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31 August 2001

Dear Mr Demarigny

FESCO's Proposed Standards for Alternative Trading Systems

The International Swaps and Derivatives Association welcomes the opportunity to comment on the FESCO consultation paper on "Proposed Standards for Alternative Trading Systems" (the "June paper"). Our responses to the questions raised in the June paper are set out in the enclosed position paper. We have also had the opportunity of seeing the submissions by the International Securities Market Association (ISMA), the Bond Market Association (TBMA) and the London Investment Banking Association (LIBA) which we also generally support.

In addition to responding to the questions raised in the June paper, we should also like to make some more general comments. These are set out below.

1. Comment on the consultation process

ISDA, together with a number of other trade associations, provided comments in response to FESCO's previous paper, "The Regulation of Alternative Trading Systems in Europe" (the "September 2000 paper"). Although the June paper states that these comments have informed its drafting, a number of ISDA's comments on the September 2000 paper have not been addressed in the June paper. In the absence of specific feedback it is impossible for ISDA to assess the basis on which our previous comments were rejected. We therefore reiterate and expand upon those of our comments that have not been fully addressed (if at all) in the June paper below.

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As a general comment, if the industry is to have confidence in the consultation process it is vital that the process is open and transparent. Indeed the need for open, transparent and systematic consultation is clearly recognised and emphasised by the final report of the Lamfalussy Committee. The June paper does not indicate whether or not FESCO intends to publish feedback on the comments received in relation to it. We believe that feedback is an integral part of an open and transparent consultation process and for that reason we request that FESCO publishes feedback on the comments it receives in response to the June paper.

We also believe that a full explanation of the issues that have been taken into account in formulating the finalised standards (which could be provided via the finalised standards themselves coupled with feedback on the comments received) will contribute to greater consistency of approach by national regulatory authorities in their implementation of the finalised standards. This is particularly important given the degree of discretion that it is envisaged national regulators will have as a result of the proposed differentiated approach to the application of the standards depending on the system in question.

2. Policy considerations

We regret that the June paper fails to explain the policy objectives behind the proposed standards in a satisfactory way. Although the paper states that standards aim to ensure in particular that users of qualifying systems are adequately protected and the integrity of the market is protected, no empirical evidence is offered in support of the need for users of electronic trading systems to have additional protections or to show how electronic trading systems threaten the integrity of the market.

In our view, new regulation should only be introduced to the extent (i) new risks have been highlighted which are not properly addressed by existing regulation and (ii) a properly considered cost-benefit analysis supports the need for it. The June paper lacks both evidence to demonstrate a need for the proposed regulation and a properly considered cost-benefit analysis.

Furthermore, in the context of the OTC derivatives market, the June paper displays what appears to be a fundamental misunderstanding about how the market currently operates. The paper states that "in the debt and standardised OTC derivatives markets, electronic trading systems are serving to move the markets from bilateral telephone trading to more centralised screen trading" it goes on to state "there are also signs of electronic trading systems developing in the non-standardised OTC markets." We strongly disagree with both of these statements. In our view, telephone trading continues to be the more usual means of communication in the OTC derivatives market. Furthermore, to the extent that 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.

These concerns are amplified by the fact that the proposed standards seem very likely to represent what will only be an interim measure. The recent Commission paper on proposed

revisions to the Investment Services Directive suggests that the Commission and FESCO are taking significantly differing approaches to the regulation of trading systems. It seems very likely therefore that any regulations that are introduced in response to the FESCO standards will need to be amended to reflect the approach taken in the revised ISD when it comes into force.

In the absence of a clear need for additional regulation at this time and the apparent likelihood that any regulation introduced now will conflict with the approach taken to the regulation of trading systems under the revised ISD, we cannot see any cost-benefit justification for introducing the FESCO standards at this stage. We strongly believe that any new regulation in this area should be introduced as part of the process of reform of the ISD (on which we will comment separately).

If FESCO presses ahead with its standards at this stage it is vital that the interaction between the regulation of qualifying systems and the regulation of "organised markets" as described in the Commission paper on the revision of the ISD is made clear to the market. It appears that the same ATS could fall within FESCO's definition of qualifying system and also within the definition of "unregulated market" in the ISD paper. However there is no guidance about how the FESCO standards are intended to interact with the proposed treatment of "unregulated markets". We therefore request that guidance be given about the interaction and that the market be given the opportunity to comment through a consultation process.

