rule would impose pre-trade transparency requirements on ATSS trading a broad range of instruments. This contrasts dramatically with the proposed ISD provision which would impose such requirements only on ATSS trading cash equities. We do not believe there is any justification for super-equivalence in this area on the part of the FSA. Pre-trade price transparency does not generally assist trading decisions in fixed income instruments since price is not generally the determining factor. Likewise, OTC derivatives are not generally homogeneous products and pre-trade price transparency will not assist transaction decisions: indeed it may well be misleading in view of the structured nature of these transactions. The European Commission's explanation in the Explanatory Memorandum to the ISD of their reasoning as to why they limited the obligations to cash equities is sound and should be followed by the FSA. This provision should be amended to apply only to equities.

A further important omission from the rule is that it does not appear to allow the operator of an ATS to make the information publicly available on reasonable commercial terms (contrast ISD proposed Article 27 and CESR Standard 3). The rule should be amended to allow for this.

MAR 5.4.8G is another example of an inappropriate linking of obligations on the operator of an ATS with exchanges operating the market in the same investments. For example, fixed income instruments are rarely traded on exchanges. The operator of an ATS on which fixed income instruments are traded should not have to comply with standards imposed on a market which is a minor venue for trading in that instrument. Problems may equally arise where an investment is traded on more than one exchange when it may be difficult to determine which exchange's standards should apply.

4. **MAR 5.4.10R**

It is not appropriate to require the operator of an ATS to monitor compliance by a user with the contractual rules applicable to his use of the ATS. The contract between the operator of an ATS and users, which will usually be market counterparties or intermediate customers, will be made up of a wide range of provisions (e.g. customers may be required to comply with all applicable laws with respect to their use of the system). The standard of monitoring required by proposed Article 24(1) of the ISD should be followed. This requires monitoring to be undertaken "in order to identify

disorderly trading conditions or behaviour that may involve market abuse". The latter is, of course, dealt with by MAR 5.4.12R.

5. MAR 5.4.13E

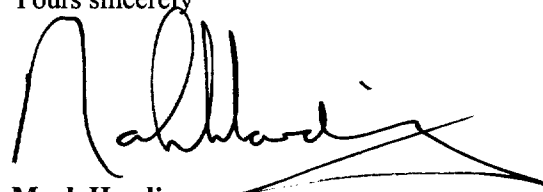
This requires an ATS operator to communicate information about suspected market abuse to the FSA and other appropriate organisations. Making reports of this kind is likely to expose the operator of the ATS to potential claims or liability, particularly if it eventually turns out that no market abuse has taken place. The operator of the ATS needs protection by way of an immunity similar to that provided to those who report suspicions of money laundering under the Criminal Justice Act 1988. We therefore strongly urge the FSA to encourage HM Treasury to introduce such an immunity in the course of implementing the Market Abuse Directive. If no such immunity is provided then operators of ATSs should not be obliged to report suspicions of market abuse.

6. MAR 5.4.15R

It is wholly inappropriate to require an ATS operator to ensure that information is publicly available regarding investments traded on the system. There is no justification for imposing this requirement, for example, on the operator of an ATS on which OTC derivatives are traded between market counterparties or professional customers. It may be unclear as to whether there is sufficient public information available to assist a judgement about the value of the investments, but it should be for the users to decide whether they have the information to trade. If retained in this form, this rule will act as a significant deterrent to the operation of ATSs providing trading facilities for many forms of OTC derivatives. This is especially the case where the users themselves use the facilities provided by the ATS to negotiate and conclude individualised transactions. FSA rules impose no similar restriction on voice and other brokers: they are able to arrange transactions between sophisticated or professional parties who themselves take responsibility as to whether they are in a position to trade a particular instrument (without advice). It would be inappropriate to discriminate against ATSs in the manner in which FSA proposes.

We hope that these comments will be of assistance to you in reviewing how to progress CP153. Please do not hesitate to contact me or Laura Mowbray in ISDA's London office if you have any questions.

Yours sincerely



Mark Harding
Chairman, European Regulatory Committee