

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London, EC4M 9QQ
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isda@isda-eur.org
website: www.isda.org

European Commission Proposed Adjustments to the Investment Services Directive (the "ISD") Response of the International Swaps and Derivatives Association

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 the Commission's working document relating to proposed adjustments to the ISD (the "Working Document") and the opportunity to participate in the Commission's open hearing in Brussels on 18 and 19 September relating to the Working Document. We believe that the exchange of views at the open hearing was very helpful and congratulate the Commission on this consultation initiative.

In commenting on the Working Document, 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

ISDA strongly supports the need for new carefully targeted legislative measures to make the single European market in financial services a reality. In this regard, it is a strong supporter of the concepts lying behind the Financial Services Action Plan and the reform to the European legislative process recommended by the Lamfalussy Committee. In particular, ISDA has long urged that, in the absence of progress at national level towards mutual recognition on the basis of country of origin rules and differentiated rules applicable to professional investors, legislation should be passed to achieve this. In that context, ISDA welcomes many of the proposals in the Commission's Working Document on the ISD. We are, however, very concerned that the

NEW YORK • LONDON • SINGAPORE • TOKYO

Incorporated as a Non-For-Profit Corporation with limited liability in the State of New York, United States of America

Working Document proposes such substantial changes to the ISD that progress on the liberalising elements will be delayed due to the need for extensive debate on the wide range of proposals. We therefore suggest that the Commission should, wherever possible, leave the current text of the ISD unchanged, thus minimising the scope for further debate.

As discussed further below, we also strongly support the approach proposed by the Lamfalussy Committee to the division of legislation and rule making into three levels. Whilst we urge the Commission to limit as far as possible the proposed amendments to the ISD so as to ensure that rapid progress is made, we also encourage the Commission to ensure that any such amendments respect the Lamfalussy recommendations by ensuring that the revised ISD remains essentially a framework directive setting high level standards and principles and does not become embroiled in the details of the rules. This should be left to Level 2 measures or even Level 3 co-ordination at a national level. Much of what is proposed in the Working Document would more appropriately fall within Level 2 or Level 3 as opposed to Level 1.

ISDA supports the Commission's twin objectives of clarifying and amplifying the existing ISD provisions where these have not established an effective legislative framework enabling the proper operation of a single financial services market and of reinforcing the existing ISD provisions in order to respond to changed business models. In particular, ISDA acknowledges the concern on the part of the Commission and EU regulators that the growth of automated trading systems and crossing networks might lead to fragmentation of trading which is currently concentrated on regulated markets. ISDA's view, however, is that this risk can be greatly exaggerated. In particular, by their very nature, bilaterally negotiated derivatives transactions have never been traded on regulated markets and the risk of market fragmentation is therefore non-existent. This has not operated to the detriment of consumers, since these markets are designed for professional or institutional participants and not consumers. Given the nature of market participants and the non-standardised characteristics of the instruments, ISDA believes that the same concerns regarding transparency and liquidity as may arise in, for example, the equity markets, do not arise in the case of OTC derivatives.

ISDA therefore believes that the significant proposed changes to the categorisation of markets and the proposed bright line divide between investment firms and organised markets is an unnecessarily ambitious reform which is not justified by any substantiated regulatory concerns. ISDA therefore urges the Commission broadly to retain the existing distinction between a regulated market on the one hand and an investment firm on the other. If, after further review of the regulatory protections provided by the current rules applicable to investment firms, the Commission concludes that those rules do not provide adequate protection to consumers utilising market facing systems operated by investment firms, then ISDA believes that the right approach would be to identify appropriate, focused enhancements to market integrity or transparency

standards which might be applied to investment firms operating such systems¹. This would continue the current flexible position under which businesses can, essentially, choose whether to operate as an investment firm or a regulated market. The benefits of such flexibility would be the continuation of an environment favourable to competition and innovation.

If the current distinction between regulated markets and investment firms is broadly retained, this will enable the ISD reform to concentrate on those areas where further liberalisation is required in order to promote the creation of the single EU financial services market.