3. FESCO's Core Conduct of Business Rules for Investor Protection Project

There are a number of proposed standards in the June paper which are in the nature of conduct of business standards, in particular standards 2, 3, 4, 5 and 10. We cannot see any justification for the imposition on ATs generally, and in particular on those whose users are professional investors, of conduct of business standards beyond those which are contemplated by FESCO in the context of its project on Standards and Rules for Harmonising Core Conduct of Business Rules for Investor Protection.

In the context of OTC derivatives, many of the systems which would be caught by the current definition of qualifying system in effect provide nothing more than a different means of communication to the telephone. Such systems operate on a bilateral basis between the system operator and the user, are used to effect the same types of transaction as are effected by voice brokers or by financial institutions directly between themselves and give rise to the same contractual arrangements as arise under contracts effected through voice brokers or directly by traditional communication methods.

One of the real risks of framing separate conduct of business rules for ATs outside the context of FESCO's more general conduct of business review is that different conduct of business rules will apply to essentially the same business activity depending upon the means of communication that has been used to effect the transaction. This would be a most undesirable outcome.

4. Scope of standards

For the reasons referred to above, we do not believe it is appropriate for the final standards to include standards that are in the nature of conduct of business standards. We strongly believe that the final standards should focus solely on market integrity issues. In our view, increased regulation for market integrity reasons is only justified in relation to systems which are of such importance to the market that they affect the price discovery process for the retail market in the instruments that are traded on them or which underlie such instruments (i.e. the market would look to that trading system as a principal source for benchmark prices for the retail market). We are not aware of any systems which are used to trade OTC derivatives contracts and which provide benchmark prices for the retail market.

5. State of origin

As we stated in our response to the September 2000 paper, in framing a regulatory approach to ATSS ISDA strongly believes that FESCO should take the opportunity to make clear that all regulation applied to ATSS will be that of the state in which the ATS is established (i.e. a state of origin approach should be adopted).

The June paper does not reflect a state of origin approach to the regulation of qualifying systems. Indeed, on page 4 of the June paper there is a statement that "ATSS operating in local markets shall comply with the relevant conduct of business rules on each and every local market in which they operate, within the scope of the ISD." This statement is reflected in the text of a number of the standards. ISDA strongly disagrees with this approach for the reasons set out below.

There should be no question that the operator of an ATS could potentially be faced with compliance with rules applied in all member states from which its users may access the system - even where the ATS acts as the central counterparty to trades with its users. Given the need for the standards to be implemented on a domestic level coupled with the wide level of discretion that necessarily comes with the proposed differentiated approach, a host state approach would face ATSS with overlapping and potentially contradictory rules due to differences in implementation among the member states and thereby make compliance impractical for ATSS. A host state approach to regulation of ATSS would also contradict the approach taken to the application of regulation in a cross-border context in the E-Commerce Directive.

As a separate, but related matter (and again as we mentioned in our response to the September 2000 paper) ISDA is aware that some member states have raised questions over the ability of ATSS authorised as broker dealers by another member state to exercise the freedom to provide services. This is clearly contrary to the requirements of EU law; if one member state's competent authorities judge it appropriate to regulate an entity in a particular manner this should not be questioned by another member state. FESCO should therefore take 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 the single passport.

Once again, we appreciate the opportunity to comment on an important area of regulation, but one in which there is in our view a real danger of creating an additional, onerous layer of regulation which will simply operate to stifle innovation to the detriment of EU markets and their users without achieving any improvement in the integrity of those markets.

If you have any questions in relation to our response please feel free to contact me or Annalisa Barbagallo in the ISDA European office.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Mark Harding', with a long horizontal flourish extending to the right.

Mark Harding

Chairman, European Regulatory Committee

Enc.

The Forum of European Securities Commissions'

Paper on Proposed Standards for Alternative Trading Systems

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 members institutions from 41 countries on six continents. These members include most of the world's major 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.

1. Introduction

Although our comments are addressed specifically at systems which are used to trade OTC derivatives transactions, in our view, the majority of our comments about trading systems will be equally applicable to systems on which other types of instruments are traded.

