European Office/Europabüro:
St. Michael's House
1 George Yard
London EC3V 9DH
Great Britain/Großbritannien
Tel +44.20.77 43 93 00
Fax +44.20.77 43 93 01

New York Office:
40 Broad Street
New York, NY 10004-2373
Tel +1.212.440.9400
Fax +1.212.440.5260
www.bondmarkets.com

Washington Office:
1399 New York Avenue, NW
Washington, DC 20005-4711
Tel +1.202.434.8400
Fax +1.202.434.8456

Fabrice Demarigny
Secretary General
Forum of European Securities Commissions
17 Place de la Bourse
75082 Paris Cedex 02
FRANCE

3. September 2001

Re: FESCO's Proposed Standards for Alternative Trading Systems

Dear Mr Demarigny:

The Bond Market Association (TBMA)[1] welcomes this opportunity to comment on the consultation paper of the Forum of European Securities Commissions (FESCO) on "Proposed Standards for Alternative Trading Systems" (11. June 2001). The FESCO paper is a further contribution to the debate on the regulation of alternative trading systems (ATSs). Nevertheless, it raises a number of general and specific concerns, which we will highlight in this paper. TBMA has also had the opportunity to read the papers drafted by the International Swaps and Derivatives Association (ISDA) and the London Investment Banking Association (LIBA), and we can generally support the observations made in these papers.

Introduction

TBMA strongly believes that it is inappropriate for FESCO to press ahead with its own proposals in this area given the likely overlap with the proposed changes to the Investment Services Directive (ISD). Any changes to the regulation of trading systems should be addressed as part of the ISD review.

If, however, FESCO insists on finalising its own standards ahead of the changes to the ISD, it should, in our view, move away from its current approach of defining a qualifying system by reference to the functionality offered by an electronic trading system. Such an approach will,

[1] The Bond Market Association is an international trade association representing approximately 200 securities firms and banks active in the global fixed income markets. More information on TBMA can be obtained from our website at www.bondmarkets.com. This letter was prepared by TBMA European Office staff with the assistance of outside legal counsel, co-ordinated by TBMA's European E-commerce Committee. This Committee comprises legal and business professionals from a broad cross-section of TBMA members with substantial interests in e-commerce developments affecting European wholesale financial market services and transactions, including issues relating to alternative trading systems.

in our view, lead to the imposition of inappropriate and unduly burdensome regulation. Furthermore, the finalised standards should be limited, in their scope, to standards which specifically address market integrity issues. We expand on these comments below.

Executive summary

- ***Consultative process:*** TBMA believes that it has been helpful that FESCO initially published a "concept paper" on the regulatory issues relating to ATSs,[2] which has been followed up by the current consultative document. However, the current consultative paper does not contain any specific feedback on the comments received in response to the September 2000 paper. While FESCO states that the comments have informed the drafting of the current consultative paper, the current paper does not discuss those comments or indicate, except indirectly, why FESCO has chosen to pursue particular avenues despite the comments received.
- ***Cost-benefit analysis:*** TBMA welcomes the indication that FESCO intends to carry out a cost-benefit analysis. However, TBMA stresses that any cost-benefit analysis provided should clearly be backed up by research which takes into account all relevant factors.

- ***Approach to regulation:*** There should be a light touch approach to the regulation of electronic trading systems whose users, in the debt market, are professional investors as well as greater acknowledgement of the important distinctions between the debt and equity markets.

- ***Positive development:*** The development of electronic trading systems is a positive market evolution bringing with it, in the fixed income market, increased pooling of liquidity and market based transparency. The adoption of regulation based on the functionality offered by an electronic trading system, will, potentially, act as a disincentive to the use of such systems. One of the potential adverse consequences of such over-regulation could well be that firms revert to the use of traditional communication methods, leading to a loss of the types of benefits mentioned above.

- ***Timing of the proposals:*** TBMA believes that it is highly inappropriate for FESCO to press ahead with its own proposals in this area at this time, given the likely overlap in the implementation timetable with the planned changes to the ISD. In any case, TBMA strongly believes that all changes should be brought in as part of the revision to that Directive.

- ***Definition of qualifying systems:*** An attempt to define a class of "qualifying system" requiring additional regulation which is based on the functionality offered by an electronic trading system will lead to the imposition of inappropriate and unduly burdensome regulation. The fact that a service is automated or that it operates according to rules is not in itself a sufficient distinguishing factor that justifies additional regulation of the kind proposed here.

- ***Focus on market integrity issues:*** Any adopted standards should focus on the specific issues associated with market integrity. In our view, electronic trading systems which are used to trade fixed income products do not, of themselves, give rise to new market integrity issues.

- ***Systemic stability:*** There may be a small number of "core systems" which are so integral to the operation of a market of wider significance that will justify a more comprehensive regulatory review to take account of risks to systemic stability. However, TBMA believes that none of the existing systems, which have been developed for trading fixed income products, would fall in this category.

- ***Transparency:*** There may be issues in equity markets associated with fragmentation reducing price transparency. However, even there, it is not apparent that it would be appropriate to single out electronic trading systems for additional transparency requirements. In any event, fixed income markets present quite different issues and there is no justification for intervention, at this point, to compel transparency on those markets.

- ***Market surveillance:*** Similarly, it is not apparent why there is a need to impose additional market surveillance costs on individual market participants, especially in fixed income markets, given that the ISD already provides for transaction reporting to home state regulators.

- ***Overlap with conduct of business regulation:*** Many of the proposed standards are in the nature of conduct of business regulation that should be dealt with in the context of FESCO's conduct of business project. TBMA can see no justification for additional conduct of business regulation being imposed on investment firms simply because they operate an electronic trading system. In any event, conduct of business standards should not apply to systems whose users are professional investors.

- ***Avoid imposing product restrictions:*** There is no justification for imposing restrictions on the type of products that can be dealt in through electronic trading systems, especially where the users are professional investors.

- ***Removing barriers to business:*** FESCO should commit to the objective of removing existing barriers to cross-border business for electronic trading. In addition, any adopted standards should clearly allocate responsibilities as between the home state and the state in which a branch is located (where a system is primarily operated through that branch).

---

[2] "The Regulation of Alternative Trading Systems in Europe. A paper for the EU Commission" (September 2000).

1. The consultative process

TBMA has previously commented on the way in which FESCO has approached consultation on other proposals, drawing attention to some of the issues that have arisen due to the way in which FESCO has approached those consultations.[3]

TBMA believes that it has been helpful that FESCO initially published a "concept paper" on the regulatory issues relating to ATSs,[4] which has been followed up by the current consultative document. TBMA believes that it is important that all significant regulatory initiatives of this kind should be initiated by a concept release outlining the options under consideration, as a prelude to consultation on any more detailed proposals. This is particularly important in the European context. There is a risk that the publication of firm proposals at too early a stage may mean that regulators negotiate and agree compromises, without the benefit of market input, which they are then reluctant to change even with the benefit of the results of consultation process.

In addition, TBMA welcomes the indication that in this case FESCO intends to undertake some form of cost benefit analysis in relation to its proposals.[5] As FESCO acknowledges in its current paper, it is important that incremental regulation is proportionate to the risks involved and is subject to consideration of the potential costs and benefits. TBMA believes that consultative papers which make specific proposals should always be supported by some form of cost benefit analysis or regulatory impact statement which is clearly backed up by research which takes into account all relevant factors.

However, TBMA would make the following observations on the consultative process in this case.

- FESCO's September 2000 paper to the European Commission on the regulation of ATSs did not specifically invite consultation responses. TBMA, along with other trade associations, and some other market participants active in Europe, nevertheless did submit comments in response to that paper[6]. However, FESCO may well have obtained comment from a wider variety of sources had it specifically invited comments from the public on the issues addressed in its September 2000 paper. It is notable, for example, that no bodies representative of investor or issuer interests appear to have commented on FESCO's original paper.

[3] See TBMA comment letter to FESCO dated 11. May 2001 responding to the FESCO February 2001 consultative paper on "Standards and Rules for Harmonizing Core Conduct of Business Rules for Investor Protection".
[4] "The Regulation of Alternative Trading Systems in Europe. A paper for the EU Commission" (September 2000).
[5] See Annex B to the current consultative paper.
[6] See TBMA comment letter, sent to the Commission 20. December 2001, regarding "The regulation of Alternative Trading Systems in Europe", a paper issued by FESCO for the EU Commission.

