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F. Demarigny
Secretary General
Committee of European Securities Regulators
17 Place de la Bourse
75082 Paris Cedex 02
France

18. March 2002



Re: CESR's Proposed Standards for Alternative Trading Systems

Dear Mr. Demarigny:

The Bond Market Association (TBMA) welcomes this opportunity to comment on the second consultation paper of the Committee of European Securities Regulators (CESR) on "Proposed Standards for Alternative Trading Systems" (14. January 2002) and the related feedback statement and inventory of comments.

The Bond Market Association is an international trade association representing approximately 200 securities firms and banks active in the global fixed income markets¹. This letter was prepared by TBMA European Office staff with the assistance of outside legal counsel, coordinated by TBMA'S European E-commerce Committee. This Committee comprises legal and business professionals from a broad cross-section of TBMA's European members with substantial interests in e-commerce developments affecting European wholesale financial market services and transactions, including issues relating to alternative trading systems.

TBMA provided extensive comments, in our letter of 3. September 2002, on the previous consultation paper published by the Forum of European Securities Commissions (FESCO) on this subject (11. June 2001).

Some of the proposals made in CESR's latest consultation paper are welcome in that they respond to our earlier comments. Nevertheless, CESR's consultation paper still raises a number of general and specific concerns, which we will highlight in this letter. TBMA also has had an opportunity to read the papers drafted by the London Investment Banking Association and the International Swaps and Derivatives Association, and we can generally support the main observations made in those papers.

¹ More information can be obtained from our website at www.bondmarkets.com.

Executive summary

In summary:

- CESR should be clear about how these proposed standards meet regulatory objectives.
- It is inappropriate to put in place an interim regime when the proposals to reform the ISD have yet to be finalised.
- The definition of qualifying system is still flawed. The definition should focus on systems that genuinely present a degree of risk to systemic stability.
- The standards should not leave so much to regulators discretion. They should make clear now that all, or at least most, of the standards do not apply to systems serving fixed income markets.
- All members of CESR should now accept that host country control will not provide an acceptable framework for the single market.
- The standards should not seek to impose new transparency requirements (and market surveillance requirements on operators of services serving fixed income markets). The paper fails to give appropriate weight to the differing characteristics of those markets.
- The paper should recognise that it is inappropriate to be imposing conduct of business regulation on the relationship between operators of systems and professional users of those systems.

Objectives

1. The development of electronic trading systems for fixed income securities is a positive market evolution that is naturally leading to a pooling of liquidity and to the provision of market based transparency in the price discovery process. In this context, as we have said before, regulation should take account of these positive developments and must neither inhibit the growth of new trading systems nor impose undue burdens on the development of existing ones.

TBMA continues to be concerned that CESR's paper proposes a regulatory response to perceived problems, which are likely to inhibit growth of these beneficial systems and to impose economic burdens on the existing systems that will increase inefficiency in the markets, without clearly stating the objectives that are served by these regulatory interventions. This is particularly true, as discussed further in the following sections, for systems used by market professionals.

Timing

2. TBMA continues to believe, as stated in our September 2001 letter, that it is inappropriate for CESR to press ahead with its own proposals for new regulation in this area at this time.
3. As CESR frankly acknowledges in its feedback statement,

"the European marketplace has not developed in the way it was anticipated when CESR began to consider the need for a regulatory treatment of ATSS. While ATSS 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 market by ATSS still remain."²

4. If the risks are prospective and hypothetical rather than present and actual, then it is difficult to see why there is a pressing urgency for CESR to implement its standards now. The argument for delay is also supported by the overlap with the proposed changes to the Investment Services Directive (ISD).
5. We do not believe that the CESR proposals can fully "anticipate the consequences of ISD revision".³ Adoption of the proposed standards as an "interim regime" would expose firms to the potential extra costs of implementing first one and then another, differing regime. There is as yet no firm indication of the final shape of any Commission proposal and any proposal will develop in the course of the legislative and implementation process.
6. There are also serious doubts as to whether all Member States will have fully implemented, or even able to implement, any "interim regime" adopted by CESR in the period before adoption and implementation of the revised ISD. As a result, there is also a risk of partial and inconsistent regulation, further distorting competition and raising new barriers to business.
7. In any event, pending the implementation of changes to the ISD, it seems unlikely that the risks with which CESR expresses concern will materialise in the retail equity markets (given that the ISD allows the continuation of concentration rules to favour exchanges over alternative methods of execution). Fixed income and other markets are also unlikely, in that period, to alter their characteristics as being primarily wholesale markets where many of the issues that CESR's proposed standards are expressed to address simply do not apply.

