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THE BOND MARKET ASSOCIATION

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GREAT BRITAIN

31. January 2003

Re: FSA Consultation on the Implementation of CESR's Alternative Trading Systems Standards (CP 153)

The Bond Market Association (BMA or the Association) welcomes this opportunity to comment on the FSA's Consultation Paper on "Alternative Trading Systems" (9. October 2002). The Consultation Paper aims to implement CESR's Standards on ATS in the UK.

The Bond Market Association is an international trade association representing approximately 200 securities firms and banks active in the global fixed income markets[1]. This letter was prepared by BMA European Office staff, in coordination with BMA's European E-commerce Committee. This Committee comprises of legal and business professionals from a broad cross-section of BMA's European members with substantial interests in e-commerce developments affecting European wholesale financial market services and transactions, including issues relating to alternative trading systems.

The Association has already provided extensive comments, in two detailed comment letters[2], to the Forum of European Securities Commissions/Committee of European Securities Regulators (FESCO/CESR) consultation papers on this subject and which should be considered as part of our comments for the consultation. Furthermore, the Association has also submitted two detailed comment letters to the Commission on the revision of the ISD, which also affect ATS[3]. As a result, the FSA should be familiar with the concerns of BMA regarding the Standards and should take account of those concerns when implementing the Standards in the UK.

[1] More information can be obtained from our website at www.bondmarkets.com.
[2] BMA comment letters 3. September 2001 and 18. March 2002 to FESCO's/CESR's consultation papers on "Proposed Standards for Alternative Trading Systems" (11. June 2001/14. January 2002)
[3] BMA's comment letters to the Commission, dated 30. October 2001 and 31. May 2002, on the "Proposed Adjustments to the Investment Services Directive".

Some of the proposals made in the FSA's Consultation Paper are welcome in that they respond to our comments to FESCO/CESR. Nevertheless, the FSA's Consultation Paper still raises a number of general and specific concerns, both in the way it approaches the implementation of the Standards, and in the substance of the specific Standards, which we will highlight in this letter.

THE BOND MARKET ASSOCIATION

Executive Summary

- BMA continues to be concerned that the FSA's paper proposes a regulatory response to perceived problems that may not exist, which is likely to inhibit growth of these beneficial systems and to impose significant economic burdens on the existing systems that will increase inefficiency in the markets, without clearly stating the objectives that are served by these regulatory interventions.

- BMA continues to believe, as stated in our letters to FESCO/CESR, that it is inappropriate to press ahead with proposals for new regulation in this area at this time. It is also difficult to see why there is a pressing need for the FSA to implement CESR's ATS Standards now, before the new ISD and its implementing measures have been adopted, which once again may require changes to the FSA's regulatory scheme.

- BMA does not believe that the FSA's proposals can fully "anticipate the consequences of ISD revision"[4]. Particularly, in respect of market transparency, where the current debate has not just become technical but also political, it is almost impossible to anticipate any final outcome.

- BMA believes that the FSA should implement the CESR ATS Standards as high-level guidance -- without the use of any rules -- with any necessary detail to be provided at "permission" stage. This would allow the FSA to adjust any requirement in tune with regulatory concerns and to differentiate appropriately between different systems.

- BMA is concerned that the FSA has not stipulated that, in some cases, there is no need for any of the Standards to apply. We argue that the FSA's proposals will not meet the proportionality and competitiveness tests unless full and effective provision is made for differentiation between systems and misapplication of the requirements where appropriate.

- BMA strongly urges the FSA to reconsider the FSA rules imposing additional pre- or post-trade transparency requirements on the fixed income market before the finalisation of the ISD, in order to avoid an unnecessary divergence of market structure regulation between the UK and the general European approach.

- It is not apparent why it is necessary for an ATS to be subjected to additional requirements to establish arrangements to facilitate satisfactory monitoring of the markets in the instrument traded and for the detection of market abuse, 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.

[4] Paragraph 22 of CESR's consultation paper.

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Objectives

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

BMA continues to be concerned that the FSA's paper proposes a regulatory response to perceived problems that may not exist, which is likely to inhibit growth of these beneficial systems, and to impose significant economic burdens on the existing systems that will increase inefficiency in the markets, without clearly stating the objectives that are served by these regulatory interventions. This is particularly true (as discussed further in the following sections) for systems used by market professionals.