- The current consultative paper does not contain any specific feedback on the comments received in response to the September 2000 paper. While FESCO states that the comments have informed the drafting of the current paper, the current consultative paper does not discuss those comments or indicate, except indirectly, why FESCO has chosen to pursue particular avenues despite the comments received. We believe that providing feedback on comments received is essential to building confidence in the regulatory process. In addition, it enables those commenting to assess whether their comments have been fully understood and to assess whether further comment on a particular issue is likely to prove fruitful. It also enables respondents to assess issues raised by other respondents, which may be of general relevance.

- In a similar vein, the current consultative paper does not indicate whether FESCO intends to publish feedback on the comments received if it publishes its final standards towards the end of 2001. As already indicated, we consider that proper feedback, even at the final stage of publication of proposed standards, is an important way of building confidence in the regulatory process. It is also of more general importance in the European context, as standards proposed by FESCO still need to be implemented by national regulators or other national agencies. A full description of the issues taken into account will better inform those responsible for national implementation (as to which see further below).

- As already mentioned, TBMA welcomes the indication that FESCO intends to carry out a cost-benefit analysis. However, TBMA stresses that any cost-benefit analysis provided should clearly be backed up by research which takes into account all relevant factors. To that effect, it would have been much more helpful if FESCO's paper had attempted a more detailed analysis on which firms could comment. The purpose of undertaking a cost-benefit analysis is undermined if it is only undertaken after receipt of responses to consultation. In any event, FESCO should commit to publication of the results of its analysis. We will comment in more detail on the cost-benefit analysis further below.

- On a related topic, TBMA considers that it would have been helpful if the original paper (or the current paper) had contained a more detailed analysis of how each member state currently regulates ATSs. There was only limited discussion of this issue in FESCO's paper to the EU Commission. For example, that discussion did not identify those countries in which ATSs are required to be regulated as an exchange (or the definition of "exchange" which applies for this purpose). Nor did it identify the current definitions used by those member states which impose notification or other requirements on ATSs (such as Italy or Spain) or the extent to which some of the provisions in the proposed standards may already be met by existing requirements. Even if there is no full cost-benefit analysis, an essential part of a regulatory impact statement is an analysis of how the proposed standards differ from current requirements (both where they are more burdensome and where they may result in a relaxation of existing requirements).

- Likewise, where detailed proposals are put forward, the consultative document should indicate the proposed method or methods for national implementation of the proposals. This is of particular importance in relation to FESCO standards that are not backed up by EU legislation. FESCO's September 2000 paper indicates that only some national regulators have latitude to prescribe additional conditions for investment firms operating ATSs, implying that primary legislation may be needed to implement the proposed standards. It is difficult to assess the proposed standards without a clear understanding of how they will be implemented into national law. This must have been addressed by FESCO members in the course of their deliberations. Publication will also serve as a benchmark against which national implementation can be assessed at a later stage. We return to the subject of national implementation further below.

TBMA believes that a more open and transparent consultation process will bring important benefits by achieving a more informed and better quality final result. Indeed, one of the recommendations in the final report of the Lamfalussy Committee is that consultation should be conducted in an open and transparent manner. Such an approach should reduce the risk of problems and delays arising in the transposition and implementation process. Thus, in fact, it may speed up the process of eventual adoption and implementation of any proposed standards.

2. General comments

As we stated in our response to the earlier FESCO paper on ATSs[7], 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. Regulation of electronic trading systems, therefore, needs to 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 believes strongly that FESCO should adopt, as part of its initiative, the objective of removing regulatory barriers to the growth of electronic trading. FESCO's paper largely focuses on the questions of whether the growth of electronic trading may result in the need for new regulation. However, it does not recognise that there are regulatory barriers to the development of the market which prevent investors (and issuers) achieving the potential benefits of increased efficiency and enhanced competition that new technologies could bring. In addition, FESCO should ensure that any new regulation does not itself create new barriers to business.

[7] See reference above.

Towards that end, TBMA believes that continuing, and even expanding, the "lighter touch" approach to the regulation of electronic trading systems whose users are professional investors, as well as greater acknowledgement of the important distinctions between the debt and equity markets, is warranted. The adoption of regulation based on the functionality offered by an electronic trading system will, potentially, act as a disincentive to the use of such systems by firms and could well lead firms to revert to the use of traditional methods of communication. This would result in a loss of benefits associated with electronic trading in the fixed income market such as increased pooling of liquidity and market based transparency.

In addition, we believe that continuing, at least for the immediate future, the existing regulatory distinctions between "regulated markets" or exchanges and investment services firms is a beneficial tool to help clarify the basic role that certain trading systems play in the overall marketplace.

For a more detailed discussion of the nature of fixed income markets and the issues presented by those markets, see TBMA's response of 20. December 2000 to the earlier FESCO paper.

With respect to the definition of "professional investors" we refer to TBMA's separate submission of 11. May 2001 in response to the FESCO consultation paper on conduct of business rules. In particular, we stressed in that paper the need for a broader categorisation of professional investors in order to include all large and institutional investors. The following references to professional investors should be read in the light of our proposals in that submission.

Finally, but not least, any approach to regulate electronic trading should respect and reflect already existing Community principles – both general in nature as well as specific principles applied by EU legislators when introducing minimum harmonisation provisions, such as: the freedom to provide services, a level playing field, the promotion of economic development within the internal market, proportionality, mutual recognition, and certainty.

3. Timing of the proposals

TBMA strongly believes that it is inappropriate for FESCO to press forward with its own proposals in this area at this time. Instead, any new initiative for additional regulation in this field should be brought in as part of the revision to the ISD. Indeed, FESCO's paper itself acknowledges that the proposed standards only represent an interim regime that could be adopted "ahead of any changes to EU legislation". Thus, from a cost-benefit perspective, implementation of a regulatory scheme that will likely be very short-lived, and imposes an undue burden on both electronic trading system providers as well as on national regulators whose resources are not unlimited.

Although TBMA has not yet had an opportunity to consider the Commission's proposals in relation to the revision of the ISD in detail (and will be commenting separately), it seems reasonably clear that the Commission is proposing a framework for the regulation of trading systems that differs, in several material respects, from that proposed by FESCO. By way of example, the Commission's paper seems to contemplate a mandatory requirement for authorisation as an "organised market" for investment firms who carry on their business in a particular way, plus additional requirements for other investment firms operating "order-matching" broker or dealing systems.

The fact that the FESCO consultation paper and the Commission’s ISD paper adopt seemingly different approaches to the regulation of electronic trading systems suggests that FESCO and the Commission may not have acted in a way which reflects the recommendations set out in the final report of the Lamfalussy Committee. That report emphasises the need for enhanced co-operation and "solid triangular relations of trust and efficiency" between the Commission and the Securities and the Regulators' Committees. The absence of co-ordination is not helpful to the market or to the market's confidence in the process of regulatory reform generally.

While FESCO suggests that its proposed standards can be implemented "relatively quickly", without specifying a timetable, the reality is that, even after FESCO agrees on any proposed standards, national regulators would themselves have to go through a process of transforming the proposed standards into national rules. In some member states, such as the UK, this would require national regulators to engage in a further domestic consultative process. In other member states, national regulators would require the assistance of other national agencies to transform the proposed rules into national law. It seems unlikely that this process would be completed prior to 2003 in all member states. Moreover, it appears that implementation of the FESCO proposals will not be uniform in approach (on key issues such as the cross-border application of rules), given the differences of approach highlighted by the FESCO paper itself.

Clearly, the Commission's proposals are likely to develop as a result of consultation and during the ensuing legislative process. While the Commission's paper does not mention a specific timetable, the final report of the Lamfalussy Committee suggested that at least some aspects of the issues covered by the Commission's paper should be adopted and brought into effect by the end of 2003 at the latest. Again, from a cost-benefit perspective it seems unreasonable to introduce the proposed FESCO ATS Standards in the light of the already proposed ISD revision.

In view of the seemingly different approach taken by the Commission in relation to the regulation of trading systems, FESCO's current proposals are unlikely to deliver a regime which will withstand the test of time. Instead, they are likely to result in inconsistent, partial implementation of a confusing new framework which will need to be replaced only shortly after its creation. This will impose unnecessary costs on the industry, which are not justified by a demonstrated urgent need to address immediate issues. TBMA therefore strongly believes that the regulation of electronic trading systems should be addressed as part of the revision of the ISD.