2. Summary

Subject to the detail set out below and in our covering letter:

- Many of the proposed standards relate to conduct of business standards. ISDA can see no justification for additional conduct of business standards beyond those which are contemplated as part of FESCO's core conduct of business project (and upon which ISDA has commented separately). However, to the extent that conduct of business standards are retained in the final standards, such standards should not apply to qualifying systems whose users comprise professional investors.
- We strongly believe that the standards should focus solely on market integrity issues. In our view, additional regulation to address such issues is only justified in relation to systems which perform a significant role in the price discovery process in the retail market for instruments that are traded on it or which underlie those instruments. We are not aware of any electronic trading systems used to trade OTC derivatives which provide benchmark prices that are used in the retail market.
- New regulatory provisions should only be adopted to the extent that ATSS raise new regulatory issues. In our view, ATSS which operate on a bilateral basis and are used to trade OTC derivatives contracts do not give rise to new regulatory issues. As such, there is no justification for ATSS which are used to trade such instruments to be subject to the standards. ISDA strongly believes that the

definition of qualifying system should therefore be amended to make it clear that it applies only to systems which operate on a multilateral basis.

- In framing a regulatory approach to ATSS, FESCO should take the opportunity to make clear that all regulation applied to ATSS will be that of the state in which the ATS is established (i.e. a state of origin approach should be adopted).

3. Responses to Questions 1 to 6

3.1 *Question 1*

In our view it is more appropriate for conduct of business type standards to be addressed in the context of FESCO's paper "Standards for Harmonising Core Conduct of Business Rules for Investor Protection" rather than separate conduct of business standards being framed specifically for qualifying systems.

Indeed, we see a real risk that two separate levels of conduct of business rules could potentially be applied to the same type of business depending on the mode of communication used to effect that business. In the context of OTC derivatives, the majority of ATSS operate in essentially the same way as a voice broker or as financial institutions effecting transactions directly between themselves through traditional methods of communication. The only real distinction is that an ATS operates electronically rather than via the telephone.

By framing separate conduct of business standards for qualifying systems, FESCO runs the risk of making a qualifying system operator subject to greater regulation than would be the case if it operated as a voice broker or directly by traditional communication methods. Clearly this would discriminate against the use of electronic means of doing business.

The different approaches taken in the FESCO Conduct of Business paper and in the June paper illustrate this potential risk. In particular, there are the following inconsistencies between the approach taken by FESCO in its June paper and its approach in the paper "Standards for Harmonising Core Conduct of Business Rules for Investor Protection":

- FESCO's conduct of business paper does not seek to regulate the form or content of agreements between an investment firm and a professional investor. However, Standards 2, 5 and 10 as currently drafted have that effect. ISDA believes that the approach taken in the June paper in this regard is inappropriate.
- FESCO's conduct of business paper does not seek to regulate the nature of the information to be provided by an investment firm to professional investors. However, Standards 3 and 4 (and to an extent Standard 10) as currently drafted would have that effect. ISDA believes that the approach taken in the June paper in this regard is inappropriate.
- FESCO's conduct of business paper does not seek to limit the types of instruments that can be the subject of a transaction with a professional investor. However, there is potential for Standard 4, as currently drafted, to be interpreted as preventing a system operator from making available for trading on its system

transactions in respect of which the system operator is not satisfied there is sufficient publicly available information to enable users to form an investment judgement. ISDA believes that the approach taken in the June paper in this regard is inappropriate.

3.2 *Question 2*

As the June paper acknowledges, the current definition of qualifying system is extremely wide. We appreciate that FESCO has sought to address some of the concerns that arise in the context of a very wide definition through the proposal that there be a differentiated approach to the application of the standards according to the particular system in question. We agree that a differentiated approach is vital given the breadth of the definition. However, we have concerns that there is scope for a differentiated approach to be applied inconsistently across different member states. In our view therefore:

- (i) the final standards should acknowledge that some standards will not apply to certain qualifying systems (as currently drafted, the paper suggests that all of the standards will, to some extent, apply to all qualifying systems - ISDA believes strongly that there are circumstances where this will not be appropriate). We have in mind, in particular, that certain of the standards should be disapplied in the context of qualifying systems whose users are limited to professional investors; and
- (ii) the standards must be applied on a state of origin basis. There should be no question that the operator of an ATS could potentially be faced with compliance with rules applied in all member states from which its users may access the system - even where the ATS acts as the central counterparty to trades with its users. Given the need for the standards to be implemented on a domestic level coupled with the wide level of discretion that necessarily comes with the proposed differentiated approach, a host state approach would face ATSs with overlapping and potentially contradictory rules due to differences in implementation among the member states and thereby make compliance impractical for ATSs. A host state approach to regulation of ATSs would also contradict the approach taken to the application of regulation in a cross-border context in the E-Commerce Directive.