2. **Lamfalussy approach**

We welcome the comments in the executive summary to the Working Document that in implementing any changes to the ISD the Commission will seek to give effect to the recommendations of the Lamfalussy Committee regarding the appropriate format of EU legislation and particularly the distinction between core principles enshrined in foundation legislation (Level 1), detailed, legally binding technical implementing measures (Level 2) and matters where informal agreements between supervisors may be sufficient (Level 3).

We strongly support the recommendations of the Lamfalussy Committee. Any revision of the ISD should be conducted wholly in accordance with the spirit of those recommendations. In that context, we would comment that a number of the proposed adjustments to the ISD appear to have been suggested in response to the failure by some member states to implement the ISD appropriately. We have in mind particularly the proposed introduction of new definitions of execution of orders on behalf of a third party and of underwriting. In our view, the existing Annex A definitions should already cater for these activities. We strongly support the Commission's efforts to resolve such issues. However, in our view, rather than responding to such failures by means of new Level 1 foundation legislation provisions or Level 2 technical implementing measures, the better approach would be to address such failures through Level 3 co-operation and/or Level 4 enforcement measures. Only to the extent that it is not possible to address issues with the existing ISD by means of Level 3 or Level 4 measures should Level 1 or Level 2 adjustments be proposed (and then the aim should be to make the minimal use possible of new Level 1 provisions).

To the extent it is necessary to make adjustments to the ISD itself, care must be taken to ensure that the division between provisions that are addressed at Level 1 and Level 2 properly reflects the Lamfalussy recommendations. Given the diversity of the markets to which the ISD applies, great care must be taken to ensure that Level 1 provisions are generally not drafted in such a way as to suggest that a "one size fits all" approach should apply. Instead, Level 1 provisions

¹ An approach of this kind was taken by FESCO in its proposals relating to ATs, on which ISDA commented in a paper dated 31 August 2001 (copy attached). Although ISDA had a number of concerns relating to the detail of the proposed FESCO standards, some of the FESCO proposals might form a helpful starting point.

should be drafted in a sufficiently generic manner to enable, where appropriate, the use of the Level 2 technical measures to implement such provisions in a manner that reflects the differences that exist between the various markets (in terms of both users and product types).

Finally in this context, we would emphasise that in the same way as consultation forms a key part of the process in formulating any Level 1 framework principles, it is similarly important in the context of any Level 2 and 3 measures.

3. **Definitions and Scope of the ISD**

3.1 ***Definition 1: Arranging***

Paragraph 1(a) of the Annex to the existing ISD, which relates to the "reception and transmission, on behalf of investors, of orders ..." has apparently been interpreted differently by member states (although no information in this regard is provided in the Working Document). If such differences cannot be appropriately resolved through Level 3 or Level 4 action, ISDA would support a clarification of this provision along the lines proposed so that order-routing operations, bulletin boards and the like are regulated and clearly have the benefit of the passport, but with the application of lesser conduct of business rules. Care should be taken, however, to ensure that this definition does not capture all types of internet portal activity. As currently drafted, this definition is arguably wide enough to do so.

As a general matter, it would be helpful for the Commission to provide an explanation for its proposed changes so that where, for example, a change is proposed because of different interpretations of the same provision by different Member States, better informed comments on the proposal can be provided.

3.2 ***Definition 2: Brokerage***

In our view, paragraph 1(b) of Section A of the Annex to the ISD covers all forms of brokerage activity, including matching countervailing client orders. If agreement on this cannot be achieved under the existing ISD, then we would support clarification. However, the definition proposed envisages that the firm acts as agent. This would potentially exclude firms that operate on a riskless principal basis. We assume this is not the intention. Any new definition or any amendment that is made to paragraph 1(b) should be drafted in such a way to ensure that riskless principal brokerage activity is caught.

It is unclear what status the language that appears in square brackets in the proposed definition is intended to have. Assuming it is intended to form part of the definition or to be reflected as a Level 2 measure, the reference to "appropriate execution venues" should be clarified - for example, is the intention to limit the choice of execution venue? If so, it is difficult, without further guidance, to appreciate the justification for such a limitation.

3.3 *Definition 6: Independent investment advice*

It is unclear from the Working Document whether the intention is for the current non-core service of investment advice concerning one or more of the instruments listed in Section B (see paragraph 6 of Section C of the Annex to the ISD) to be removed and replaced with the core service of independent investment advice. If that is the intention then we strongly disagree with that proposed adjustment.