If, however, FESCO insists on pressing ahead with its own standards in this area at this time, it is absolutely essential that there is very close co-operation between FESCO (or the Committee of European Securities Regulators) and the Commission so that any adopted standards reflect the spirit and approach taken to the regulation of trading systems in the context of the ISD reforms. The industry should also be given an opportunity, via further consultation, to comment on the interaction between the proposed standards and the proposed ISD reforms in this area.

4. Whose rules apply?

The consultative paper does not clearly address the issue of which state's rules should apply to qualifying systems in the cross-border context. As a consequence, TBMA considers that there is a real danger that the adoption of the proposed standards, in their current form, could lead to firms that operate electronic trading systems being subject to more, rather than less, overlapping and conflicting regulation. This is of particular concern given that many of the proposed standards are to be applied on a differentiated basis in reliance on subjective assessments (e.g. as to the degree of significance of the system) on which regulators' views may well differ. TBMA believes that the appropriate authority for implementing those standards which are in the nature of conduct of business regulations should be the country of origin.

It is essential that any adopted standards make clear which states' rules apply in the context of qualifying systems (however this term is defined) where there is a cross-border context. It is also essential that any adopted standards give full effect to the principles set out in the E-commerce Directive, which EU member states are required to implement by 17. January 2002.

In this respect, one can distinguish the following possible jurisdictional bases for regulation:

- *The home state:* i.e. the state in which the head office of the investment firm in question is located, regardless of whether the qualifying system is primarily operated through a branch or where the users are located.

- *The country of origin:* i.e. the state from which a particular qualifying system is operated, which may be the operator's home state or, in the case of a system primarily operated from a branch in another state, the country in which that branch is located.

- *The user's country:* i.e. the country in which a user of the qualifying system is located.

Users' countries should not impose their own rules

TBMA considers that any adopted standards should at least make clear that regulators in users' countries (or, indeed, in countries in which 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. There should be mutual recognition of the standards applied by the home state and country of origin (if different). Failure to ensure full mutual recognition in the context of cross-border business will tend to restrict competition, by creating new barriers to cross-border business.

In similar vein, any adopted standards should make clear that member states should remove any barriers currently imposed on cross-border business, such as requirements for notification or approval of electronic trading systems (or requirements for firms to be regulated locally as an exchange) as a condition of their conducting business with local users or counter parties. TBMA is particularly concerned by the remarks made 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". We are also concerned by the suggestion that at least one FESCO member believes that national regulators should have power to impose recognition requirements on an electronic platform which "operates in their respective territories and accounts for a material volume or market share there". These remarks suggest that national regulators should have powers to impose their rules on firms operating cross-border merely because they have local users.

The standards are, by their nature, concerned with electronic trading systems through which investment firms provide "information society services" within the meaning of the E-commerce Directive. If a user's country were to impose standards of the kind set out in the consultative paper, this would restrict the freedoms guaranteed by that Directive within its "co-ordinated field".

The proposed standards are not, for example, of the kinds that are concerned with "contractual obligations regarding consumer contracts" within the specific derogations provided for in the Annex to that Directive. The fact that the standards are to be implemented in a co-ordinated manner across member states means that it would also be wholly inappropriate for a member state to rely on article 3(4) of that Directive specifically to derogate from the freedom to provide services.

Even absent the E-commerce Directive, it would be inappropriate if users' countries could impose their own implementation of the standards on firms operating electronic trading systems from another state. In the first place, as already noted, this would be likely to lead to the imposition of overlapping and conflicting standards on firms. In addition, the standards themselves recognise that their effective application depends on the regulators having access to the information proposed to be required under Standard 1. This information is unlikely to be readily available to regulators in the user's country even if there were elaborate provisions for the exchange of regulatory information.

Furthermore, as TBMA has made clear in its comment letter on FESCO's paper on "Standards and Rules for Harmonizing Core Conduct of Business Rules for Investor Protection", conduct of business rules should not be applied to cross-border business conducted by a firm from another member state, especially where the local customer or counter party is a professional investor, including a large or institutional investor. Users of electronic trading systems in fixed income markets will normally fall within this category. Many of the proposed standards are in fact linked to conduct of business obligations.

We should add that the adopted standards should make absolutely clear that a state could not impose its regulation on a firm operating a qualifying system merely because the system is used to trade instruments that are also traded on a regulated market in that state.

Role of the country of origin

Therefore, in TBMA's view, the main issue is as to the respective responsibilities of the home state and the country of origin in the case of qualifying systems operated through branches outside a firm's home state.

The consultative paper indicates that, to a large extent, FESCO regards its proposed standards as being linked to Articles 3, 10 and 20 of the ISD. This is made clear in Annex A to the consultative paper in relation to Standards 1, 7, 8 and 9.[8] These would therefore be matters within the exclusive province of the home state under that Directive.[9]

However, Annex A to the consultative paper also indicates that FESCO regards certain of the proposed standards as being linked to conduct of business regulation of the kind provided for in Article 11 of the ISD. For the most part, the link is to those conduct of business standards designed to protect the clients of an investment firm, i.e., in the case of a firm operating an electronic trading system, the users of the system. This is the case in relation to Standards 2, 3, 4, 5 and 10. FESCO only links one of its proposed standards (Standard 6 on pre- and post-trade transparency) to the requirement that firms must act in the best interests of the integrity of the market (Article 11(2), second indent).

Under the ISD, the implementation and supervision of conduct of business regulation is the responsibility of the member state in which a service is provided. Therefore, where a firm has established a branch in another member state, the ISD contemplates that conduct of business regulation should be the province of the regulators of a branch in relation to the activities of that branch.

We return below to the question of the link between conduct of business regulation and the proposed standards. However, this split between home and branch state responsibilities could make it more difficult effectively to implement many of the proposed standards where the qualifying system is primarily operated through a branch, especially those which are to be applied on a "differentiated" basis (i.e. Standards 6 and 8). The country in which the branch is located would not readily have access to the information provided in response to the requirements contemplated by Standard 1. This could be addressed, to some extent, by an exchange of information between regulators. However, this must be done in a way that does not result in making it more difficult for firms to operate through branches.

---

[8] See Appendix B to this letter recasting the information in Annex A to FESCO's consultative paper.

[9] Article 10 does allow a limited role to the regulators in the country in which a branch is located as regards rules regarding the organisational structures required to minimise the risks to clients from conflicts of interest. However, Annex A to the consultative document does not suggest that any of the proposed standards is based on these requirements.

We have considered whether a solution might be found, in the context of a revision to the ISD, in applying the concept of a "home regulator" for an electronic trading system operated by an investment firm. This might, in the context of a system operated through a branch outside the home state, be the regulator of the branch. Using this concept would mean that the "home regulator" of an electronic trading system would be responsible for implementing all the standards contemplated by the consultative paper. However, this would undermine the single passport, and indeed the role of the home state regulator, as many of the standards are clearly closely linked to the prudential supervision of firms. Therefore, TBMA does not believe that this would be an appropriate route.

Accordingly, TBMA believes that the appropriate authority for implementing those standards which are in the nature of conduct of business regulation should be the country of origin, where a qualifying system is operated primarily from a branch of the firm outside its home state. The appropriate authority for implementing those standards, which are in the nature of prudential regulation, should, in all cases, be that of the home state. Any adopted standards should make this clear.

Finally, any adopted standards should require national regulators to remove existing barriers to cross-border business where firms using electronic trading systems offer their services cross-border to users based in other countries. In addition, any adopted standards should clearly allocate responsibility to the home state or, in relation those standards in the nature of conduct of business rules, to the country in which a branch is located (where a system is operated primarily from that branch). We discuss these issues in greater detail below.

5. Definition of qualifying system

We believe that any attempt to define a "qualifying system" by reference to the functionality or method of operation employed by the operator of an electronic trading system will not achieve any useful objective. In effect, FESCO's approach means that FESCO is seeking to regulate "electronic trading systems".

In many cases, the functionality and method of operation of so-called "exchange like" systems is little different than those employed by a broker or dealer which chooses to operate electronically or indeed by more conventional means.

Although, it is not clear exactly how FESCO's proposed definition operates in a number of cases or what range of systems would be covered by the proposed definition we have assumed that it is not FESCO's intention that the definition should capture order routing systems and the other types of systems we describe and discuss in Appendix A to this paper and in the following parts of this section 5.

The discussion of "semi-automated" systems in the consultative paper suggests that FESCO's current definition is intended only to cover cases where the contract formation process is entirely automated i.e. where the user interacts with the system electronically[10] and the operator's decision to enter into a contract (or to produce a contract between users or between users and a central counter party or a liquidity provider which participates in the system) is entirely automated i.e. takes place without human intervention.