Unless this approach is taken, we strongly believe that there is potential for the standards to give rise to an unjustifiable increase of regulation which is applied, potentially, on a highly inconsistent basis across different member states. This would be extremely undesirable.

In our view new regulatory provisions should only be adopted to the extent that ATSs raise new regulatory issues. In the context of OTC derivatives, the majority of the ATSs currently in operation are effectively a different means of communication. In all other respects they replicate voice brokers or financial institutions communicating directly between themselves by traditional methods. Such systems operate on a bilateral basis between the system operator and the user, are used to effect the same types of transaction as are effected by voice brokers or financial institutions communicating directly between themselves by traditional methods

and give rise to the same contractual arrangements that arise under contracts effected by voice brokers or financial institutions communicating directly between themselves by conventional methods.

Focussing particularly on voice brokers, by way of example, the following similarities exist between them and investment firms which operate electronic trading systems (electronic brokers) in the OTC derivatives market:

- Neither act as principal, rather both bring financial institutions together who then confirm the trade, handle settlement and legal documentation themselves.
- Both work exclusively with experienced, professional users and do not provide services to retail users.
- Traders who use the services of a voice broker or an electronic broker have the choice where they execute their business, which will invariably be where the best trading opportunity exists. It is irrelevant to that trader whether the voice broker or the electronic broker provides the best opportunity.
- Both gather prices from many sources and bring together institutions with corresponding (or almost corresponding) interests in terms of pricing, structure and maturity.
- Prices are displayed (in the case of electronic brokers) or passed by telephone (in the case of voice brokers) anonymously with the names of the relevant financial institutions disclosed only once the trade is agreed.

The actual displaying of prices by brokers to traders is not new. For many years now, most voice brokers have been supplementing their voice services by offering pages on various screens to display prices via bulletin board type presentation. Even if prices have not been displayed on a screen by voice brokers, it is open to the financial institution to call the voice broker and ask it to provide a summary of the various interests expressed by the other financial institutions serviced by that voice broker.

The overlap between the two methods of communication is further emphasised by those electronic brokers who supplement their services by having voice brokers introduce liquidity into their systems or who bring two sides together "off line". This leads to voice brokers displaying prices electronically and electronic brokers who use the telephone to close transactions.

In our view therefore, electronic trading systems used to trade OTC derivatives do not give rise to new regulatory issues and do not justify additional regulation. To impose an increased level of regulation on such systems gives rise to a very real risk that the same type of business activity will be subject to different levels of regulation purely as a consequence of the method of communication used to effect a transaction. This result cannot, in our view, be justified.

We strongly believe that the definition of qualifying system should therefore be limited to systems through which multiple buy and sell interests are matched on a continuous or periodic basis i.e. systems that effect order matching and execution of orders on a multilateral basis.

3.3 *Question 3*

We have commented in section 4 below on how we believe the individual standards should be differentiated in the context of the OTC derivatives market.

3.4 *Question 4*

As we mention in section 3.2 above, in the context of ATSS which provide no more than a different mode of communication (which is the case in relation to all, or almost all, ATSS used in the OTC derivatives market) a definition which triggers additional regulation on the basis of automation gives rise to a real risk of unjustified additional regulation.

ISDA does not see any justification for extending the already wide definition of qualifying system to semi-automated systems. Such an extension is likely to lead to almost all trading arrangements being caught by the definition at some point in the next few years.

3.5 *Question 5*

We do not believe it is appropriate for national regulatory authorities to have the discretion to apply the framework to non-ISD instruments unless and until the ISD passport rights are conferred on such instruments.