Definition of qualifying system

8. TBMA welcomes the proposal to narrow the scope of application of the standards by limiting the definition of qualifying system. In particular, TBMA does not believe that it would be appropriate for CESR to impose regulation of the kind contemplated here on operators of bilateral trading systems, just because they are using automated means to transact business. However, CESR's proposed definition still suffers from serious conceptual flaws:
 - The function of many intermediaries is to bring together multiple buying and selling interests in a way that results in a contract. The use of the term "multilateral" does not provide concrete assistance in distinguishing "qualifying" from other systems. Thus, under the definition, the only characteristics that would distinguish a

² Paragraph 5 of CESR's feedback statement.

³ Paragraph 22 of CESR's consultation paper.

"qualifying system" from an "ordinary" agency broker appear to be that the operator of a "qualifying system" operates its "system" on the basis of "non-discretionary rules".

- However, there is no policy basis for imposing additional regulation of the kind proposed by CESR merely because a firm operates a system providing agency type services on the basis of non-discretionary rules. Imposing such regulation, in effect, penalises those firms that provide services on the basis of transparent standards. The proposal discriminates against agency business models and distorts competition.
- We do not believe that there is any merit in the argument that "qualifying systems" of this kind perform similar functions to "exchanges" (regulated markets) and thus should be regulated in a similar manner. Regulated markets benefit from a number of special privileges which are not available to authorised investment firms. In addition, many (if not all) regulated markets are so integral to the markets in which they operate as to justify additional regulation. We do not believe that any so-called alternative trading systems have such a market position.

9. As we have suggested in our previous submissions, we consider that tests which focus on the functions performed by a particular operator or system are artificial and do not respond any particular legitimate regulatory objective. We continue to believe that the appropriate approach is to focus any regulatory attention on those "core systems" which have become so integral to the operating of a wider market which is of significance that they can truly be said to be part of the market infrastructure. It would be appropriate to direct regulatory requirements designed to ensure systemic stability at operators of systems of this kind. On the other hand, we do not consider that it is appropriate to single out particular market participants to impose additional transparency or surveillance requirements merely because they happen to operate an automated system which functions in a particular way.

10. In any event:

- It is unclear what is intended by the use of the term "system", even though this appears to be a central part of the definition. For example, a telephone (voice) broker might direct its personnel to operate in a "systematic" way in conducting their business (possibly even by reference to non-discretionary rules). Indeed, it seems that the definition is not intended to operate in a technology neutral manner and is really intended only to apply to processes involving the use of computers, in which case it should be made clear (at the very least) that it is restricted to fully automated systems.
- Furthermore, it is unclear whether the definition covers a system which merely routes orders to regulated markets or market makers or brokers for execution. This may depend on the question of whether the buying/selling interests are brought together "in the system" (which may be difficult to answer in the case of a series of interconnected computer systems). There can be no justification for imposing addi-

tional regulation on systems which merely route orders to regulated markets or market makers. The adopted standards should at a minimum exempt order routing systems from the scope of the standards.

- Similarly, it is unclear whether the definition, in fact, excludes single dealer systems, in particular those which involve an element of order matching. The definition should itself incorporate the elements referred to in the last two sentences of paragraph 14 of CESR's paper to make clear that firms that take trading risk or that match incidentally to other activities are not caught by the definition⁴.
- Furthermore, it should be made clear that the definition of qualifying system is limited to systems which operate according to "published" non-discretionary rules. The fact that a broker or dealer automates its internal decision making process should not itself be the basis for additional regulation.
- It is inappropriate to define a qualifying system as "an entity which ...". Entities may conduct business using a number of different business models only some of which may involve the operation of qualifying systems. A qualifying system should be defined as "a system which ..." meets specified criteria.
- Similarly, it seems inappropriate to refer to systems which are not regulated "as an exchange". Presumably, this should refer to systems which are not regulated as a "regulated market".