Even if the current definition was intended only to cover systems where the contract formation process is entirely automated, such a definition would catch many different types of trading systems used by firms. For example, the definition is likely to catch:

- Increasing numbers of trading systems operated by broker-dealers as firms develop filters or other techniques which allow for the acceptance or execution of transactions or particular classes of transactions without human intervention.

- Many types of systems designed to route orders for execution on third party exchanges or other execution venues. The result of the execution of the order is often a contract between the operator (or the broker-dealer to whom the order is transmitted) and the user of the system (e.g. where the broker-dealer executes the order on-exchange but the result of a successful execution is a risk less principal transaction between the broker-dealer and the user of the system[11]).

- Any secure email or other messaging system which enables an investment firm to communicate with a customer or counter party to transmit and receive offers and acceptances of offers to enter into contracts.

- Systems for the online distribution of new issues of bonds or other securities, at least if the system enables a contract to be formed electronically for the allotment of the securities.

- Bulletin board systems which provide messaging facilities by which the firm and users can enter into contracts with one another.

It is unclear why FESCO would consider that the use of automation in this sense should be the determining characteristic which results in a system becoming subject to additional requirements that do not apply to other electronic systems. In particular, in the case of many systems (particularly dealers' own quote driven systems), the users may have no means of knowing (and may be wholly indifferent to) whether the decision to deal was taken by a human being working for the firm or a computerised process.

---

[10] We assume that it is not FESCO's intention to cover cases where a firm interacts with a firm over the telephone and the firm then enters the results of the interaction into a computerised system which determines whether a contract results.

[11] Indeed, it is unclear whether the definition might apply even if the transaction is executed on the third party venue as agent of the customer.

We should add that the designation "alternative trading systems," used in the title of the paper, confuses the debate by implying that electronic trading systems are in some way an alternative to an accepted benchmark way of trading. In the fixed income markets, in particular, where trading has typically taken the place over-the-counter, a wide variety of different means of electronic trading have developed. The fact that they are alternatives to, or more commonly supplement, trading over the telephone does not illuminate the regulatory issues involved.

If FESCO proposes to continue with its current definition, it should make clear, in its feedback on the present consultation, exactly how its definition operates in a number of concrete cases and should clarify that systems such as those set out in Appendix A would not be caught.

For completeness, we would also add the following more detailed comments on the proposed definition:

- The proposed definition of a qualifying system should apply to a system operated by an entity (the current definition suggests that it is the entity itself which is a qualifying system).

- The definition should also make clear that it only applies to a system operated by an "investment firm" (rather than any entity) where the system is not a "regulated market" (rather than an "exchange").

- The definition should only apply to a system that involves trading in "financial instruments".

- The definition should make clear how it applies to financial instruments (such as repurchase transactions or OTC derivatives) that are not bought or sold as such.

6. Scope of standards

In part, the broad definition of qualifying system appears to follow from the nature of the proposed standards which deal with a variety of different objectives, including conduct of business regulation aimed at the protection of users, prudential regulation and wider concerns about market integrity.

FESCO does not set out any justification for imposing standards aimed at the protection of users (i.e. conduct of business type standards) on investment firms simply because they operate an electronic trading system. We believe it would be more appropriate to deal with any conduct of business issues specifically related to electronic trading within FESCO's conduct of business project, rather than in the context of "alternative trading systems".

In our view, any adopted standards should focus on the much narrower range of market integrity issues that are presented by changes in the way that securities are traded (see below). If such an approach was taken it would be possible to move away from an overly broad definition which gives rise to the types of issues described in section 5 above.

***Systemic stability*:** It would seem that underlying some of FESCO's proposed standards are broad concerns that certain trading systems may present risks to the stability of key markets that may not be captured by a conventional prudential review of the operator of that system. TBMA believes that, to the extent that this is a concern, only a handful of "core systems" will present these kinds of risks. These will be systems which have become integral to the operation of a wider market in financial instruments which is itself of wider significance. For example, while some (but not all) "traditional" exchanges would meet this test, TBMA believes that none of the currently existing electronic systems developed for trading bonds and other fixed income products would do so. In all cases, these systems merely provide alternative venues for trading in products which continues to take place by conventional means. If one of these systems fails, users can simply continue their trading by alternative means. In addition, price formation in these markets is more heavily influenced by a variety of externally available benchmark rates in particular interest rate and currency exchange rates for which external data is already available.

Transparency: Another key issue highlighted by FESCO's paper is the concern that the development of electronic trading systems may result in fragmentation of markets with reduced price transparency, which impedes an efficient price formation process. Although this may be a concern in relation to markets which, at present, have a high degree of transparency i.e. equity markets where trading is currently concentrated, in practice, through an established "traditional" exchange, TBMA does not believe this concern is justified in relation to the fixed income markets.

In any case, it is far from clear that the appropriate response to this issue is to single out operators of electronic trading systems, or particular categories of electronic trading systems, by requiring them to make available their information to the market (especially if this is to depend, as FESCO's paper suggests, on whether or not the system is located in the same state as the regulated market concerned). Indeed, this fragmentation might equally well arise as a result of internalisation of trades within broker-dealers not using electronic trading systems or by the growth of off-exchange telephone trading.

Be that as it may, it is clear that fixed income markets present quite different issues. Transactions currently take place largely over-the-counter and are not subject to trade reporting. FESCO's paper seems to suggest that the mere fact that an operator chooses to establish a trading system as a regulated market to trade a particular instrument or class of instruments (and accepts with that a level of price transparency) is sufficient justification for imposing price transparency requirements on other market participants. In particular, it is even more inappropriate to single out for transparency requirements market participants who operate particular types of electronic trading system, that have not chosen to operate as regulated markets, just because they happen to trade the same instrument class by electronic means. FESCO's paper is even more troubling as it suggests that the imposition of price transparency requirements could depend on the happenstance of where the particular regulated market is located.

This issue of price transparency is particularly problematic in fixed income markets, which are global in nature with trading taking place in many venues, including many outside the EU. Imposing transparency requirements on one segment of a market may achieve relatively little for the efficiency of the price formation process. In addition, fixed income markets present special issues because of the range of different instruments traded (of widely varying degrees of liquidity).

TBMA believes that it would be wholly inappropriate for FESCO or the Commission, through the revised ISD to intervene, at this point, in the fixed income markets to compel transparency. This would require a justification of which markets to select for this treatment and to identify which market participants should be subject to these requirements. Market forces may well produce greater transparency without additional regulation. Furthermore, competition laws provide protection against anti-competitive practices and abuse of dominant positions.

Market surveillance: Similar issues arise in relation to market surveillance. As FESCO's paper recognises, it is necessary to justify the imposition of market surveillance costs on market participants by reference to factors such as the significance of the overall market and its susceptibility to abuse. However, again, it is difficult to see that the mere fact that a particular market participant chooses to operate by electronic means is sufficient justification for imposing surveillance costs on that participant. Nor is it obvious that the mere fact that a regulated market has chosen to trade a particular instrument should result in regulators imposing surveillance costs on other market participants that trade that same instrument.

In addition, it must be recognised that information provided for surveillance purposes may have a value which can be exploited by the person to whom the information is provided, at least if that information is to be provided to a competitor exchange. Also, it is inappropriate, as FESCO suggests, that exchanges (regulated markets) should have a say in determining the level of regulation imposed on other market participants.

The ISD already requires transaction reporting which should enable regulators to fulfil their role of market monitoring.

Based on our analysis of market integrity issues in the context of electronic trading systems, TBMA has concluded that it would be inappropriate for FESCO to seek to address transparency and market surveillance issues by seeking to impose new burdens on particular classes of electronic trading system, especially in the fixed income markets. Although there may be a case for regulators to reserve the right to impose some additional requirements on "core systems" that are integral to the operation of a wider market that is in itself significant and where there are genuine systemic issues, TBMA believes that in the fixed income markets there are no systems that would currently present issues of this kind, given the existence of alternative, conventional methods of trading.

7. Overlap with conduct of business regulation

FESCO indicates that many of its proposed standards are linked to the conduct of business standards designed to protect the clients of an investment firm, i.e., in the context of an electronic trading system, the users of a system. This is illustrated in Appendix B to this letter which recasts the information in Annex A to FESCO's consultative paper. The scope of the proposed standards thus overlaps with those set out in FESCO's February 2001 consultative paper on "Standards and Rules for Harmonizing Core Conduct of Business Rules for Investor Protection". TBMA strongly believes that the adopted standards should focus on market integrity issues that are presented by changes in the way that securities are traded. We believe it would be more appropriate to deal with any conduct of business issues specifically related to electronic trading within the conduct of business rules project, rather than in the context of the regulation of "alternative trading systems". Nevertheless, we would make the following general comments on the conduct of business aspects of the proposed standards.