3.6 *Question 6*

The differentiated approach that is contemplated by the standards clearly leaves potential scope for significant discretion at national regulatory authority level. In our view, in order for there to be as consistent an approach as possible at the national level:

- full feedback on the responses to this paper should be provided so that it is clear what factors have been taken into account in formulating the final standards;
- the standards should be applied on a state of origin basis;
- the standards should include detailed and clear guidance about how the differentiated approach will work according to, for example, the type of user and the type of product;
- the standards should make it clear that they are only to be applied to systems which perform a significant role in the price discovery process in the retail market for instruments that are traded on it or which underlie those instruments;
- national regulatory authorities should not be permitted to impose "super-equivalent" standards to those comprised in the final standards. All national regulatory authorities should therefore, for example, respect a state of origin approach and reflect the distinction between systems whose users are professional investors and those which are not. Furthermore, to the extent that national regulatory authorities currently apply rules which would be super-equivalent to the finalised FESCO standards, those regulatory authorities should be required to repeal such super-equivalent rules; and

- arrangements should be made for co-ordination between national regulatory authorities in relation to their application of the differentiated approach. Such co-ordination should be open and transparent and conducted in the manner contemplated for CESR consultation outlined in the Lamfalussy Report.

4. **Comments on the Proposed Standards**

4.1 ***Standard 1***

The reference in this standard to "register" should be replaced with a reference to "notify". Under the E-Commerce Directive, member states may not make the taking up or pursuit of the activity of an information society service provider subject to authorisation requirements or measures having equivalent effect.

The standard refers to "regulatory authorities responsible for the licensing and oversight...". The standard should reflect a state of origin approach so that it is clear that the notification should be given to the regulatory authorities in the state in which the qualifying system is established and not any other.

The standard refers to the need to give certain types of information, including information about outsourcing arrangements, to regulators. The standard should make it clear that information on outsourcing is required only in circumstances where the outsourcing arrangements are material to the operator of the system - this is consistent with the general approach taken by regulators in relation to outsourcing.

The standard also includes a requirement for information about volumes and values traded to be provided on an ongoing basis. This type of reporting requirement overlaps with obligations which are imposed under Article 20 of the ISD. If the requirement is intended to have the effect of imposing new reporting requirements in circumstances where no reporting requirements currently exist there should be very careful consideration of the costs implications of such an approach together with a clear identification of the benefits to be gained by imposing such new reporting requirements.

4.2 ***Standard 2***

This standard is in the nature of a conduct of business standard. We do not believe it is appropriate for specific conduct of business type standards to be developed in isolation for ATSS.

However, if this type of standard is to be adopted as part of the final standards for ATSS, the differentiated approach proposed by FESCO should reflect that this standard does not apply to qualifying systems whose users are made up of professional investors.¹

¹ When we refer to "professional investors" in this response we mean it to include:

- (i) those entities automatically treated as professional under FESCO's categorisation (as outlined in its paper "Standards and Rules for Harmonising Core Conduct of Business Rules for Investor Protection");
- (ii) large corporate and other institutional investors as defined under FESCO's categorisation, without the need for them to elect to be treated as professional; and

The terms of the agreement between the operator of a system and a professional user is a matter for the parties to determine themselves. It is not a matter for regulation.

4.3 *Standard 3*

Again, this standard is in the nature of a conduct of business standard. We do not believe it is appropriate for specific conduct of business type standards to be developed in isolation for ATSS.

However, if this type of standard is to be adopted as part of the final standards for ATSS, the differentiated approach proposed by FESCO should reflect that this standard does not apply to qualifying systems whose users are made up of professional investors.

If a professional user considers that it requires assistance in order to use the system efficiently and/or to understand the potential risks that may arise in the context of its use of a system, it is open to that user to seek advice or, as appropriate, negotiate additional protections in the agreement with the system operator.

It would be quite alien to the arms-length nature of the relationship between professional investors for one party (in this case, the user) to expect the other party (in this case, the operator of the system) to provide it with the types of protection that one might expect to be applied in the context of an investment firm providing services to a retail investor. It follows that the rights and remedies as between professional investors should be enforced where necessary through recourse to the courts - not through the imposition of regulatory protections better suited to retail investors.

As a separate point, it should not be for the operator of a system to inform the user about the user's own regulatory reporting requirements - they are the responsibility of the user alone.

4.4 *Standard 4*

Again, this standard is in the nature of a conduct of business standard. We do not believe it is appropriate for specific conduct of business type standards to be developed in isolation for ATSS.