Differentiation

11. TBMA welcomes the fact that CESR is committed to a differentiated application of the proposed standards. This could mitigate some of the adverse effects of an inappropriate definition. However, we are concerned that if all regulators have complete discretion as to how to apply these requirements this will lead to inappropriate, inconsistent and opaque application of the standards in a manner that will distort competition.
12. In the first place, we consider that it should be reasonably clear that there is no need for any of the standards to apply in some cases. In particular, there seems to be some evidence that the standards have been devised primarily with the equity markets in mind. We consider that the benefits of applying the standards to fixed income markets are unlikely to be significant. The adopted standards should not apply to qualifying systems operating in fixed income markets or, at least, segments of that market, such as the government bond market where there can be little doubt as to levels of liquidity.⁵
13. In any event, the adopted standards should make clear that in some cases it would be inappropriate to apply particular standards to certain types of system. We identify areas where this could be done below.

⁴ Compare rule 3b-16(b)(2) under the US Securities Exchange Act of 1934.

⁵ Compare rule 301(a)(4) of US Regulation ATS.

Whose rules apply?

14. TBMA welcomes the emphasis, in the new proposed standards, on the role of the home country regulatory authority. As stated in our September 2001 letter, it is essential that any rules make clear which states' rules apply where there is a cross-border context. In particular, it is essential that regulators in users' countries (or indeed, in countries where clients of users are located) should not be entitled, by reason of that fact, to impose their regulation on the operator of a qualifying system.
15. However:
 - Not all members of CESR have accepted the proposed limits on the role of "host country" regulators.⁶ This exacerbates the risk of inconsistent implementation. We do not see any justification for host country controls of the kind envisaged. Given the current differentiations in regulatory approaches across Europe, all CESR's members should now accept that host country controls will divide and distort the single market.
 - CESR's paper suggests that "host country" regulators can continue to impose their own rules, even on cross-border business with professional users, so long as the rules amount to "conduct of business" regulation covered by Article 11 ISD. Furthermore, the boundary between conduct of business rules and the standards remains unclear. The adopted standards should make clear that host country regulators should refrain from imposing their own conduct of business rules in relation to cross-border business with professional users, especially where those users are themselves authorised investment firms. After all, this would be consistent with the e-commerce directive and the Commission's proposed approach under the revisions to the ISD.
 - Only some of the proposed standards explicitly address the role of the home country regulator. All the adopted standards should make clear that a firm operating a qualifying system only has to comply with relevant implementing rules established by the home country.
 - CESR should make clear that all Member States will have to take down any barriers to cross-border business which operate against firms conducting cross-border business. In particular, all Member States should be committed to remove additional licensing, authorisation or notification requirements that host countries may impose on properly passported firms which are conducting cross-border business, whether or not they are operating a qualifying system.

The standards

16. We have a number of comments on the wording and structure of a number of the proposed standards.

⁶ See in particular the remarks regarding the position of the Spanish CNMV in footnote 9 on page 6 of CESR's consultation paper.

Standard 1: Registration and Notifications

17. This standard contemplates a new requirement for notification of change in controllers. The standard applies to investment firms which already will be subject to rules on change of controllers by virtue of the ISD (or in the case of banks, the consolidated banking directive). There is no need to prescribe duplicative and potentially inconsistent new regulation.

Standard 2: Fair and Orderly Trading

18. This standard continues to have a focus on user protection issues which are more appropriate to conduct of business rules than rules targeted at market integrity. For systems designed to serve professional users, the standard appears to contemplate an inappropriate degree of control and interference by regulators. The standard should recognise that it is only in exceptional cases that it would be necessary to intervene, on market integrity grounds, in the design or operation of a system used by professional counterparties.

Standard 3: Publication of Trading Information

19. TBMA considers that it is inappropriate and distorts competition to single out particular intermediaries for additional pre or post-trade transparency requirements merely because of the way in which they provide services to the market. In particular, TBMA considers that the mere fact that a firm uses non-discretionary rules is not a sufficient justification for the imposition of requirements of this kind.
20. In addition, TBMA considers that it is inappropriate to suggest that regulators should, especially in what is after all supposed to be an interim regime, be given the flexibility to impose wholly new transparency requirements on fixed income markets.
 - The paper appears to suggest that the mere fact that the qualifying system handles some instruments traded on a regulated market is sufficient justification to impose on the qualifying system the same pre- and post-trade transparency requirements as applied in the regulated market. However, this would allow the regulatory regime for regulated markets which do not significantly influence the price formation process effectively to dictate the regime for what are still essentially over-the-counter markets. There is no "fragmentation issue" to address in the context of fixed income markets.
 - The paper fails to give adequate weight to the other characteristics of fixed income markets that make them different from equity markets. For example, fixed income markets are more diverse than equity markets. There are large numbers of issues many of which trade relatively infrequently (in particular because they are held to maturity). Information about trading in one bond may say little about where another should trade.