Timing

BMA continues to believe, as stated in our letters to FESCO/CESR, that it is inappropriate to press ahead with proposals for new regulation in this area at this time. It is also difficult to see why there is a pressing need for the FSA to implement CESR's ATS Standards now, before the new ISD and its implementing measures have been adopted, which once again may require changes to the FSA's regulatory scheme.

In paragraphs 3.23 to 3.25, the FSA justifies its proposal to proceed at this time, despite some of the clear differences between CESR and the Commission, based on a belief that present risks, which are not covered by regulation, outweigh the risk of not introducing a regime before the likely final shape of the ISD. The FSA also believes it is able at this stage, to achieve a seamless transition between the UK implementation and the ISD, despite some of the difficult discussions the Members States and the Commission are faced with.

BMA does not believe that the FSA's proposals can fully "anticipate the consequences of ISD revision"[5]. Particularly, in respect of market transparency, where the current debate has not just become technical, but also political, it is almost impossible to anticipate any final outcome. Thus, given that there is no firm indication of the final shape of the revision of the ISD, we believe that by implementing the CESR Standards as an "interim regime" would unnecessarily expose UK firms to potential extra costs of implementing first one and then another, differing regime. In fact, the Association would argue that markets would clearly benefit from only having to adapt to one set of regulatory changes, instead of two, as is currently the intention.

Furthermore, there are serious doubts as to whether other EU Member States will implement, or even be able to implement, this "interim regime" in the period before adoption and implementation of the revised ISD. As a result, there is a risk of partial and inconsistent regulation, which would further distort competition and raise new barriers to business in the UK.

[5] Paragraph 22 of CESR's consultation paper.

Given that many of the risks for the fixed income market are prospective and hypothetical, rather than present and actual and, where the fixed income is unlikely in that period, to alter its characteristics as being primarily wholesale markets, many of the FSA's proposed rules are unnecessary.

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Proposed Implementation Options

BMA believes that the FSA should implement the CESR ATS Standards as mere guidance -- without the use of any rules -- with any appropriate detail to be provided at "permission" stage. Pursuing this approach would be supported by our arguments made in respect of the overlap with the ISD revision (see "Timing" paragraph above), in addition to the fact that the FSA would only need to make changes to its regulatory regime once.

We support this "individual requirement", particularly with respect to the issues addressed in the proposed MAR 5.4G. However, the Association is concerned that the FSA has not stipulated that in some cases there is no need for any of the Standards to apply. We argue that the FSA's proposals will not meet the proportionality and competitiveness tests unless full and effective provision is made for differentiation between systems and misapplication of the requirements where appropriate. Thus, we suggest that the FSA should include some text in MAR 5.4, which makes clear that in some cases it will be appropriate or adequate to take no action at all. For example, in many cases it would be disproportionate to impose any new requirements at all (going beyond existing systems checks) on an ATS, which represents only a small percentage of the overall volume of trading in a particular instrument. Requirements should only apply "to the extent (if any) as is appropriate" or "where appropriate".

Commenting on the proposed timeframe for implementing these standards, the Association does agree with the FSA that three months may be unreasonably short for ATS, if it becomes necessary to implement any specific requirements. We therefore suggest including some specific language, enabling the FSA to grant individual temporary waivers from the specific requirements, should the system require substantial changes to its business.

Scope and Definition

BMA sees no reason to widen the application of the Standards beyond investment firms and financial instruments outside the ISD. There is no policy basis for imposing additional regulation of the kind proposed by the FSA, merely because a firm operates a system providing agency-type services on the basis of non-discretionary rules. In effect, imposing such regulation penalises those firms that provide services on the basis of transparent standards. The proposal discriminates against agency business models and distorts competition. As we have suggested in our submissions to FESCO/CESR, we consider that tests which focus on the functions performed by a particular operator or system are artificial and do not respond to any particular legitimate regulatory objective. We continue to believe that the appropriate approach is to focus any regulatory attention on those "core systems" that have become so integral to the operating of a wider market, and which are of such significance that they can truly be said to be part of the market infrastructure.

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By the same token, it is unclear why the FSA would like to include telephone (voice) brokers into the definition of ATS. Voice brokers provide outsourced execution expertise, pre-trade transparency, value added information flow and enhance the price discovery process. Voice brokers have operated with price display screens in the Fixed Income and Government Bond markets for over twenty years. The dealing community values the flexibility afforded by voice brokers. The nature of service provision clearly distinguishes voice brokers from ATS and, as such, they should not be subject to similar standards.

