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Fabrice Demarigny
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15 March 2002

Dear Mr Demarigny

Paper dated 14 January 2002: Proposed Standards for Alternative Trading Systems

The International Swaps and Derivatives Association ("ISDA") is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 530 member institutions from 41 countries on six continents. These members include most of the world's major financial institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

We welcome the opportunity to comment on CESR's paper entitled Proposed Standards for Alternative Trading Systems (the "Paper"). As we mentioned in our response to CESR's previous paper on this subject, ISDA believes that feedback is an integral part of an open and transparent consultation process and so we particularly welcome the Feedback Statement and Inventory of Comments provided in connection with the comments made on CESR's previous proposals.

We welcome a number of the amendments that CESR has made to its proposed standards, which reflect some of our comments. However, the current proposals continue to raise concerns for ISDA which we raise in the following sections of this letter.

We have had the opportunity of seeing the draft submissions by The Bond Market Association, the International Securities Market Association, the London Investment Banking Association and the British Bankers Association which we generally support. However, in the following

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comments on the Paper, ISDA focuses on the impact on the OTC derivatives markets. Its comments should therefore not be taken necessarily to imply any position in relation to other instruments or markets.

1. **Principal Issues**

1.1 *Policy objectives*

The Paper again fails to explain the policy objectives behind the proposed standards in a satisfactory way. In particular, no evidence is offered in support of the need for users of trading systems to have additional protections or to show how trading systems threaten the integrity of the market. Indeed, quite the reverse is shown, as the feedback statement states:

"the European market place has not developed in the way it was anticipated when CESR began to consider the need for a regulatory treatment of ATs. While ATs have made considerable impact in wholesale bond markets, their role in equity trading in Europe is not yet significant. However, CESR considers that the risks posed by the potential penetration of the retail markets by ATs still remain."

We are disappointed to see, in paragraph 1 of the Paper, the following statements from CESR's previous paper:

"In the debt and standardised OTC derivatives markets, electronic trading systems are serving to move the markets from bilateral telephone trading to more centralised multilateral screen trading."

and

"There are also signs of electronic trading systems developing in the non-standardised OTC derivatives markets."

As we stated in our response to CESR's previous paper, ISDA strongly disagrees with both of these statements. In our view, telephone trading continues to be the usual means of communication in the OTC derivatives market. Furthermore, to the extent trading is effected by electronic means, that trading is conducted on a bilateral, not centralised basis. This is the case with both plain vanilla and non-standard OTC derivatives.

1.2 *An interim measure*

ISDA continues to be concerned that the proposed standards represent only an interim measure until amendments are made to the ISD. We note that at paragraph 22 of the Paper CESR states that "the scope of the proposed CESR standards has therefore been revised to anticipate the consequences of ISD revision." Given the likelihood that changes will be made to the proposed amendments to the ISD following the consultation process, CESR cannot be in a position to ensure that its proposals reflect the amendments

that will be made to the ISD. As such, we cannot see how amendments to any regulations which are introduced at member state level in response to CESR's proposed standards can be avoided once a revised ISD is adopted (unless the ISD revision in fact introduces very little change to the current position).

In the absence of a clear need for additional regulation at this time, we therefore fail to see any justification (particularly on a cost-benefit basis) for introducing CESR's proposed standards at this time.

1.3 *The definition*

ISDA welcomes the narrowing of the definition of qualifying system so as to exclude bilateral systems. We note, however, that CESR indicates that it has concerns as to the impact of bilateral systems on market fragmentation and the price discovery process. ISDA continues to believe that there is no evidence to suggest that bilateral systems have an adverse impact in those areas and that, in the absence of such evidence, CESR should impose no additional regulation on bilateral systems. Furthermore, CESR has not demonstrated even that multilateral systems have such an adverse impact, particularly in the case of OTC derivatives.