However, if this type of standard is to be adopted as part of the final standards for ATSS, the differentiated approach proposed by FESCO should reflect that this standard does not apply to qualifying systems whose users are made up of professional investors.

As the paper recognises, the need for information of the type contemplated in the standard and its extent, will depend on the experience of the users of the system and on the complexity of the product. The paper goes on to state that "the more complex the product is, the greater will be the need for such information being provided to *all* users." ISDA strongly disagrees with the latter statement.

(iii) sophisticated individuals and other investors who have been assessed as having the necessary expertise in a manner similar to that proposed by FESCO.

As we mention above, it is not appropriate, in the context of a relationship between professional investors, for regulators to provide for the interests of one party to the arrangement to be given specific protection. To do so would be alien to the manner in which inter-professional dealings are customarily effected - ie broadly on the basis of caveat emptor.

The presumption should be that a professional investor has considered its own interests before entering into any transaction (irrespective of the medium through which that transaction is effected). It follows that it is for the professional user itself to assess (and obtain) the information it requires in order to form its own investment judgement and to decide what steps it is appropriate for it to take to protect its position in the absence of publicly available information about a particular transaction or instrument. This may mean that the user elects to seek separate investment advice. It should not be for a system operator to determine (or provide) the type of information that a professional user requires.

Our comments above are particularly focussed on the application of the standard to a qualifying system which is not open to retail users. We would also like to comment in relation to the application of this standard to a qualifying system which is used to trade OTC derivatives. The paper suggests that the operator of a system through which derivatives transactions are effected must provide users with current trading information on the underlying assets. Particularly in the context of OTC derivatives which are not based on financial instruments, a broad range of underlying trading information may well not be available. To make such information available could potentially give rise to significant costs for a system operator.

Although it is not entirely clear, the way the standard is drafted suggests that if "sufficient publicly available information" is not available in relation to the type of transaction that is to be made available for trading on a qualifying system, the operator of a system is not permitted to offer such transactions through the system. It is unclear on what basis this is justified. The effect of such a standard would be to impose a greater level of regulation on business conducted by automated means than is applied to business conducted by conventional means. In particular, FESCO's conduct of business rules do not impose any restrictions on the types of instruments in which a firm can transact business with its customers and counterparties by conventional means.

4.5 *Standard 5*

Again, this standard is in the nature of a conduct of business standard. We do not believe it is appropriate for specific conduct of business type standards to be developed in isolation for ATSS.

However, if this type of standard is to be adopted as part of the final standards for ATSS, the differentiated approach proposed by FESCO should reflect that this standard does not apply to qualifying systems whose users are made up of professional investors. It is for the professional user to establish for itself whether or not the system meets its needs. To the extent that a professional investor determines that it needs additional protections they should be negotiated in the agreement with the system operator.

As a general comment we can see no justification for regulation relating to errors in the context of OTC derivatives transactions which are effected on a bilateral basis. Such errors do not have an impact on the broader market. Furthermore, such regulation is inappropriate in the context of arrangements between professional investors where it is for the user to determine itself whether or not it considers it has appropriate protections and, to the extent it considers it does not, to negotiate additional protections in its contract with the system operator.

4.6 *Standard 6*

We assume that one of the main motivations behind this standard is to fill a perceived regulatory gap in relation to transparency in respect of business which has been traditionally conducted on regulated markets and which has migrated to ATSS. OTC derivatives business has not migrated from regulated markets. As we have previously mentioned, the vast majority of ATSS on which OTC derivatives are traded operate in essentially the same way as voice brokers or financial institutions dealing directly between themselves by traditional communication methods.

Furthermore, it is implicit in the standard that an assumption has been made that by making information about quotes and orders publicly available this will contribute to the integrity of the broader market in the instrument in question. It is not clear to us that this is an appropriate assumption to draw in the context of the OTC derivatives market. First, 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 the underlying asset. Secondly, because OTC derivatives are individually negotiated instruments which can often be part of a complex structured transaction, unless very comprehensive information about the terms of the transaction (at the level of, say, a term sheet) is released (which could not be justified on a cost benefit analysis, would often require sensitive proprietary information to be disclosed and would in any event often be difficult for all but the most experienced user to understand), there is a real risk that information about completed transactions would be misleading.