As TBMA stated in its response of 11. May 2001 to FESCO's paper, on conduct of business rules we welcome the proposals to introduce differentiated conduct of business regulation which takes into account the need to distinguish the professional nature of the person to whom the services are provided. However, TBMA also made clear that it was essential that FESCO should reconsider its earlier proposals as to the way in which the divide is drawn between professional and non-professional investors. In particular, large and institutional investors should automatically be treated as professionals regardless of whether they have elected for this status.

We also made clear that it was essential to recognise the arm's length relationship between a firm and professional investors. Requirements to act in the best interests of professional investors are wholly inappropriate to interprofessional dealings and are wholly inappropriate in the case of firms operating electronic trading systems. At the very least, professional investors should be able to waive any best execution requirements.

Against this background, the proposed standards set out in the current consultative paper would discriminate against firms using an electronic trading system to provide services to professional investors by imposing additional conduct of business regulation solely on the basis that a firm is using electronic means to provide those services. For example:

- The proposed principles and rules set out in the conduct of business paper do not seek to regulate the form or content of agreements between an investment firm and a professional investor. In contrast, Standard 2 in the current paper would require that the agreement with users set out the nature of the relationship. Standard 10 also would impose requirements as to clarity of responsibilities with respect to settlement. Standard 5 also, in effect, would regulate the terms on which services are provided by requiring the operator to establish that the trading system is "fair" and by requiring arrangements to prevent unwitting execution of trades at prices different from recent prices on the system.
- The proposed principles and rules set out in the conduct of business paper would not regulate the nature of information that must be given to professional investors regarding the nature of the services provided (other than by extending the information requirements

of the E-commerce Directive to all services). In contrast, Standard 3 in the current paper would require extensive information to be given to users about the nature of the services provided through the electronic trading system (and Standard 10 also in some ways amounts to a requirement as to the nature of information that must be provided to users of a system).

- The proposed principles and rules set out in the conduct of business paper would not limit the types of instruments in which an investment firm may transact business with professional investors. In contrast, Standard 4 in the current paper would restrict the nature of instruments that can be traded electronically with a professional investor (and would impose monitoring obligations on the operator of an electronic trading system with respect to those instruments).

The essence of the arm's length relationship between the operator of an electronic trading system and professional investors that are users of the system is that those users should make their own assessment of the appropriateness of the system for their own purposes (or for the purposes of their clients' trading). The fact that a service is provided electronically is not sufficient justification to impose additional requirements on this relationship. FESCO provides no evidence of market failure, information asymmetry or other traditional justifications for conduct of business regulation to support these proposed standards. Indeed, it seems difficult to justify these standards on these bases in relation to relationships with professional investors.

8. Comments on proposed standards

We set out below our more detailed comments on the proposed standards:

Standard 1

It is difficult to see that there is a justification for seeking to impose a registration requirement on all qualifying systems, particularly in the case of systems which are not material to a firm's operations or are not "core systems".

TBMA recognises that it is legitimate for a firm's home state regulator to require information from a firm, as part of its authorisation process, about the systems that a firm proposes to use to conduct its business. We also recognise that the home state regulator should be able to require firms to keep it informed of significant changes in this information.

However, in general, regulators would normally take the view that a firm need only provide information on systems that are in some way material in relation to the firm's operations. It cannot be assumed, especially given the breadth of the definition of qualifying system, that every qualifying system is material in this sense. This is particularly important given that the requirement will apply to the worldwide operations of a firm. In the case of a firm operating internationally through a number of branches, this could be a very onerous requirement indeed, particularly if it operates on a decentralised basis.

Regulators should have an adequate market awareness to know when a system (that is not material to the operator) becomes or is likely to become so material to the functioning of the wider market that additional information is required beyond that which will normally be obtained as part of a prudential review.

Any requirement to provide information on qualifying systems should be solely a requirement to provide information to the home state authority responsible for licensing and oversight. It should be up to that authority to establish appropriate links with separate local market regulators.

However, in the same vein, it is important, to ensure consistency with the E-commerce Directive, that requirements to keep regulators informed as to changes in the systems used by firms should not operate as form of authorisation requirement for the use of electronic trading systems. 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.

With respect to the detailed requirements in relation to information provided on "initial registration":

- The standard suggests that the firm must notify all outsourcing arrangements which relate to qualifying systems. This contradicts the approach generally taken by regulators on outsourcing issues, namely that outsourcing arrangements are only a matter of regulatory concern where they are material to the firm. It is not the case that every outsourcing arrangement relating to an electronic trading system is, by reason of that fact alone, material.
- Firms cannot be expected to notify the "numbers of users" on first registration (when the system will not in any event be operational).
- Firms should only be required to provide information on the types of instruments traded (not the individual instruments themselves).

The standard suggests that a firm should always be required to notify its home state regulator of volumes and values traded. This to some extent (at least as regards operations within the EU) duplicates information that will already be provided pursuant to transaction reporting requirements under Article 20 of the ISD (or with respect to systems which provide for execution on an exchange, exchange reporting requirements). In addition, this requirement may well be very burdensome where the system is not designed to capture this type of data.

The standard also suggests that a firm operating the system should immediately notify changes to its controllers. There is no need to impose this requirement. The Consolidated Banking Directive and the ISD already have provisions about changes of control of banks and investment firms which adequately address the issues of control over those entities.

Standard 2

This standard should not apply in relation to relationships with professional users.

As already made clear, in principle it is inappropriate to seek to regulate the content of the contractual terms of business that apply to relationships between a firm and other professional investors.

Standard 3

This standard should not apply in relation to relationships with professional users.

It is especially inappropriate to impose obligations on firms to provide information to professional investors as to the nature of the risks involved in trading using electronic systems. The essence of the arm's length relationship between a firm and professional investors is that regulators accept that it is the responsibility of the professional investor to evaluate for itself the nature of the risks that it incurs by trading in a particular instrument or trading in a particular way (and the appropriateness of using a system for any client trading).

Standard 4

This standard should not form part of the adopted standards.

As already noted, FESCO's conduct of business standards do not impose any restrictions on the types of instruments in which a firm can transact business with its customers and counter parties by conventional means.

Clearly, there should be no restriction as to the instruments in which a firm can provide trading facilities to professional investors. For example, firms currently trade emerging market securities where it may be difficult to establish whether there is adequate public information. Similarly, firms may trade complex derivatives where it is difficult to make valuation or other judgments about the transaction. Firms may also send orders to exchanges or other markets where the standards of investor protection may fall short of international norms. The fact that a firm makes available electronic trading facilities for trading these instruments should not change the arm's length nature of the relationship with professional investors.

It is up to professional investors to satisfy themselves as to whether they have adequate information about a particular instrument (and to contract for advice should they require it). Imposing regulatory requirements on a firm to make clear the risks involved in particular instruments merely because they are traded through an electronic trading system would undermine that clarity of responsibilities.

It is inappropriate to extrapolate the "proper market" standards applied to regulated markets and to apply this standard to all electronic trading systems operated by investment firms. Regulated markets are not subject to conduct of business regulation and provide a trading venue which benefits from the endorsement given by regulators through regulated market status.

Standard 5

This standard should not apply in relation to relationships with professional users. Regulators should place primary reliance on market forces to ensure that operators design their systems to meet the requirements of users.

Professional investors that are users of electronic trading systems should evaluate for themselves whether the system meets their trading needs (or the trading needs of their clients). Regulators should not seek to interpose themselves into these relationships.

In relation to non-professional users, clearly any trading system should be fair, in the sense of meeting the legitimate expectations of users. In relation to non-professionals the proposed standard goes further by seeking to mandate some form of modified best execution rule. There is no reason to impose additional best execution requirements in these standards when this is already adequately covered by the conduct of business standards.

The proposed standard also seeks to mandate particular features of system design. It would require that systems enable users to view completed transactions. However, completed transactions will normally be subject to separate confirmation requirements. In some cases, this may be perfectly adequate (especially when combined with normal requirements for rendering of accounts or reporting to clients). This sort of obligation is best left to market forces to set the level of availability of completed transactions within a particular system.