The removal of investment advice from Section C of the Annex and the inclusion of independent investment advice as a core service would have the effect of providing a passport, in the context of investment advice, only in relation to independent advice paid for by the client. As a consequence, investment firms would be required to obtain local licences in those jurisdictions where the provision of other types of investment advice requires a licence. The proposed adjustment would therefore create a barrier to business in those member states which regulate all types of investment advice.

3.4 *Definition 8: Securities lending or borrowing*

In our view, paragraph 2 of Section A of the Annex to the ISD covers securities and lending activity conducted by investment firms for their own account. One of the potential consequences of including the proposed new definition 8 is that it may imply that securities lending transactions entered into by a firm as principal are not covered by the existing paragraph 2 of Section A of the Annex. Any amendment in this context should be drafted so as to avoid the risk of any such implication.

3.5 *Definition 9: Foreign exchange services*

We support the removal of the requirement for foreign exchange services to be connected with the provision of investment services.

3.6 *Definition 10: Margin lending*

It is unclear to us why, as a policy matter, the provision of margin lending should be limited to firms that act as agent - we can see no justification for the proposal to remove the passport for margin lending from firms that technically act as principal. In our view, paragraph 3 of Section C of the Annex to the ISD should be retained in its current form. It currently deals only with lending connected to a transaction in financial instruments in which the firm itself is involved: we do not understand what the existence of a fiduciary relationship adds to this.

3.7 *Definition 12: Financial instruments*

The Working Paper suggests that commodity derivatives should be included in the list of financial instruments, thus giving rise, amongst other things, to a licensing requirement in the context of such instruments.

The OTC commodity derivatives market is a wholesale market; it does not have retail participants. Its participants are well able to make their own assessment of the risks involved in dealings in commodity derivatives. In order to avoid unnecessarily burdensome regulation, any proposed regulatory treatment of commodity derivatives must reflect this characteristic. Investor protection measures designed to protect consumers are simply not appropriate in the OTC market.

Furthermore, defining the scope of the investment service relating to commodity derivatives which should be regulated without inappropriately extending regulation to physical commodities business will be very difficult. As an example, physically settled forward commodity transactions should clearly, in our view, fall outside the scope of regulation. However, the line is not likely to be capable of being drawn so simply, since many such transactions may either have a cash settlement option or may in fact be subject to cash settlement by agreement between the parties. The structure of the transaction will simply be a function of the commercial objectives of the parties.

In broad terms it seems to us that there are three possible alternative approaches that the Commission might take to the treatment of commodity derivatives:

- First, do not extend the scope of the ISD to commodity derivatives and instead concentrate efforts on the removal of barriers to business created by inappropriate licensing and on-going regulatory requirements at domestic member state level. The ideal position would be that member states are permitted to impose licensing requirements in the context of commodity derivatives only in circumstances where a firm provides services to retail investors. This would require a rolling-back of regulation in certain member states and could be achieved by a new provision prohibiting member states extending licensing requirements beyond the requirements of the directive. We appreciate that, however desirable, this might be difficult to achieve in the short term.
- Secondly, treat activities relating to commodity derivatives (including trading, advising and managing) as non-core services by adding them to Section C of the Annex, thus giving investment firms the benefit of a passport which will have real value in the context of cross border business into member states which have imposed licensing requirements on such activities under domestic law.

If such an approach were to be adopted it would be vital to include a provision to ensure that market participants which only enter into commodity derivative transactions for their own account with, or through the agency of, licensed investment firms are not themselves required to be licensed. This would enable market participants who operate in this way, but are not themselves investment firms (including producers and users of commodity products) to continue to participate in the commodity derivatives market without the need to be licensed. Although this point is brought into sharper focus by the proposal to extend the

ISD to cover commodity derivatives, we suggest that a provision of this kind should be applied generally to transactions in OTC derivatives, whether financial or otherwise. This would have the benefit of clarifying that entities dealing for their own account are not providing any investment service to a third party.

In addition, it would also be important to ensure that the Section C activities extend to trading in the underlying commodities themselves so as to cater for the position where member states impose domestic licensing requirements on physical trading activity.