Territorial Scope

BMA welcomes the emphasis on the role of the "home country" regulatory authority. As stated in our letters to FESCO/CESR, it is essential that any rules make clear which states' rules apply where there is a cross-border context. In particular, it is essential that regulators in users' countries (or indeed, in countries where clients of users are located) should not be entitled, by reason of that fact, to impose their regulation on the operator of a qualifying system.

Standards

Standard 1: Registration and Notifications

We support the FSA's proposal not to provide a detailed list of significant changes to the operation of an ATS, which would, in effect, trigger a requirement to update information provided. We also support the FSA's view that there is no need for additional statistics to be supplied to the FSA from ATS operators

Standard 2: Fair and Orderly Trading

BMA takes the view that this Standard should merely be introduced as guidance (with additional requirements imposed in Part IV permissions as necessary), given its focus on user protection issues. For systems designed to serve professional users, this Standard, if introduced as a detailed rule, could be considered to provide an unnecessary degree of control and interference by the FSA. It should only be necessary in exceptional cases to intervene on market integrity grounds, in the design or operation of a system used by professional counterparties. It should also be recognised that ATS in the wholesale market will already have a strong commercial incentive to ensure that trading is fair and orderly and to disseminate information fairly to system users.

Standard 3: Publication of Trading Information

BMA considers that it is inappropriate and distorts competition to impose additional pre- or post-trade transparency requirements on ATS, where such requirements do not apply to the broader OTC market in an instrument that is primarily traded OTC.

Also, any regulatory proposal for transparency requirements on bond markets should take into account the forms in which bonds are traded and ensure that regulatory intervention does not adversely affect market players nor distort competition.

The Association offers to participate again actively in any work of the FSA concentrated on the appropriate level of transparency for the various segments of the bond market.

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In the fixed income markets, it seems particularly inappropriate to impose a specific pre- or post-trade reporting regime for ATS. As the Commission has already recognised in its ISD proposal, there are a host of characteristics of fixed income markets that make them different from equity markets, which need to be taken into account before implementing specific regulation in this area. To briefly illustrate this, the fixed income market is predominantly a primary market, in which bonds typically have a finite maturity and are held from issue to maturity. Secondary trading is mainly between dealers or as part of a wholesale market – as a feed to the institutional investors, as a means of funding, or to give the dealers low underlying risk exposure to interest rates. Therefore, investors provide little or no 'natural' day-to-day liquidity to the market. In addition, the number and value of the underlying securities and secondary trading is substantially higher in fixed income markets, and wholesale pricing reflects both the lower relative cost of funding and the economies of scale in that sector. The fixed income market is dominated by institutional rather than retail investors, where the retail investment in bonds is generally intermediated by institutions via UCITS and pension funds. Institutional investors have significant knowledge of the instruments and will "shop around" to ascertain the prices that are being offered by dealers in the required size. The equity market, on the other hand, is predominantly dominated by secondary trading with new issues occurring on a relatively rare basis. Investors derive profit mainly from capital gain by buying and selling, with dividends contributing to a small proportion of a portfolio's profits.

Also, a substantial proportion of transactions in the fixed income markets is entered into in order to provide low-cost funding for dealers and secured lending for institutional investors (repurchase or "repo" transactions). Due to the purpose of these deals, the prices are likely to differ from, and be irrelevant to, market participants who are making investment portfolio decisions. Instead, they reflect the cost of funding (i.e. a "lending" rate, which *inter alia*, reflects the credit of the counterparty) rather than the intrinsic value of the underlying securities. In these circumstances, publication of prices could be actively misleading to the market, particularly as the technique involves subjective variations between wholesale and retail sectors of the market.

Moreover, fixed income markets are "over the counter" markets and generally global in nature. Trading takes place in many different venues outside the EU, as trading books are "passed" around the globe. Imposing transparency requirements on one geographic segment of the market may achieve relatively little for the efficiency of the price formation process overall. For example, mandating trade reporting and publication by dealers in the EU, in relation to a particular bond that trades largely outside the EU, would be of no benefit to the market as a whole nor would it address the Commission's underlying regulatory concerns. In fact, it may possibly even drive the OTC business outside the UK.