The proposed standard would also require the operator of a system to design the system to include arrangements to reduce the likelihood of users unwittingly executing trades at prices which are substantially different from recent prices in the system. Again, regulators should place primary reliance on market forces to play a role in ensuring that system operators design their systems to be attractive to users, especially where those users are themselves professional investors.

Standard 6

It is not clear what justification exists for imposing this type of standard on a firm merely because it operates an electronic trading system. In any event, these types of disclosure requirement are inappropriate in the context of the fixed income market.

We do not consider that it is appropriate for securities regulators to impose these sorts of disclosure requirements in fixed income markets. These markets currently largely operate as over-the-counter markets and issues of fragmentation do not arise. Market forces should provide an adequate solution to any issues that arise. To the extent that, in due course, any electronic trading system obtains a dominant position in any particular market, then normal antitrust rules should be applied to control any abuse of that dominant position.

It is unclear why it is appropriate to impose pre- and post- trade transparency requirements on particular market participants merely because they operate an electronic trading system when similar obligations are not imposed on all intermediaries who trade by conventional means.

Furthermore, it cannot be the case that one member state should be able to dictate to other member states when they should impose pre- or post-trade transparency requirements on intermediaries involved in the trading of particular instruments. Even if member states could agree on which markets require the imposition of pre- or post-trade transparency requirements on all European intermediaries, the fact is that many instruments, in particular fixed income instruments, are now traded globally. At best, those requirements would only capture a portion of that trading and transparency would at best be partial. Opportunities would still exist to avoid those requirements by trading in other venues.

Standard 7

Regulators should rely on the self-interest of operators to enforce their contractual terms.

We do not see the value of imposing a requirement on operators of electronic trading systems to monitor users' compliance with their contractual terms and conditions. It is not apparent what regulatory policy objective is served by imposing a broad ranging and unfocussed obligation of this kind. Operators of electronic trading systems may design their contractual terms and conditions to serve a variety of objectives. Regulators should rely on the self-interest of operators to enforce their contractual terms. After all, no similar requirement is imposed on firms with respect to the monitoring of other contractual terms of business.

In addition, it is not apparent that the operators' conduct would not be covered by general obligations to treat customers fairly. In relation to users that are professional investors, regulators should leave it to the parties concerned to negotiate the protections that they require. This requirement seems (contrary to the suggestion in Annex A to the FESCO paper) to be one more in the nature of a conduct of business requirement aimed at investor protection rather than a prudential rule.

Standard 8

It is not apparent why this standard is necessary given the existing reporting and record keeping requirements imposed under Article 20 of the ISD.

The recent proposal for a Market Abuse Directive, suggests that the market abuse regime will only apply in respect of instruments admitted to trading on a regulated market. Thus, the proposed standard should, at the very least, be limited to cases where the market abuse regime is capable of applying to those trading through an electronic trading system. The proposed standard suggests that its requirements would apply whenever a qualifying system provides for trading in instruments "traded on other systems", regardless of the nature of those other systems.

Consequently, it is not apparent why it is necessary to adopt this standard when all member states should already have adopted requirements mandating all investment firms to report transactions and to maintain records of transactions in accordance with Article 20 of the ISD. The purpose of these transaction reporting and record keeping requirements is precisely to enable authorities to investigate cases of insider dealing and market manipulation. Thus, it is wholly unclear why additional obligations should be imposed on particular market participants merely because they trade using an electronic trading system, nor should regulators impose reporting and record keeping obligations on someone who operates an electronic trading system when similar obligations are not imposed on those engaging in equivalent business by conventional means.

Likewise, it would be inappropriate to impose a requirement to maintain market monitoring facilities of the kind currently maintained by some regulated markets merely because a firm operates an electronic trading system rather than trading by conventional means, while a particular operator may choose to do this to enhance the confidence of users and to encourage use of the system, such a requirement should not be mandated.

Moreover, the fact that such a requirement may be imposed on regulated markets does not justify the imposition of the same requirement on electronic trading systems, as regulated markets obtain the important benefit of regulatory endorsement not conferred on operators that choose to operate as investment firms. Additionally, imposing such a requirement tends to distort the market in the provision of trading services by imposing additional costs on particular market players that should be more equitably spread among all intermediaries through regulatory charges.

Standard 9

It is difficult to see why the home state regulators should depart from a traditional analysis of the prudential risks to the firm itself arising from the operations of a system.

Again, the text of this standard does not clearly identify which authorities are the "relevant regulatory authorities" responsible for supervising compliance with the proposed requirements in a cross-border context. However, Annex A to the FESCO paper suggests that the proposed requirements are linked to the prudential requirements under Article 10 of the ISD. These are, of course, home state matters. We believe that this is an appropriate allocation of responsibility in this regard. It would be duplicative and unduly burdensome if a firm had to demonstrate the adequacy of its systems and controls to regulators in countries in which its branches are located just because a particular system is operated through a branch. The home state regulator should be able to take account of any wider issues presented by a firm's operation of a proposed system, even if that system is primarily operated from a branch located in another member state.

This is the case even though the primary focus of the proposed standard is not just the possible adverse impact of a systems failure on the firm itself - which would be the traditional focus of prudential standards. Clearly, any material systems failure might threaten the continued existence of the operator and this is something that would normally be addressed as part of a prudential review. However, the standard proposes a wider review which focuses on the possible adverse impact of a failure on users and the wider market. It is important that FESCO's standard makes clear when it is necessary to conduct such a wider review.

We agree that it is conceivable that an electronic system might become so integral to the functioning of a significant market (i.e. a "core system") that a broader review should be applied because of the systemic risks that might result from a systems failure - even though the failure does not itself threaten the continued existence of the operator. However, we believe that, currently, this is unlikely to be the case with respect to any electronic trading system operating in Europe that is not licensed as a regulated market. In particular, the temporary or permanent failure of those electronic trading systems operating in the fixed income markets would not leave market participants with no alternative means of trading and seems unlikely to cause significant disruption. FESCO should indicate whether or not it agrees with this assessment.

In the absence of such circumstances, it is difficult to see why the home state regulator should depart from a traditional analysis of the prudential risks to the firm itself arising from the operation of a system, at least where the users of the system are professional investors. Therefore, to this extent, we consider that the proposed standard overstates the need for additional intervention by regulators in these markets.

As already indicated, we do not consider that it would be appropriate to use quantitative thresholds to measure whether a system has become integral to the operation of a significant market.

Standard 10

This standard should not apply in relation to relationships with professional users.

Again, this standard should not, in principle, apply to relationships with professional investors. Professional investors that are users of electronic trading systems need to evaluate for themselves whether the system meets their trading needs. Regulators should not seek to interpose themselves into these relationships by mandating particular types of disclosures to professional investors that are considering using a particular electronic trading system.

Access to trading

TBMA welcomes the fact that the consultative paper does not seek to impose requirements on firms operating qualifying systems to admit users. We agree that this is an issue which is best addressed by competition law authorities in accordance with established competition rules.

9. National implementation

As already indicated, we are concerned about the overlap between FESCO's process and Commission's proposals to upgrade the ISD. However, if these proposals are to move forward as an interim step then the following issues need to be addressed. The consultation document does not make clear whether it proposes fully to harmonise the additional standards that relate to electronic trading systems or, rather, to impose minimum standards. It seems likely that the latter is the case. In particular, the consultation document suggests that there would be national discretion to apply the proposed standards to partly automated systems and to systems for trading financial instruments that fall outside the scope of the ISD. In addition, the high degree of discretion left to national authorities by the proposed standards (and in particular by the subjective nature of many of the proposed criteria) implies that the degree of co-ordination will be relatively limited.

Thus, there is a danger that the implementation of the proposed standards will not do much to achieve a level playing field between member states. Rather, it is possible that the adoption of the proposed standards will trigger a new round of regulation in this area, with different regulators taking differing approaches to the imposition of new standards while preserving existing means of regulation of ATSs. At the very least, member states should commit to abolish their existing specific regimes for the regulation of ATSs so that all regulation of electronic trading platforms is based on a common framework.

The risk of possible divergence in the application of these standards is exacerbated if, as seems likely, the implementation of the proposed standards in a number of states will depend on action by national agencies other than FESCO members themselves. This raises the possibility that some member states will implement these standards significantly earlier than others, leading to potential competitive disadvantages for those firms to whom the standards are applied earlier. The fact that the proposals will only operate as an interim regime in the period prior to any revision of the ISD may be a disincentive to other national agencies to take the relevant implementing steps.