- Thirdly, as the Working Document suggests, add commodity derivatives to the list of financial instruments to which the ISD applies so as effectively to make the entering into of commodity derivatives transactions a core service within Section A of the Annex.

If this approach were adopted, it would be important for it to be coupled with:

- a provision of the kind outlined above to ensure that entities dealing for their own account with, or through the agency of, an authorised firm do not require licensing;
- an amendment to Article 2(2) to disapply the Directive to entities which do provide services to third parties but where such services relate exclusively to commodity derivatives and the third parties are professionals;
- an appropriate definition of professional investors which includes all corporates involved in commodity derivatives;
- an appropriately flexible set of conduct of business rules which provides a light touch regime for business with professionals;
- a provision allowing member states to apply a lighter capital adequacy regime to specialised commodity firms, at least where their business is exclusively with professionals; and
- the inclusion within Section C of the Annex of activities in relation to physical commodities, as outlined above.

Taken together, these provisions would potentially achieve both a light-touch regulatory regime and a passport for commodities business in a way which would be appropriate for the professional commodity markets where traditional consumer protection concerns are not relevant.

Our strong preference would be for the Commission to adopt the first of these three approaches. If, however, the Commission determines that it is appropriate to amend the ISD to include commodity derivatives we have a strong preference for the second of the three possible approaches over the third possible approach.

3.8 Definition 13: Organised market and Definition 14: Regulated market

In our view the current ISD framework which allows entities to be licensed either as investment firms or, if they meet the criteria, as regulated markets (as opposed to being compelled to be one or the other according to rigid criteria) works well. The new approach, as suggested in the Working Document would, in our view, very likely stifle innovation and provide, albeit unintentionally, an unfair competitive advantage for existing regulated markets.

As we understand the proposals, any entity operating an automated system which meets the definition of an organised market would be obliged to be categorised as an organised market rather than as an investment firm. It is not clear from the text of the Working Document whether the same legal entity could be regulated both as an organised market in respect of those systems and as an investment firm in respect of its other investment services. If that were not possible, firms would effectively be obliged to separate out any business done by way of an automated system meeting the organised market test, even though such business may be commercially integrated with its other investment services. Even if it could be regulated simultaneously as an organised market and as an investment firm, this may well be impractical in view of the differing obligations (depending, of course, on the detail of those obligations).

As a further refinement, any organised market which met the "regulated market" tests could (must?) apply for regulated market status. Any "market" which did not meet these tests would be domestically regulated by its country of establishment and would not benefit from the passport. This would create a significant impediment for firms operating automated systems which might qualify as organised markets. We would not imagine that this would be at all attractive and would in practice inhibit the development of new multilateral ATSS since they would either have to incur the significant cost of creating the infrastructure necessary for a regulated market (assuming they could qualify for this status) or would face potential regulatory impediments to cross-border business.

A further consequence of the proposed treatment of organised and regulated markets is that a regulated market would effectively have the power to dictate whether another entity would be required to become a regulated market. This results from the prohibition on an organised (but not "regulated") market trading instruments that are admitted to trading on a regulated market.

As indicated earlier, we appreciate that the Commission's proposals are designed to tackle regulatory and consumer protection concerns which may result from possible fragmentation of markets, leading to separate pools of liquidity and possible difficulty in ensuring best execution for retail clients in particular. As indicated in our response to FESCO's consultation paper on the regulation of ATSS, we do not believe that there are any grounds for concern in this area in relation to the OTC derivatives markets. These markets are used by professionals, not retail customers. Since the transactions are non-standardised, it will not help to impose price transparency requirements suited to markets in standardised instruments, such as equities.

Indeed, any price publication may be highly misleading in relation to structured transactions. Furthermore, there is no centralised market place in these instruments whose liquidity or price transparency is at risk.

In the context of OTC derivatives, it is acknowledged that a limited number of apparently similar instruments are traded on regulated derivatives markets. These are, however, a recent innovation and have little liquidity in comparison with the OTC derivatives market, which is effectively quite a different market. ISDA therefore believes that it would be quite inappropriate to require firms operating automated systems for concluding OTC derivatives transactions to become organised markets if they meet the defined criteria. If this division between investment firms and organised markets were adopted, it would similarly be quite unacceptable on the one hand to prevent a business operating an organised market in OTC derivatives from having a passport or, on the other hand, to give a regulated market trading a similar instrument the power to prevent a firm operating an organised market in OTC derivatives unless it became a regulated market.