Furthermore, across Europe today, the level of transparency in different markets is mainly determined by voluntary arrangements such as through the sale of trading data, membership in exchanges and other trading venues, or through other private-law agreements, and not by regulatory or governmental bodies. Indeed, the existences of services such as TRAX, and the evolution of the new bond trading platforms, have made a positive impact on the transparency in the markets. Regulatory intervention could result in duplicate reporting given that many market participants

already report to relevant exchanges or TRAX. Not only is this duplicative reporting unnecessary and unwarranted, it is also a costly measure which eventually trickles down to the retail customer.

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In addition, BMA does not believe that it would be appropriate for the FSA to impose any specific rules on ATS, whose business is solely focused on inter-professional fixed income business, and which should be made clear in the guidance.

Finally, imposing regulatory transparency requirements may have unforeseen adverse consequences for dealers in the fixed income market, in that the premature publication of trades represents a higher risk to the dealer, as there is less time to hedge the exposure.

In fact, the Commission, based on many of the abovementioned factors, finally decided to omit fixed income traded instruments from the pre- and post-trade transparency requirements under the proposed revision of the ISD. We clearly think that the FSA should follow suit, and not prejudice the outcome of any future discussion on this topic.

If the FSA decides to move ahead with the imposition of specific transparency requirements for operators of ATS, active in the fixed income market, we would at least argue for making clear that additional transparency requirements are not appropriate in every case for ATS, and would therefore propose inserting the words 'where and in so far as' before "appropriate" in 5.4.5 R(2).

In addition we think that if the FSA decides to move ahead with these requirements, a specific reference, similar to the approach taken by the Commission, should allow ATS to make available trade related information on a "reasonable commercial basis". Today, ATS already provide mechanisms for an improved consolidation of information and level of transparency, as a result of the technology and changing economic environment, to the members of an ATS. If an ATS would now have to publish this information freely to the public, without having to be a member of an ATS, the operations and structures of an ATS would have to be completely changed or forced to operate outside the UK.

BMA is concerned with the fact that the suggested pre- and post trade transparency requirements are triggered automatically by the fact that instruments are traded on an EEA regulated market. The use of the exchange operating the underlying market as a benchmark is, for example, not reasonable where, as is typical, fixed income instruments are traded only once (usually when being issued) on an exchange and thereafter only traded on the OTC market. The Association believes it would be wholly inappropriate to require an ATS to publish these instruments merely because they were traded once on an EEA exchange. Furthermore, the use of the exchange operating the underlying market as a benchmark is also not workable where the instrument is traded on more than one exchange with different transparency requirements, in which event it may not be readily evident which exchange operates the underlying market.

Standard 4: Monitoring

It is inappropriate for there to be a regulatory duty on operators to monitor user compliance with the contractual rules of the system where the users are professional investors.

As already mentioned in our earlier submissions, we reject any underlying assumption that simply because an ATS might appear to provide an equivalent service to regulated markets, it

should, therefore, be subjected to "equivalent" system management obligations. Regulated markets benefit from a number of special privileges which are not available to ATS. In addition, many (if not all) regulated markets are so integral to the markets in which they operate as to justify additional regulation. We do not believe that any ATS has such a market position, and should therefore not be subjected to this type of requirement.

Furthermore, it is unreasonable to require active monitoring of the contractual terms of business under which an operator of an ATS conducts business with its clients, in particular when no equivalent obligation is imposed on other brokers. In many cases, it is impossible to tell whether a client is in breach of its obligations and in most cases this is of no consequence to other users of the system, especially where the operator acts as principal on transactions. We note that the Commission proposes to limit the obligations in the ISD to the monitoring of disorderly trading and the detection of market abuse.

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

It is not apparent why it is necessary that an ATS should be subjected to additional requirements to establish arrangements facilitating satisfactory monitoring of the markets in the instrument traded and for the detection of market abuse, 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 very purpose of these transaction reporting and record keeping requirements, is 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.

Again, 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, which is 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.

Furthermore, given the nature of the fixed income market, it is difficult for an ATS to track a particular instrument or, more importantly, to see what the rest of the market is doing. Therefore, arguably the best place for such monitoring would be TRAX to which a number of market participants in the fixed income market are reporting trades on a daily basis.

More importantly, however, given the significant cost that this requirement would entail (much higher than what has been estimated by the FSA) and any lack of evidence that there is currently market misconduct taking place, we believe this proposed measure is disproportionate to any future risk.