These risks suggest that there should be agreement on the date from which any adopted standards are to be applied as well as a commitment to achieve a high degree of openness and transparency as to the use made of any discretionary elements of the standards. At the outset, this means that there should be a high degree of openness and transparency as to the national implementation of the proposed standards, including proper national consultation exercises on the proposed methods for national implementation. The FESCO paper should commit national regulators to such a process.

The FESCO paper adopting any final standards should also make clear that EU member states must comply with the transparency provisions of Directive 1998/34/EC, as amended by Directive 1998/48/EC. The adoption of standards in this area clearly relates to information society services.

10. Comments on cost benefit analysis

We have the following comments on the proposed framework for the cost-benefit analysis:

Direct costs

The consultation paper suggests that the direct costs to regulators will generally be low. However, it seems likely that the requirement to notify regulatory authorities of qualifying systems will generate a very significant number of notifications if the proposed broad definition of qualifying system is applied and if firms are required to notify regulators of all qualifying systems regardless of their materiality to the firm. Home state regulators will be required to review each such notification in accordance with Standard 1 (both at the outset and on an ongoing basis) and to assess the adequacy of each system under Standard 9 (again, both at the outset and on an ongoing basis). A number of these systems will be located in overseas branches which may entail overseas inspection by national regulators. It is questionable whether all national regulators currently have the expertise to evaluate information provided by firms in this respect. Where this is not the case, national regulators will have to acquire the necessary expertise.

In addition, the proposed standards would require national regulators to make an assessment of the "significance" of each and every notified system to determine whether to impose the additional requirements contemplated by the proposed standards (such as those imposed by Standard 6). To do this properly may require significant expertise, individualised study of market characteristics (including the characteristics of global markets or markets in other member states) and considerable negotiation with individual firms, especially if a relatively low threshold of "significance" is applied. In particular, controlling the prices that a firm may charge for pre- or post-trade information implies a relatively high degree of intervention in firm's affairs.

These costs may be greater where regulatory responsibilities are divided between national regulators. In addition, they will be greater where it is necessary to co-ordinate any assessment with national regulators in other states, i.e. in those cases where systems are operated through branches and some aspects of regulation are the responsibility of national regulators in the countries in which the branches are located.

Compliance costs

We have already identified a number of areas where the proposed standards may give rise to significant implementation costs, in addition to the costs involved in negotiating with and providing general information to regulators (and providing additional information to users). In particular:

- Standard 1 may require significant redesign of some qualifying systems so that they can provide the necessary information on volumes and values traded, etc.

- Standard 4 would impose significant operational requirements on firms, in particular those trading in the inter-professional markets.

- Standard 5 could also impose significant redesigning costs in particular cases e.g. if it imposes a form of best execution requirement and requirements to be able to view completed transactions and to reduce the risk of off-market trades where the required functionality is not already available.

- Standard 6 could clearly involve significant costs in restructuring systems so as to make available information feeds to third parties. In addition, there will be costs in administering access to this information.

- It is difficult to assess the possible costs of Standard 7 as it is unclear exactly what regulators might expect of firms in this respect.

- Again, it is difficult to make any assessment of the impact of Standard 8 as the proposed standard gives little indication of what information (going beyond existing transaction reporting and record keeping) national regulators might require. However, it would seem that the proposed standard might result, in at least some cases, in the imposition of transaction reporting on firms not currently subject to that requirement. In addition, it seems that some national regulators may use the proposed standard as a basis for transferring to regulated firms market monitoring responsibilities which may involve significant costs - especially if firms have to design software or other tools to facilitate the identification of possibly suspect transactions.

The extent to which these costs are material will also depend on the number of regulators with which a firm has to interact to clear the use of a proposed new system. There is a particular concern that the current structure of the proposed standards will in fact lead to the imposition of even more overlapping and possibly conflicting requirements than at present, especially if regulators in users' countries insist on playing a role in the process and imposing their own rules on firms operating cross-border.

Quantity of product sold

The consultation document suggests that any higher costs are only likely to have a marginal impact on business decisions. This seems excessively optimistic as the proposed standards seem likely to affect a very broad range of electronic trading systems. In addition, the likely lack of transparency as to when additional requirements will be imposed (because of the subjective and discretionary nature of many of the proposed standards) and the possibility of future shifts in the application of those standards may well operate as a deterrent to firms considering the introduction of new electronic trading systems. In particular, it may be difficult to predict which future requirements will be imposed on firms if their proposed system is successful in achieving significant market penetration. Also, the possibility of even more overlapping and conflicting regulation, with different national regulators asserting the right to apply their own rules, is likely significantly to limit the willingness or ability of firms to expand the use of their systems cross-border to users in other countries.

Quality of product sold

The suggestion that the proposals will improve the level of quality of information provided in relation to qualifying systems might imply that existing systems operating in these markets offer inadequate levels of disclosure. No justification is proposed for this suggestion in relation to the professional markets in which TBMA members operate. Nor is there any reason to believe that market forces are somehow inadequate to ensure adequate levels of disclosure in interprofessional markets.

In addition, it is suggested that improved arrangements for monitoring trading will assist in deterring and detecting market abuse. Given the lack of clarity of the proposals as to exactly what will be required, it is difficult to assess whether any new arrangements will be any more successful in the achievement of this objective than existing arrangements. In any event, it may be easier to achieve the objective by more active investigation and enforcement without imposing additional costs on firms operating electronic trading systems.

Variety of product offered

To the extent that the proposed standards impose significant compliance costs and create regulatory uncertainty, they may well have an adverse impact on the willingness of firms to introduce new competitive offerings. In addition, it seems reasonably clear that Standard 4 would have a significant adverse effect on the ability of firms to offer electronic trading platforms relating to a variety of instruments that can currently be traded by conventional means.

Efficiency of competition

For the reasons already noted, it seems unlikely that the proposed standards will achieve any significant improvements in the consistency of regulation between national regulators. In addition, it is unclear that the introduction of the proposed standards in their current form will do anything to remove the barriers to cross-border business currently faced by investment firms offering electronic trading services. Indeed, TBMA believes that there is a considerable risk that it will increase those barriers.

Imposing additional costs on firms operating electronic systems with a view to "equalising" their treatment with that of regulated markets may in fact distort competition. Regulated markets have a number of advantages (including the benefit of regulatory endorsement) which are not available to firms that choose to operate as investment firms. Imposing additional costs on those firms without conferring similar benefits on them only serves to protect the position of those entities operating as regulated markets.

In addition, the proposed standards may distort competition by imposing additional requirements on firms offering electronic trading services where no equivalent requirements are imposed on firms trading by conventional means. In a number of cases it is unclear why the mere fact that electronic means are used should result in the imposition of additional requirements.

Annex B to the consultation document also suggests that the proposed standards will increase confidence in ATSs. It is questionable whether this will be the case in the inter-professional markets in which TBMA members operate.

Overlap with Investment Services Directive upgrade

Any proper cost-benefit analysis needs to factor in the unnecessary duplicative costs incurred if, as seems likely, the eventual structure for the regulatory framework for electronic trading under a revised ISD is materially different from that proposed by FESCO.

Again, TBMA appreciates the opportunity to comment on FESCO's proposals and to share with FESCO the views of our members active in the European wholesale financial markets on these important issues. If there are any questions arising from this letter, please feel free to contact either of us (Scott Rankin at +44.20.77 43 93 33 or Matthias Bock at +44.20.75 52 12 80) at your convenience. Please note that we have sent copies of this letter to a number of interested persons in addition to those listed below.

Yours sincerely,

Dr. Scott Rankin
Executive Director, TBMA European Office
and Vice President
The Bond Market Association

Dr. Matthias Bock
Chair, TBMA European
E-Commerce Committee
Goldman Sachs International

Joined by:

International Primary Market Association

Clifford Dammers
General Secretary
IPMA

cc:
George Wittich, *Chairman*, Forum of European Securities Commissioners
John Mogg, *Director General*, DG Internal Market, European Commission
David Wright, *Director*, Financial Markets, DG Internal Markets, European Commission
Howard Davies, *Chairman*, Financial Services Authority
Jean-Louis Duplat, *Chairman*, Commission Bancaire et Financiere
Juan Fernández-Armesto, *Chairman*, Comisión Nacional del Mercado de Valores
Arthur Docters van Leeuwen, *Chairman*, Stichting Toezicht Effectenverkeer
Michel Prada, *Chairman*, Commission des Operations de Bourse
Luigi Spanventa, *Chairman*, Commissione Nazionale per le Societa e la Borsa
Stavros Thomadakis, *Chairman*, IOSCO European Regional Committee
Nickolaus Bömcke, *Secretary General*, European Banking Federation
Members of TBMA European E-Commerce Committee

Appendix A

A non-exhaustive set of examples of the types of systems that should fall outside the scope of any definition of "qualifying system"

1. Secure messaging

A broker-dealer operates a system which enables its customers to communicate electronically securely with the broker-dealer's traders. The customer and the broker-dealer's traders may propose or accept proposed transactions using the system. The broker-dealer's terms of use specify when a contract is formed between it and the customer as a result of using the system. The system may or may not involve the display of indicative prices generated by the broker-dealer.