In combination with the price reporting and, in particular, the proposed new transparency requirements, the proposed organised market provisions threaten to re-introduce a concentration requirement by the back door. ISDA does not believe this is in the interests of the development of the EU financial markets or of the ultimate consumer.

3.9 *Definition 18: Professional investor*

We welcome the proposal to include a definition of professional investor in the revised ISD. In addition to the Working Document, we have had the opportunity to consider briefly the Consultative Document on the Harmonization of Conduct of Business Rules published by the Committee of European Securities Regulators on 18 October 2001. This proposed an alternative categorisation of professional investors. The two proposed definitions will need to be rendered consistent. We will be responding separately to CESR, but our initial view is that we favour the CESR proposals in a number of respects, although we believe that they too need some additional changes.

We believe that the Commission's proposals should be amended to categorise as professionals:

- large companies, irrespective of whether they have offered their securities to the public (the CESR proposals appear acceptable on this point) or whether established in the EU or elsewhere;
- all companies whose securities are listed or traded on EU regulated markets or on recognised third country markets;
- all companies in the same group as large or listed companies (so as to cover dedicated treasury or financing companies);

- provisional, regional, local and municipal authorities; and
- individuals assessed by the investment firm as sufficiently experienced or expert in the products in question.

It is also essential to ensure that, where an investor is automatically classed as a professional, the exercise of its right to opt out of treatment as such does not result in it being treated as a retail investor with the full application of retail conduct of business rules. Instead, the investor should be able to negotiate an appropriate level of treatment by contract. If retail treatment were the default position, it might well result, for example, in some of the world's largest companies being treated as retail investors for some products however large their resources.

4. **Investment Firms - Rights and Responsibilities under the ISD**

4.1 *Article 2: Vetting and approval of business operations*

The provision relating to conflicts of interest should not require a firm to "limit the scope for any conflicts of interest" if by this is meant minimising conflicts. Conflicts of interest are inherent in today's full-service investment firms. Conflicts should certainly be appropriately managed so as to minimise the risk of clients' interests being prejudiced (as required by current ISD Article 10 and proposed new Article 12) but this is not the same as minimising the scope for conflict itself.

4.2 *Article 12: Organisational requirements*

The proposed Article 12 sets out a detailed list of organisational requirements. These would appear to be too extensive for Level 1 framework legislation. We would suggest that most of the detail should go into Level 2 measures.

The Commission raises an interesting question as to whether some elements of the branch organisation should be supervised by the host country responsible for supervising branch compliance with conduct of business rules. ISDA appreciates that there are arguments in favour of such an approach, particularly in the context of principles 6 to 8 (i.e. those relating to identification of assets, identification of client money and conflicts of interest). This is not least because such principles have a close inter-relationship with the underlying legal system of the place in which the branch is located. Whether it will be more appropriate for a firm to be regulated in these areas by the home state or branch regulator may well depend on how the firm structures its operations. We therefore believe that it would be appropriate to allow firms to elect whether its branches will operate under home state or local rules in these areas.

As to detailed points, we question, on a cost-benefit basis, the need for all systems used by a firm to be robust enough to contend with large fluctuations in levels of demand/usage. Not all systems are likely to be affected by large fluctuations of this type. Similarly it is not clear why a

firm should, in every case, be required to put in place contingency arrangements for processing clients' orders if the system becomes unavailable. In the case of clients who are professionals, they are likely to have access to alternative trading venues provided by third party service providers.

It is unclear what justification exists to single out matching systems as requiring prior approval by the competent authority, as opposed to any other significant system which is integral to the provision of services by the firm.

The provision relating to the outsourcing of functions appears to envisage that it will be necessary to obtain prior approval from the competent authority for a very broad range of outsourcing. Many functions which are important to a firm will in practice be outsourced including, for example, legal services or custody services. It would be quite inappropriate for the regulator to involve itself in the approval of such outsourcing arrangements. Regulated firms should be left to make their own commercial judgements in these areas.