1.4 *Differentiation*

We welcome the further guidance in some of the standards regarding their application on a differentiated basis. However, none of the guidance recognises that in some cases it will not be appropriate to apply particular standards at all. This should be remedied; if it is not, there is a real risk that regulators will feel obliged to apply all of the standards in all circumstances.

1.5 *Whose rules?*

We welcome the fact that CESR has taken the opportunity to make clear which regulatory authority has responsibility for implementing the standards. However, as we stated in our previous response, ISDA believes that the standards should be implemented on a country of origin basis not on a home state basis. ISDA therefore requests that the references to home state be replaced and a country of origin approach be reflected in each of the finalised standards and guidance thereto.

On a separate, but related point, CESR does not appear to have taken the opportunity to clarify that entities which meet the regulatory requirements of their home state to provide the services of an ATS are entitled to a single passport. We presume that this is because CESR has assumed that these entities will be investment firms under the ISD and will therefore be entitled to the passport. We nevertheless believe that it would be helpful to make the point in the final standards.

1.6 *Conduct of business rules*

The conduct of business guidance refers to the provision in Article 11(1) of the ISD requiring member states to take account of the professional nature of the user when applying their rules. This is helpful, but we suggest that CESR should be more specific in indicating that most of the rules should have little application in the context of dealings between professionals. We also urge CESR to take a position on the question of whose rules apply by making it clear that it is now time to move to disapply all host state rules to dealings between professionals. This is particularly appropriate now that CESR's proposed Conduct of Business Rules are nearing finalisation.

2. **Qualifying system definition**

The proposed definition is:

"an entity which, without being regulated as an exchange, operates a multilateral system that brings together multiple third party buying and selling interests in financial instruments - in the system and according to non-discretionary rules set by the system's operator - in a way that forms, or results in a contract."

The definition suggests that the entity is a system. This is unhelpful in the sense that it mixes together the system and the operator; a better approach might be to replace the word "entity" with the word "system" and modify the remainder of the definition accordingly. The reference to regulation "as an exchange" is confusing and should presumably be a reference to regulation "as a regulated market" since it is not a defined category.

More fundamentally, the definition does not seem to us to be sufficiently clearly worded so as to define precisely which systems are caught. For example, it is not clear that it is only computerised systems which are caught (which we assume is the intention). We suggest the addition of the word "automated" before "multilateral" ("automated" was used in the definition in the previous draft).

3. **Comments on the proposed standards**

3.1 *Standard 1: Registration and notifications*

As we stated in our response to CESR's previous paper on this subject¹, the reference to "register" in this standard should be replaced by a reference to "notify". We are unclear why the reference has been changed to "register/authorise". We strongly disagree with this change - the standard should be limited in scope to a notification requirement.

¹ See paragraph 4.1 of that response

3.2 *Standard 2: Fair and orderly trading*

As a preliminary point, we continue to believe that this standard addresses conduct of business matters and should be dealt with under conduct of business rules.

We believe that this standard should not apply to a qualifying system whose users are made up of professional investors. It is for the professional user itself to determine whether or not a system meets its needs. To the extent that such a user determines that it needs additional protections they should be negotiated in the agreement with the system operator.

The standard refers to the need to ensure that the arrangements are consistent with "wider market integrity". We accept that, if a qualifying system's prices are used in the retail market as benchmark prices, this type of standard would have a role to play in the context of wider market integrity. However, that is not the case if the qualifying system does not play that role.

We therefore believe that the guidance to the standard should make it clear that this standard does not apply to systems whose users are wholly professional users and whose prices are not used as benchmark prices.

3.3 *Standard 3: Publication of trading information*

This is a particular example of a standard importing significant extra regulatory burdens on a particular method of communication. We see no reason to change our view that it is quite inappropriate to distort competition by imposing such burdens on firms which chose to carry on their investment business by using computerised methods of communication.