The FSA should make clear that this Standard simply does not apply in fixed income markets.

In respect of MAR 5.4.13 E., the Association believes that passing on information to the FSA about client affairs, may contravene duties owed to the client and expose the ATS to claims from the client in question. The FSA should not introduce any such requirements unless and until the law provides the ATS with immunity from claims along the lines mentioned above. The FSA should urge HM Treasury to introduce such protection when it implements the market abuse directive. Also, it should be made clear that there is no need to put in place any surveillance systems when all activity is already subject to the rules of an exchange, such as the LSE.

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Standard 6: Systems

It is unclear to what extent the systems review contemplated differs from that applicable to any investment firm. Clearly, any investment firm will wish to demonstrate that its systems are adequate. We do not see any need for any additional requirement in most cases, and therefore agree with the FSA that no additional measures are needed.

Application of Conduct of Business Rules

We welcome the FSA's assessment that no changes are needed in respect of Conduct of Business. It should, however, clearly state that these considerations are irrelevant to the extent that the system has professionals as users.

In respect of making information available, however, BMA has serious concerns as it places an unrealistic burden on ATS to collect, consolidate and store information about the instruments it trades. ATSs, in many cases, only have limited resources of information about the instruments traded on their system. It is wholly inappropriate to require an ATS operator to establish that information is publicly available regarding the instruments traded on the ATS (MAR 5.4.15 R.) or to make corresponding disclosures to clients (COB 4.2.1 E(8)). No similar requirement is placed on voice or other brokers who arrange transactions between professional investors (market counterparties or intermediate customers). These customers make their own evaluation of the instruments in which they trade and seek advice where they require it. It is difficult to see how a firm would be expected to monitor this information with respect to securities traded on a wide range of primary markets.

More importantly, however, BMA questions why the FSA has decided to include MAR 5.4.15 R under the heading of "Arrangements to reduce market abuse", instead of under conduct of business rules. This is clearly against the Standards adopted by CESR, and we would urge the FSA to ensure that this obligation is merely addressing conduct of business issues, if at all.

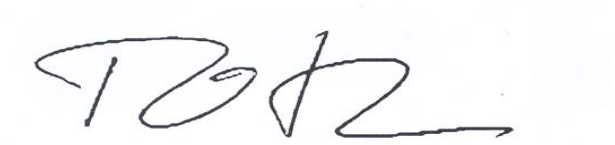
Finally, BMA also believes many of the requirements in COB 4.2.17E are, wholly or partly, inappropriate. To require ATS to include in their terms of business the information prescribed in paragraphs (1), (2), (6) and (8) is wholly or partly unnecessary. Particularly, it is wholly inappropriate to include items (4) and (9) in COB 4.2.17E, as firms are generally not in a position to advise clients as to their disclosure obligations (which might arise under many different systems of law). In many cases, it will be impossible to know whether a particular instrument will or will not fall within the market abuse regime.

Again, BMA appreciates the opportunity to comment on the FSA's proposals and to share with the FSA the views of our European members and other international members active in European

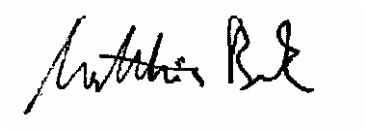
wholesale financial markets on these important issues. If there are any questions please feel free to contact Scott-Christopher Rankin, Executive Director at +44.20 77 43 93 00 or Jens Pöhland, European Legal Counsel at +44.20 77 43 93 34 at your convenience.

Please note we have sent copies of this letter to a number of interested persons in addition to those listed below.

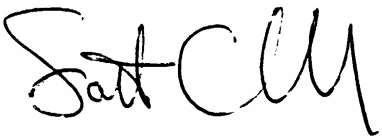
Yours sincerely,



Ralf Roth
Co-Chair BMA European E-Commerce Committee
(CTO and Head of E-Commerce for Fixed Income, Deutsche Bank AG London)



Dr. Matthias Bock
Co-Chair, BMA European E-Commerce Committee
(Executive Director and Counsel, Goldman Sachs International)



Dr. Scott-Christopher Rankin
Executive Director, BMA European Office
Executive Director, European Securitisation Forum