4.3 *Article 13: Obligations of investment firms in conducting business on behalf of clients*

The proposals in relation to Article 13 are expressly stated to be subject to review in the light of the further work by CESR in this area. As indicated above, we have only had an opportunity to review the CESR proposals briefly and will be commenting on them further. We therefore do not propose to comment here on the details of the rules.

Nevertheless, we do believe that the Commission should as far as possible avoid changes to the existing Article 11, which, for the most part, appears to contain suitable high level principles on which to base the detailed rules using Level 2 and 3 measures. The principal change which we believe should be made is the move to country of origin rules for both conduct of business rules and marketing and solicitation rules, which we strongly support. We also believe the ISD should prohibit member states from adopting conduct of business or marketing rules which are more onerous than the principles and rules contained in Level 1 and Level 2 measures.

We also strongly disagree with the "look-through" proposals, which would be quite unworkable. It should be for the firm dealing directly with the client to ensure appropriate protection for the client, not the firm with which that firm deals. To oblige the second firm to look through the first firm would result in duplicative regulation. It would also be quite impractical, since the first firm would often for perfectly good commercial sensitivity reasons refuse to give details of its clients to the second firm, which would consequently be unable to fulfil its regulatory obligations.

4.4 *Article 15: Order routing disclosure*

It is unclear what cost-benefit justification exists for the imposition of a requirement to submit quarterly reports to competent authorities given that firms will already be under a requirement to report transactions to the regulated market to which such orders are routed.

The stated intention behind this new requirement is to promote transparency as to the selection of trading venue. In our view, this is a matter for conduct of business rules which can be addressed by a requirement to disclose to retail clients the regulated markets to which the firm may route its clients' orders and the imposition of best execution requirements.

In our view there is no demonstrable need for this Article to be introduced.

4.5 *Article 16: Requirements to uphold integrity and orderliness of market conditions*

In our view, market integrity related regulation should be a matter for home state authorities. This should be reflected in any adjustment made to the ISD in this area.

We note that the guidance notes alongside the proposed Article 16 suggest that proscribed behaviour is as defined in the proposed Directive on market abuse. We agree that it is vital that any market abuse related provisions in the ISD are wholly consistent with the approach taken in that proposed Directive. However, this does not appear to be the case: Article 16 is couched in quite different language from the operative provisions contained in Articles 2, 3 and 5 of the proposed Directive on market abuse.

The proposed Article 16 states that where investment firms match countervailing orders they will be required to establish arrangements with the "relevant domestic market authorities" to facilitate satisfactory monitoring and detection. It is unclear who the relevant domestic market authorities are for this purpose. ISDA strongly believes that any arrangements should be made with firms' home state regulators.

We note that firms which match orders appear to be singled out for increased regulation in the context of market integrity concerns. Without more detailed guidance as to what types of systems such firms would be expected to put in place it is difficult to determine the impact of the proposed Article. However, as a general comment, in our view such firms should be subject to no greater (or lesser) obligations than investment firms which utilise other methods of dealing. In this context we should mention that we appreciate that the position may be different if a matching system accounted for a significant proportion of trading in a particular instrument. However, this is not the case (and is highly unlikely to be the case in the foreseeable future) in the context of OTC derivatives. It is unclear what justification or empirical evidence exists to suggest that order matching as opposed to other forms of dealing activity give rise to increased risks of market abuse.

4.6 Article 17: Obligation to report transactions executed on regulated markets

The proposed new Article 17 would result in a significant change to the current reporting obligations, in particular in that firms would be required to duplicate reporting to the relevant regulated market with a further report to the firm's home state regulator. Not only is this likely to involve substantial additional cost in providing an alternative feed of information, but the cost will also be increased if the details required to be reported to each market and to the home state differ in any material respect.

We are also particularly concerned by the suggestion that the report to home state regulators should include the identity and professional or retail nature of the client. This is likely to add significantly to the cost of reporting. It is also not clear why regulators require the provision of confidential information of this kind on a routine basis.

4.7 Article 18: Obligations for reporting off-exchange transactions in regulated market instruments

We should emphasise that we strongly support the principle of transparency. However, any requirements relating to transparency must take account of the market (in terms of instruments and users) to which such requirements will be applied. A "one size fits all" approach is not appropriate in this context.