In the context of systems which operate, effectively, in the same way as a voice broker or financial institutions communicating directly by traditional methods, we cannot see any justification for imposing an additional disclosure requirement on the operator of that system which would not be imposed on it if it operated as a voice broker or communicated directly by traditional means.

The paper states that the amount of pre- and post-trade information made available and the timing of its release should be no more onerous than the standards prevailing in the wider market in that instrument and that where a regulator mandates pre and post-trade transparency standards for trading the same instruments on a regulated market, those mandated standards will form the benchmark for the qualifying system. It should be made clear, in the context of OTC derivative transactions, that there are no mandated transparency standards and that as such this standard will not apply to qualifying systems through which such transactions are effected.

The paper goes on to state that if there are no mandated transparency standards the general convention prevailing in the *member state's* market for trading in instruments of that kind should usually form the minimum acceptable level. Again, it is unclear what this means in the context of OTC derivatives.

Finally, it should be made clear that this standard should be implemented on a state of origin basis i.e. member state should be replaced by a reference to the state in which the qualifying system is established.

4.7 *Standard 7*

We cannot see any justification for this standard, particularly in the context of a qualifying system whose users comprise professional investors. An investment firm would not be subject to equivalent requirements in the context of its non-automated business.

The implication of this standard is that a qualifying system operator would be required, in all circumstances to enforce its rights under contracts with its users. This is not a matter for regulation.

4.8 *Standard 8*

It is not apparent why there is a need for this standard given that the purpose of the reporting and record keeping requirements imposed under Article 20 of the ISD is to enable authorities to investigate cases of market manipulation and insider dealing.

We understand there has been some suggestion that the intention is to give the regulators access to "real time" reporting. The costs implications of this type of requirement are likely to be significant. Provided information is available on a timely basis which it would be pursuant to Article 20 requirements, it is unclear why real time reports should be required.

Furthermore, in our view, additional regulation of the type contemplated in this proposed standard, which addresses market integrity issues, is only justified in relation to systems which perform a significant role in the price discovery process in the retail market for instruments that are traded on it or which underlie those instruments. In our view, therefore, to the extent that this standard is seeking to address issues which are not properly addressed by the reporting and record keeping requirements contemplated by Article 20 of the ISD and the need for such requirements can be justified on a cost benefit analysis, this standard should only be applicable to systems which perform a significant role in the price discovery process in the retail market. We are not aware of any electronic trading systems used to trade OTC derivatives which provide benchmark prices that are used in the retail market.

4.9 *Standard 9*

In our view, this standard should not be applied to a qualifying system whose users are professional investors. As we have stated previously, it is for a professional investor to satisfy itself that the system will deliver the service they require. To the extent that a professional investor requires additional assurances or protections it is open to that investor to negotiate the same in its contract with the system operator.

The standard refers to the "relevant regulatory authorities". It does not provide any guidance as to which authorities will be relevant in this context. The standard should be revised to make it clear that the relevant regulatory authority is that in the jurisdiction in which the ATS is established.

In the absence of a definable market in OTC derivative products we do not think that quantitative thresholds offer a workable approach.

4.10 *Standard 10*

This standard is in the nature of a conduct of business standard. We do not believe it is appropriate for specific conduct of business type standards to be developed in isolation for ATSS.

However, if this type of standard is to be adopted as part of the final standards for ATSS, the differentiated approach proposed by FESCO should reflect that this standard does not apply to qualifying systems whose users are made up of professional investors. The presumption should be that the professional user has considered its own interests and satisfied itself as to the arrangements that will arise in the context of its use of a qualifying system.

5. **Question 17**

We are extremely disappointed that we are at the stage where, we understand, no further consultation at EU level will take place and yet there has been no proper attempt by FESCO to analyse or quantify the likely costs and benefits that the proposed standards will have on the industry.

Indeed, the paper states that no attempt has been made at this stage to quantify the costs or benefits of the proposed framework but then goes on to make a series of assumptions that the costs should generally be low. It is unclear on what basis these assumptions have been made (particularly given the introductory statement referred to above).

Given the level of discretion that is envisaged and the corresponding potential for significantly differing approaches to the implementation of the standards across different member states we have found it extremely difficult to make any sensible comments about the likely costs that would arise as a result of the proposed standards, other than to say that we regard the assumptions as extremely optimistic.

31 August 2001