We are not against proposals to improve the transparency of markets. Indeed, the existence of services such as TRAX, and the evolution of the new bond trading platforms, have made some positive impact on the transparency in the markets. However, there is

little to be gained by powers used in an *ad hoc* manner depending on the happenstance of whether a qualifying system chooses to trade a particular instrument. The adopted standards should expressly exempt fixed income markets from the scope of these requirements.

21. In any event, additional requirements should only be imposed where there are appreciable benefits. Such appreciable benefits of the imposition of transaction requirements, might be justified when an ATS's market share of the securities it trades reaches some predetermined significant percentage of the overall market⁷.
22. Further, we have particular concerns with the new proposals to impose requirements for pre-trade transparency on OTC transactions, especially as these have been introduced at a late stage in the consultation process. It seems to us that it is wholly inappropriate to impose pre-trade transparency requirements merely because the parties are making use of an "alternative trading system" to communicate bids/offers to one another. It might be possible to meet any requirements for post-trade transparency by making use of existing reporting systems. In contrast, this is less likely to be possible for the provision of pre-trade transparency which means that operators may incur significant additional costs in this respect. Again, this is likely to have a particular impact on the fixed income markets if regulators apply these proposed standards in these markets merely because, for example, one market participants chooses to operate as an exchange.

Standard 4: Monitoring

23. The CESR paper asserts that users rely on the operator to enforce the rules of the system. It is unclear that this is in fact correct, at least in all cases. If this is designed to protect other users of the system then it is an obligation more in the nature of a conduct of business requirement. It is inappropriate for there to be a regulatory duty in this respect where the users are professional investors. In any event, where the users are professionals, it is unlikely that they will omit to ensure that they have contractual protection, if indeed this is material to them. It is unclear what role there is for the regulator in such a relationship.

Standard 5: Arrangements with Regulators Facilitating Market Integrity and Investor Protection

24. Again, it is unclear why a firm that operates under non-discretionary rules should, by reason of that fact alone, be subjected to additional costs which do not apply to its competitors. The implication that this will "level the playing field" with exchanges again ignores the very significant advantages that exchanges enjoy by reason of their status as regulated markets.
25. Again, CESR should make clear that this standard simply does not apply in fixed income markets. It is unclear how an operator of a qualifying system would operate any

⁷ Even the US does not seek to impose transparency requirements on all ATSS, even those that trade "covered securities". Rather it restricts the transparency requirements to those with a significant (5%+) market share. See rule 301(b)(3) of US Regulation ATS.

surveillance operation that produced significant regulatory benefits, given the structure and characteristics of the market.

Standard 6: Systems

26. It is unclear to what extent the systems review contemplated differs from that applicable to any investment firm. Clearly, any investment firm will wish to demonstrate that its systems are adequate. We do not see any need for any additional requirement in most cases.
27. On the other hand, we strongly agree that there is no need to demonstrate full capability to switch to a standby trading facility unless the system has a degree of significance to its users and the markets. The standard should state this explicitly as a constraint, not merely as a factor to be considered.

Standard 7: Clearing and Settlement

28. In the context of professional users, this standard is more like a conduct of business rule. It should be deleted.

Application of conduct of business rules

29. We welcome the move to limit the overlap of these standards with conduct of business rules. However:
 - The standards should clearly state that these considerations are irrelevant to the extent that the system has professionals as users.
 - In particular, it is wholly inappropriate to use a proper market standard to limit the extent to which a qualifying system can trade instruments (just because there is difficulty in getting information on those instruments) when no such restrictions would apply to an authorised investment firm not operating a qualifying system. This is especially the case where the users are professionals.

Again, TBMA appreciates the opportunity to comment on CESR's proposals and to share with CESR the views of our European members and other international members active in European wholesale financial markets on these important issues. If there are any questions please feel free to contact any of us (Scott Rankin at +44.20 77 43 93 33, Matthias Bock at +44.20 75 12 80 or Jens Pöhland at +44.20 77 43 93 34) at your convenience. Please note we have sent copies of this letter to a number of interested persons in addition to those listed below.

Yours sincerely,



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cc:

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