Attachment: Appendix A - BMA comment letter 18. March 2002 to CESR's consultation paper on "Proposed Standards for Alternative Trading Systems" (14. January 2002)

cc:
Dr. Alexander Schaub, *Director General* for Competition, European Commission
David Wright, *Director,* Financial Markets, DG Internal Markets, European Commission
Arthur Docters van Leeuwen, *Chair of CESR, Chairman*, Stichting Toezicht Effectenverkeer
F. Demarigny, *Secretary General*, Committee of European Securities Regulators
Niall Bohan, *Administrator,* European Commission, Internal Market Directorate-General
Nickolaus Bömcke, *Secretary General*, European Banking Federation
Howard Davies, *Chairman*, Financial Services Authority
Blas Calzada, *Chairman*, Comisión Nacional del Mercado de Valores
Michel Prada, *Chairman*, Commission des Operations de Bourse
Luigi Spanventa, *Chairman*, Commissione Nazionale per le Societa e la Borsa
Joseph W. Sack, *Senior Vice President*, The Bond Market Association
Paul Saltzman, *Executive Vice President & General Counsel,* The Bond Market Association
Members of TBMA European E-Commerce Committee

Appendix A - BMA Comment Letter 18. March 2002 to CESR's Consultation Paper on "Proposed Standards for Alternative Trading Systems" (14. January 2002)

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

18. March 2002

Re: CESR's Proposed Standards for Alternative Trading Systems

Dear Mr. Demarigny:

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

The Bond Market Association is an international trade association representing approximately 200 securities firms and banks active in the global fixed income markets[6]. 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's European members with substantial interests in e-commerce developments affecting European wholesale financial market services and transactions, including issues relating to alternative trading systems.

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

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

[6] More information can be obtained from our website at www.bondmarkets.com.

Executive summary

In summary:

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

Objectives

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

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

Timing

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

3. As CESR frankly acknowledges in its feedback statement,

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> "the European marketplace has not developed in the way it was anticipated when CESR began to consider the need for a regulatory treatment of ATSs. While ATSs have made considerable impact in wholesale bond markets, their role in equity trading in Europe is not yet significant. However, CESR considers that the risks posed by the potential penetration of the retail market by ATSs still remain."[7]

4. If the risks are prospective and hypothetical rather than present and actual, then it is difficult to see why there is a pressing urgency for CESR to implement its standards now. The argument for delay is also supported by the overlap with the proposed changes to the Investment Services Directive (ISD).

5. We do not believe that the CESR proposals can fully "anticipate the consequences of ISD revision".[8] Adoption of the proposed standards as an "interim regime" would expose firms to the potential extra costs of implementing first one and then another, differing regime. There is as yet no firm indication of the final shape of any Commission proposal and any proposal will develop in the course of the legislative and implementation process.

6. There are also serious doubts as to whether all Member States will have fully implemented, or even able to implement, any "interim regime" adopted by CESR in the period before adoption and implementation of the revised ISD. As a result, there is also a risk of partial and inconsistent regulation, further distorting competition and raising new barriers to business.

7. In any event, pending the implementation of changes to the ISD, it seems unlikely that the risks with which CESR expresses concern will materialise in the retail equity markets (given that the ISD allows the continuation of concentration rules to favour exchanges over alternative methods of execution). Fixed income and other markets are also unlikely, in that period, to alter their characteristics as being primarily wholesale markets where many of the issues that CESR's proposed standards are expressed to address simply do not apply.

Definition of qualifying system

8. TBMA welcomes the proposal to narrow the scope of application of the standards by limiting the definition of qualifying system. In particular, TBMA does not believe that it would be appropriate for CESR to impose regulation of the kind contemplated here on operators of bilateral trading systems, just because they are using automated means to transact business. However, CESR's proposed definition still suffers from serious conceptual flaws:

[7] Paragraph 5 of CESR's feedback statement.
[8] Paragraph 22 of CESR's consultation paper.

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- The function of many intermediaries is to bring together multiple buying and selling interests in a way that results in a contract. The use of the term "multilateral" does not provide concrete assistance in distinguishing "qualifying" from other systems. Thus, under the definition, the only characteristics that would distinguish a "qualifying system" from an "ordinary" agency broker appear to be that the operator of a "qualifying system" operates its "system" on the basis of "non-discretionary rules".

- However, there is no policy basis for imposing additional regulation of the kind proposed by CESR merely because a firm operates a system providing agency type services on the basis of non-discretionary rules. Imposing such regulation, in effect, penalises those firms that provide services on the basis of transparent standards. The proposal discriminates against agency business models and distorts competition.