Furthermore, we believe it is inappropriate for CESR to single out qualifying systems to be subject to pre-trade transparency requirements. A major development such as this should be considered in the context of a more detailed transparency specific consultation process and should not be introduced in the context of these standards.

Turning to detail, it is unclear what is meant by "instruments that are traded on a regulated market". We appreciate that the intention behind this wording may well be to limit the potential application of this standard so that instruments such as OTC derivatives which have not traditionally been traded on a regulated market are not covered. If (as we hope) that is the intention, it must be clear in the guidance to the standard that the reference to an instrument is not intended to capture generic instruments (such as options, forwards or contracts for differences). Instead it catches only those OTC instruments that are legally fungible with instruments that are traded on a regulated market. Otherwise there is a real risk of this standard being interpreted so as to capture instruments which have not traditionally been traded on a regulated market, and in respect of which concerns about fragmentation do not arise. To stress the point further, we would strongly oppose the extension of the proposed CESR regime to systems for

trading OTC derivatives just because a regulated market trades a contract which is economically equivalent while not identical.

Even where a qualifying system does provide for trading in an instrument which is also traded on a regulated market (ie the qualifying system instrument and the regulated market instrument are legally fungible), we do not believe it is appropriate for full post-trade transparency requirements to be applied to the qualifying system unless: (a) the regulated market attracts a significant proportion of the overall volume of trading in the instrument in question. To do otherwise would put the system operator in the position where the admission to trading of the same instrument by a regulated market would automatically trigger (potentially significantly) enhanced transparency obligations for the operator; and (b) the qualifying system itself attracts a significant proportion in the overall volume of trading. In this context we note that the US Regulation ATS restricts transparency requirements to those systems with a significant (5% plus) market share.

The second sentence in the standard refers to "completed transactions". The sentence should be supplemented to make it clear that it relates to completed transactions in legally fungible instruments.

We are concerned by the reference in the penultimate paragraph of the guidance to this standard that "where the traded instruments are not quoted on any regulated market, CESR still encourages the member states to move towards an adequate minimum level of transparency." It is unclear what function this sentence is intended to perform. The risk is that regulators will use this sentence as a basis for applying the standard to instruments such as OTC derivatives. In our view that would be wholly inappropriate and the sentence should therefore be deleted. As we stated in our response to CESR's previous paper on this subject, in the context of OTC derivatives, it is not clear to us that, by making information about quotes and orders publicly available, any real contribution will be made to the integrity of the broader market in the instrument in question. OTC derivatives transactions are almost invariably entered into on a bilateral basis and it would be extremely rare for an OTC transaction to have an effect on the market price of an underlying asset. Furthermore, because OTC derivatives are individually negotiated instruments (and are often part of a complex structured transaction) unless very comprehensive information about the terms of the transactions is released there is a real risk that information about such transactions would be misleading.

3.4 *Standard 4: Monitoring*

As we stated in our response to CESR's previous paper on this subject, we cannot see any justification for imposing this standard on systems whose users are made up wholly of professional users. The commentary to this standard indicates that monitoring will be particularly important if non-professional users have access or if the system plays an important role in price formation. We believe that these are in fact the *only* circumstances in which application of this standard is appropriate and that this should be made clear.

3.5 *Standard 5: Arrangements with Regulators facilitating market integrity and investor protection*

This is another example of a potentially burdensome standard applicable to an investment firm just because it uses computerised business methods. We do not believe it is justified.

3.6 *Standard 6: Systems*

As we stated in our response to CESR's previous paper on this subject, we do not believe this standard should be applied to a system whose users are wholly professional users. The guidance to this standard should therefore make it clear that the standard does not apply to such systems if their prices are not used as benchmark prices in the retail market.

Once again, we very much appreciate the opportunity to comment on an important area of regulation. If you have any questions in relation to this response please feel free to contact me or Annalisa Barbagallo in the ISDA European Office.

Yours sincerely

Mark Harding
Chairman, European Regulatory Committee