We appreciate that the proposed requirement may have been suggested to plug a perceived regulatory gap in relation to business that has traditionally been conducted on regulated markets and which has migrated away from those markets. However, it must be recognised in this context that no such migration has occurred in relation to OTC derivative transactions (or indeed, for that matter, any instrument other than equities). The fact that a product that has traditionally been (and almost invariably, still is) traded off-market may also be available for trading on a regulated market does not justify a reporting requirement to that market. Specifically the existence of an interest rate swap futures contract on an EU regulated market such as LIFFE would not justify the reporting of all interest rate swap transactions to that market.

It is implicit in Article 18 that an assumption has been made that reporting off-market transactions to a regulated market will contribute to the integrity of the broader market in the instrument in question. We do not believe this is an appropriate conclusion to draw in the context of the OTC derivatives market. It would be extremely rare for an OTC transaction to have an impact on the price-formation process of equivalent OTC derivative transactions or of the underlying asset or, indeed, of comparable on-exchange transactions.

Furthermore, it would be wholly inappropriate to give a regulated market control of all the information flow relating to OTC derivatives trading in a particular instrument merely because that market has decided to make that instrument available for trading. Indeed, in the context of

OTC derivatives, which do not have a high degree of standardisation and are by their very nature bilateral, individually negotiated transactions, we question the ease with which it would be possible to determine whether an OTC derivative qualifies as an instrument admitted to trading on a regulated market.

As the Working Document recognises, the proposal that transactions should be reported to a "reference" regulated market is particularly problematic in view of the difficulty of determining what the "reference" market is. This difficulty is even more significant in the context of OTC derivatives. Furthermore, the proposal envisages that a firm will potentially need to set up multiple reporting links to different markets. This would potentially be a very costly exercise.

In our view, the suggestion that firms be required to report transactions to a "reference" market is anti-competitive. Many regulated markets operate on a "for profit basis" and derive a significant proportion of their income from the sale of trading data. It is wholly inappropriate that investment firms should be obliged to act in a way which can be commercially exploited by the entity to whom reports are made.

For these reasons we believe that the proposed Article 18 should be disapplied in its entirety to OTC derivatives transactions.

Finally, in addition to our specific comments in the context of OTC derivatives, we would also make the general point that any proposal relating to post-trade reporting should preserve the approach taken in the current Article 20 of permitting a report to be delayed in certain circumstances. If this feature is not retained such a reporting requirement would potentially deter firms from using their own balance sheets to execute large or block trades in securities instruments, since instantaneous publication would have an extremely detrimental effect on their ability to manage their risk. This would have a negative impact on liquidity in the markets.

4.8 ***Article 22: All authorised investment firms are entitled to transmit orders for execution on regulated markets***

We welcome the clarification in the proposed Article 22 regarding the right of investment firms authorised in their home state to transmit orders to all EU regulated markets. We also welcome the obligation, in the proposed Article 33, that operators of regulated markets should refrain from imposing additional obstacles to participation on participants from other member states.

5. **Clearing and Settlement**

Although clearing and settlement systems for regulated markets are not of direct concern to the OTC derivatives industry, we nevertheless also welcome the proposal in Article 23 to allow investment firms to become remote members of local clearing and settlement systems linked to regulated markets. We also welcome the proposal to allow firms to route orders for settlement to a system chosen by them rather than the default system. Coupled with this, we welcome the

proposed Article 38 permitting regulated markets to establish clearing and settlement arrangements with systems in other member states.

6. **Other Issues**

We welcome the proposal to remove the concentration rule in Article 14(3) of the ISD.

We urge the Commission to reconsider the proposal in Article 21 to continue to allow member states to impose restrictive criteria on counterparties with whom they will deal in the primary markets. In particular we do not believe that any nationality or location criteria are justified among EU established firms.

We very much welcome the opportunity to comment on the Working Document. In our view, it has the potential to play a significant role in making the single European market in financial services a reality. In order to make the most of this opportunity, we urge the Commission to concentrate its efforts on the liberalising elements contained in the Working Document and avoid making the substantial changes to the ISD which are suggested particularly in the context of the proposed bright line between investment firms and organised markets.

If you have any questions in relation to our response please feel free to contact Mark Harding, Chairman, European Regulatory Committee or Annalisa Barbagallo in the ISDA European office.

1 November 2001