- We do not believe that there is any merit in the argument that "qualifying systems" of this kind perform similar functions to "exchanges" (regulated markets) and thus should be regulated in a similar manner. Regulated markets benefit from a number of special privileges which are not available to authorised investment firms. In addition, many (if not all) regulated markets are so integral to the markets in which they operate as to justify additional regulation. We do not believe that any so-called alternative trading systems have such a market position.

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

10. In any event:

- It is unclear what is intended by the use of the term "system", even though this appears to be a central part of the definition. For example, a telephone (voice) broker might direct its personnel to operate in a "systematic" way in conducting their business (possibly even by reference to non-discretionary rules). Indeed, it seems that the definition is not intended to operate in a technology neutral manner and is really intended only to apply to processes involving the use of computers, in which case it should be made clear (at the very least) that it is restricted to fully automated systems.

- Furthermore, it is unclear whether the definition covers a system which merely routes orders to regulated markets or market makers or brokers for execution. This may depend on the question of whether the buying/selling interests are brought together "in the system" (which may be difficult to answer in the case of a series of interconnected computer systems). There can be no justification for imposing additional regulation on

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

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- Similarly, it is unclear whether the definition, in fact, excludes single dealer systems, in particular those which involve an element of order matching. The definition should itself incorporate the elements referred to in the last two sentences of paragraph 14 of CESR's paper to make clear that firms that take trading risk or that match incidentally to other activities are not caught by the definition[9].

- Furthermore, it should be made clear that the definition of qualifying system is limited to systems which operate according to "published" non-discretionary rules. The fact that a broker or dealer automates its internal decision making process should not itself be the basis for additional regulation.

- It is inappropriate to define a qualifying system as "an entity which …". Entities may conduct business using a number of different business models only some of which may involve the operation of qualifying systems. A qualifying system should be defined as "a system which …" meets specified criteria.

- Similarly, it seems inappropriate to refer to systems which are not regulated "as an exchange". Presumably, this should refer to systems which are not regulated as a "regulated market".

Differentiation

11. TBMA welcomes the fact that CESR is committed to a differentiated application of the proposed standards. This could mitigate some of the adverse effects of an inappropriate definition. However, we are concerned that if all regulators have complete discretion as to how to apply these requirements this will lead to inappropriate, inconsistent and opaque application of the standards in a manner that will distort competition.

12. In the first place, we consider that it should be reasonably clear that there is no need for any of the standards to apply in some cases. In particular, there seems to be some evidence that the standards have been devised primarily with the equity markets in mind. We consider that the benefits of applying the standards to fixed income markets are unlikely to be significant. The adopted standards should not apply to qualifying systems operating in fixed income markets or, at least, segments of that market, such as the government bond market where there can be little doubt as to levels of liquidity.[10]

13. In any event, the adopted standards should make clear that in some cases it would be inappropriate to apply particular standards to certain types of system. We identify areas where this could be done below.

[9] Compare rule 3b-16(b)(2) under the US Securities Exchange Act of 1934.
[10] Compare rule 301(a)(4) of US Regulation ATS.

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Whose rules apply?

14. TBMA welcomes the emphasis, in the new proposed standards, on the role of the home country regulatory authority. As stated in our September 2001 letter, it is essential that any rules make clear which states' rules apply where there is a cross-border context. In particular, it is essential that regulators in users' countries (or indeed, in countries where clients of users are located) should not be entitled, by reason of that fact, to impose their regulation on the operator of a qualifying system.

15. However:

- Not all members of CESR have accepted the proposed limits on the role of "host country" regulators.[11] This exacerbates the risk of inconsistent implementation. We do not see any justification for host country controls of the kind envisaged. Given the current differentiations in regulatory approaches across Europe, all CESR's members should now accept that host country controls will divide and distort the single market.

- CESR's paper suggests that "host country" regulators can continue to impose their own rules, even on cross-border business with professional users, so long as the rules amount to "conduct of business" regulation covered by Article 11 ISD. Furthermore, the boundary between conduct of business rules and the standards remains unclear. The adopted standards should make clear that host country regulators should refrain from imposing their own conduct of business rules in relation to cross-border business with professional users, especially where those users are themselves authorised investment firms. After all, this would be consistent with the e-commerce directive and the Commission's proposed approach under the revisions to the ISD.