Discussion: It appears that this system would not be a "qualifying system" (under FESCO's proposed definition), as the system is not fully "automated". The broker-dealer's decision whether or not to deal is taken by the human intervention of its traders. Note that this is not entirely clear (under the proposed definition as it stands) as the system is "automated" (in the sense of being electronic) and brings together buying and selling interests in the system and according to rules set by the system's operator. The system also results in the formation of an irrevocable contract.

However, the FESCO paper's discussion of "semi-automated" systems suggests that FESCO's proposed definition is narrower than it might appear. It suggests that, if there is an element of human intervention in the contract formation process, the system falls outside the current definition. Nevertheless, if the proposed definition were expanded to cover "semi-automated systems" this would appear to bring the system within the scope of new standards, as there is some element of automation in the process.

Note that it appears to be irrelevant whether:

- the indicative prices displayed by the system are generated by the broker-dealer autonomously (e.g. by reference to models), by reference to data derived from other markets or by reference to orders submitted by other customers;

- the prices displayed are indicative or firm prices;

- the broker-dealer takes risk positions (i.e. is supplying liquidity) or is only executes transactions for customers where it also enters into a matching, back-to-back transaction with another customer;

- the broker-dealer's traders are under instructions to execute transactions meeting criteria set by defined rules.

2. Secure messaging with filter

The system is the same as in example 1, except that the broker-dealer applies an electronic "filter" which identifies possible transactions submitted by the customer by reference to criteria defined by set rules (e.g. size and price). Transactions identified by these means are automatically accepted by the system. Other possible transactions are routed to the broker-dealer's traders who accept or reject the transaction.

Discussion: It appears, based on the proposed FESCO definition, that this system would be a qualifying system as the system is fully "automated" (at least for some classes of transactions) and forms contracts "in the system" according to "rules".

3. Internal execution facility
A broker-dealer's sales team takes orders over the telephone and enters them into an internal system. The system routes the orders to the broker-dealer's traders who decide whether or not to accept or reject the transaction, except that certain transactions are "filtered" and automatically executed by the system.

Discussion: While not entirely clear, it appears, based on the proposed FESCO definition, that this system would not be a qualifying system as the system is not "fully automated". In this case, the customer's interaction with the broker-dealer is not automated in any way.

Would the position be different if the system routes the orders to an affiliate of the broker-dealer which executes those orders (using its traders or the filter built into the system), the resulting transactions being booked between the affiliate and the broker-dealer in an omnibus account? In this case, the system is fully automated as between the broker-dealer and its affiliate (at least in part). This suggests that there should at least be an exception to cover systems that operate between affiliated parties.

4. Order routing to exchanges
A broker-dealer operates a facility under which a customer can enter orders electronically into a system. The orders are routed to an electronic trading system operated by an exchange of which the broker-dealer is a member. If the order is executed on the exchange, the system automatically generates a riskless principal transaction between the customer and the broker-dealer matched by a corresponding transaction between the broker-dealer and the exchange clearing house.

Discussion: It would appear, based on the proposed FESCO definition, that this is a qualifying system. However, it is unclear whether the position would be different if the transaction was executed on the exchange as agent of the customer.

Note that some derivatives exchanges (such as LIFFE) require that members contract on exchange as principal.

5. Order routing to other broker-dealers
A firm operates a system under which participating third party broker-dealers can display indicative prices to users of that system. Users of the system may enter orders directed at particular broker-dealers electronically onto the system which then routes those to the broker-dealer concerned. The broker-dealer to whom the order is directed may accept the order by a return transmission through the system. The firm operating the facility has terms of use which specify when a contract comes into existence between the broker-dealer and the user as a result of these transmissions.

Discussion: The system appears, based on the proposed FESCO definition, to be a qualifying system. Note that it appears to be irrelevant whether or not the participating broker-dealers decide to accept or reject transactions using human intervention (or whether they operate filters which decide whether or not to accept transactions). It also appears to be irrelevant whether or not users know the identity of the broker-dealer to which the order is routed at the time of submission of the order (i.e. whether or not there is pre-trade anonymity).

However, it appears to be critical, under the proposed FESCO definition, that the operator of the system "sets" the rules by which contracts result from the transmissions. If, for example, the broker-dealers set the terms on which they will contract with users of the system by direct contracts between them and the users, the system may not be a qualifying system (although this may not be of assistance if the operator prescribes the form of those contracts).

Note that the same analysis appears to apply to a system which routes orders to a single broker-dealer, including an affiliate of the broker-dealer.

6. Bulletin board

A firm operates a system under which users can display indications of interest in particular types of transaction on an anonymous basis. If a user wishes to pursue the possibility of a transaction with another user it may use the system to communicate (on an anonymous basis) with the other user. If, after an exchange of communications, the users wish to proceed, they can declare their identity to one another through the system. They may then agree on a transaction over the telephone or using the messaging system incorporated in the system.

Discussion: Based on the proposed FESCO definition, the system would appear only to be a qualifying system if the operator sets rules under which contracts are formed using its messaging system. However, this is not entirely clear under the current definition. As in example 1, the definition might cover systems where the rules set relate to the manner in which buying and selling interests are brought together even if the rules do not relate to the manner in which contracts are formed. However, if that were the case, the definition would equally apply even if it were not possible to enter into contracts through the system (and would also apply to any price display system which included an enquiry system - even if operated on a bilateral basis).

It is unclear whether an extension of the definition to "semi-automated" systems would bring the system within the extended definition (even in the absence of rules set by the operator as to when a contract is formed).

Appendix B

Links between the proposed standards and the Investment Services Directive

The following table recasts the information provided in Annex A to FESCO's consultative paper to indicate, in relation to each proposed standard, the issue(s) which the standard seeks to address and the articles of the ISD to which member states requirements on ATSs could be linked. It illustrates that only a minority of the proposed standards address market integrity issues, as such, as opposed to prudential or customer protection issues.

Standard	**ISD provisions**	**Issues**
Standard 1 (registration of ATS and notification of key features and significant changes)	Article 3(4), 3(7)(c) (submission of business plan)	Investor protection risks: best execution, conflicts of interest Market integrity risks: access to trading (fitness and propriety, trading ability, capital adequacy and competence of users) Systemic risks: financial resources
Standard 2 (information to user of relationship operator/user)	Article 11, indent 5 (disclosure to clients)	Investor protection risks: conflicts of interests Market integrity risks: enforcement
Standard 3 (provision of sufficient information about system)	Article 11, indent 5 (disclosure to clients)	Investor protection risks: conflicts of interests
Standard 4 (access to sufficient information about instruments)	Article 11, indent 5 (disclosure to clients)	Market integrity risks: admission to trading (proper market)
Standard 5 (fair and orderly trading/equitable treatment)	Article 11, indents 1 and 2 (acting in best interests of client, due skill care and diligence) Article 11, indent 6 (fair treatment of clients)	Investor protection risks: best execution, conflicts of interest
Standard 6 (making available quotes and/or orders that systems display to users)	Article 11, indent 7 (regulatory requirements so as to promote integrity of the market)	Market integrity risks: fragmentation, transparency
Standard 7 (monitor user compliance with contractual rules of the system)	Article 10 (prudential rules which investment firms shall observe at all times)	Market integrity risks: monitoring, enforcement
Standard 8 (establish arrangements with national authority to facilitate satisfactory monitoring)	Article 20 (transaction reports to relevant authority) Article 10, indent 4 (keeping of records)	Market integrity risks: monitoring
Standard 9 (systems capability, technical operation and contingency)	Article 10, indent 1 (sound control and safeguard arrangements for electronic processing) Annex IV, Capital Adequacy Directive 93/6/EEC contingency for "other risks"	Market integrity risks: systems
Standard 10 (clarity of responsibilities for settlement)	Article 11, indent 4 (information from client as regards services required)	Systemic risks: performance of transactions