- Only some of the proposed standards explicitly address the role of the home country regulator. All the adopted standards should make clear that a firm operating a qualifying system only has to comply with relevant implementing rules established by the home country.

- CESR should make clear that all Member States will have to take down any barriers to cross-border business which operate against firms conducting cross-border business. In particular, all Member States should be committed to remove additional licensing, authorisation or notification requirements that host countries may impose on properly passported firms which are conducting cross-border business, whether or not they are operating a qualifying system.

The standards

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

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

Standard 1: Registration and Notifications

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

Standard 2: Fair and Orderly Trading

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

Standard 3: Publication of Trading Information

19. TBMA considers that it is inappropriate and distorts competition to single out particular intermediaries for additional pre or post- trade transparency requirements merely because of the way in which they provide services to the market. In particular, TBMA considers that the mere fact that a firm uses non-discretionary rules is not a sufficient justification for the imposition of requirements of this kind.

20. In addition, TBMA considers that it is inappropriate to suggest that regulators should, especially in what is after all supposed to be an interim regime, be given the flexibility to impose wholly new transparency requirements on fixed income markets.

- The paper appears to suggest that the mere fact that the qualifying system handles some instruments traded on a regulated market is sufficient justification to impose on the qualifying system the same pre- and post-trade transparency requirements as applied in the regulated market. However, this would allow the regulatory regime for regulated markets which do not significantly influence the price formation process effectively to dictate the regime for what are still essentially over-the-counter markets. There is no "fragmentation issue" to address in the context of fixed income markets.

- The paper fails to give adequate weight to the other characteristics of fixed income markets that make them different from equity markets. For example, fixed income markets are more diverse than equity markets. There are large numbers of issues many of which trade relatively infrequently (in particular because they are held to maturity). Information about trading in one bond may say little about where another should trade.

We are not against proposals to improve the transparency of markets. Indeed, the existence of services such as TRAX, and the evolution of the new bond trading platforms, have made some positive impact on the transparency in the markets. However, there is little to be gained by powers used in an *ad hoc* manner depending on the happenstance of whether a qualifying system chooses to trade a particular instrument. The adopted stan-

dards should expressly exempt fixed income markets from the scope of these requirements.

21. In any event, additional requirements should only be imposed where there are appreciable benefits. Such appreciable benefits of the imposition of transaction requirements, might be justified when an ATS's market share of the securities it trades reaches some predetermined significant percentage of the overall market[12].

22. Further, we have particular concerns with the new proposals to impose requirements for pre-trade transparency on OTC transactions, especially as these have been introduced at a late stage in the consultation process. It seems to us that it is wholly inappropriate to impose pre-trade transparency requirements merely because the parties are making use of an "alternative trading system" to communicate bids/offers to one another. It might be possible to meet any requirements for post-trade transparency by making use of existing reporting systems. In contrast, this is less likely to be possible for the provision of pre-trade transparency which means that operators may incur significant additional costs in this respect. Again, this is likely to have a particular impact on the fixed income markets if regulators apply these proposed standards in these markets merely because, for example, one market participants chooses to operate as an exchange.

Standard 4: Monitoring

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

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

24. Again, it is unclear why a firm that operates under non-discretionary rules should, by reason of that fact alone, be subjected to additional costs which do not apply to its competitors. The implication that this will "level the playing field" with exchanges again ignores the very significant advantages that exchanges enjoy by reason of their status as regulated markets.

25. Again, CESR should make clear that this standard simply does not apply in fixed income markets. It is unclear how an operator of a qualifying system would operate any surveillance operation that produced significant regulatory benefits, given the structure and characteristics of the market.

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

Standard 6: Systems

26. It is unclear to what extent the systems review contemplated differs from that applicable to any investment firm. Clearly, any investment firm will wish to demonstrate that its systems are adequate. We do not see any need for any additional requirement in most cases.

27. On the other hand, we strongly agree that there is no need to demonstrate full capability to switch to a standby trading facility unless the system has a degree of significance to its users and the markets. The standard should state this explicitly as a constraint, not merely as a factor to be considered.

Standard 7: Clearing and Settlement

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

Application of conduct of business rules

29. We welcome the move to limit the overlap of these standards with conduct of business rules. However:

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

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

Yours sincerely,

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cc:

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