



THE FORUM OF EUROPEAN SECURITIES COMMISSIONS

Date : June 11, 2001

Ref : Fesco/01-035b

PROPOSED STANDARDS

FOR

ALTERNATIVE TRADING SYSTEMS

Consultative Paper



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1 INTRODUCTION

CHANGING MARKET STRUCTURE CALLS FOR REGULATORY REVIEW

1. The structure of many markets is going through a period of change. The extent of this change varies considerably from asset to asset and from country to country. But a central feature of the process is frequently the emergence of new trading systems. In the debt and standardised OTC derivative markets, electronic trading systems are serving to move the markets from bilateral telephone trading to more centralised multilateral screen trading. In equity markets, the development of new trading systems has often signalled incipient additional competition for exchanges that had previously enjoyed near monopolies. There are also signs of electronic trading systems developing in the non-standardised OTC derivative markets. In regulatory terms, these non-exchange trading systems are commonly referred to as Alternative Trading Systems ('ATs').
2. Traditionally, most countries have regulated investment firms and exchanges on the basis of a clear distinction between their respective roles in the market. The increased blurring in these roles in cases where both investment firms and exchanges provide electronic trading platforms – often trading the same instrument – has raised the issue as to whether, and in what ways, regulation needs to be modified to address this change.

BACKGROUND TO CONSULTATION

3. In October 1999 FESCO established an Expert Group to consider these issues. In the first stage of its work the group focused on identifying the issues raised by new trading systems and, in light of the EU Commission's decision to review the Investment Services Directive ('ISD'), the broad options for addressing those issues in the context of EU legislation. This work resulted in a paper on 'The Regulation of Alternative Trading Systems in Europe'. The paper was adopted by the FESCO meeting in Paris in September 2000 and subsequently submitted to the Commission.

4. Although the September paper did not invite consultation responses, FESCO did receive useful comments from six trade associations (London Investment Banking Association (LIBA), British Bankers Association (BBA), Futures and Options Association (FOA), Bond Market Association (BMA), Federation of European Stock Exchanges (FESE) and International Swaps and Derivatives Association, Inc. (ISDA)) and some market participants. These comments have informed the drafting of this paper.
5. At the same meeting, FESCO mandated the Expert Group to develop proposals to address the risks potentially posed by investment firms operating ATs. The intention was to develop proposals that FESCO members could implement ahead of any changes in EU legislation. These proposals would also provide the Commission with FESCO's more detailed view of the regulation considered appropriate for these systems before the Commission drafted amendments to the ISD. The Expert Group presented its proposals to the FESCO meeting in May and this paper sets out those proposals for public consultation.
6. FESCO would welcome comments on all aspects of the consultation paper. A number of questions have been listed in the text on which FESCO would be particularly interested in obtaining views, but responses are invited on all relevant issues. FESCO asks for comments to be submitted to the FESCO secretariat (secretariat@europefesco.org) by 31 August. Responses to this formal consultation paper will be made available for public inspection unless the respondent requests otherwise. In any case, FESCO envisages publishing a list of the names of all those who respond.

OBJECTIVES OF THE STANDARDS

7. The proposed standards that FESCO sets out in this paper focus on the potential risks posed by ATs identified in FESCO's September 2000 paper (see Annex A). The standards have been developed with a view to providing appropriate regulation under the ISD of investment firms operating ATs. This paper does not directly address the issue of ATs operated by entities other than investment firms¹. Member states' regulators should address the

¹ One example would be a 'regulated market' running an automated trading service on an "off-market" or "unregulated" basis. Another would be ATs providing for dealing in financial instruments which are not included in Section B, Annex to ISD (e.g. commodity derivatives). These activities do not benefit from the passport under the ISD and operators thus have to provide such cross-border services in the EU based on general principles (e.g. the Treaty, general EU case law, Dir. 2000/31/EEC on e-commerce and national laws). Regarding the use of the term investment firm in this paper see below.

issues raised by ATSS operated outside the ISD in a manner provided for by their domestic regulatory powers (where they do so), but in a way that is generally consistent with these standards.

8. In order to develop standards which Member States will be able to implement relatively quickly, the standards relate to matters which fall within the contemplation of the ISD and, in particular, Articles 3, 10, 11 and 20. FESCO's view is that all the standards proposed in this paper can be properly related to those Articles (see Annex A).
9. The European Commission considers that a detailed assessment of the services provided by ATSS currently in operation indicates that they can generally be equated with the investment services undertaken by investment firms and listed in Section A of the Annex to the ISD. The European Commission considers that such an assessment also indicates that the performance of ATS functions may in some cases interact with the general securities trading environment - notably in respect of overall price formation and orderliness and integrity of markets. The European Commission considers that the customised application of organisational requirements (Art. 10), conduct of business rules (Art. 11) and transaction reporting requirements (Art. 20) may represent a useful interim solution to providing an appropriate regulatory environment and the benefits of a single passport for ATS authorised as investment firms. The European Commission believes that this approach can respond adequately to the additional risks implied by the operation of ATSS as they are currently operated in the European market. However, a formal modification of relevant EU provisions may ultimately be required to underpin a legally secure and homogeneous regulatory response to further evolution in this type of investment business.
10. The standards aim to ensure, in particular, that:
 - users of 'qualifying systems' (defined below) are adequately protected²;
 - the integrity of the market is protected.

2 The standards deliberately refer to participants in the qualifying systems as 'users' rather than 'clients'. This is to avoid any confusion between the person who is the participant in the operator's system (here called 'user') and any retail or other end-investor who is likely to be a client of that participant (here called 'client'). 'Users' may also be customers or counterparties of the investment firm operating the qualifying system, and this relationship will be subject to relevant conduct of business rules.

The need for these additional standards arises because existing conduct of business rules do not fully address the particular risks posed by the specific nature of services provided via qualifying systems. The standards therefore identify particular matters for which FESCO believes that additional regulation is required to secure these two overall objectives. These standards, which are to be implemented by the investment firm's regulator, therefore complement existing conduct of business rules (as laid down by Member States in order to implement the principles set out in Art. 11 of the ISD) and, potentially, any other standards concerning investor protection which may in future be agreed on by FESCO (e.g. Standards and for Harmonising Core Conduct of Business Rules for Investor Protection – Fesco/00-124b, February 2001). ATs 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.

11. While ATs authorised as investment firms will therefore be required to comply with conduct of business rules established in accordance with Art. 11(1) of the ISD in their dealings with their users, the application of these conduct of business rules must be adapted to take account of the professional nature of the user. In particular, the application of conduct of business rules governing, inter alia, suitability, advice and disclosure can be modulated as a function of the 'need for protection' of the users of the qualifying system. Elsewhere, the European Commission has also clarified its view on the implications of the professional/retail distinction of any cross-border provision of services that might be undertaken by an investment firm operating an AT (COM (2000) 722).
12. FESCO recognises that it is essential that the introduction of these standards does not unnecessarily hinder financial innovation, limit competition or impose unreasonable cost. The proposed standards have therefore been developed to address potential risks to market integrity in a way that is proportionate to the nature and materiality of those risks. Moreover, the proposed standards should enhance competition by introducing a more consistent regulatory approach across Europe. A suggested framework for analysing the costs and benefits arising from the proposed standards is set out in Annex B.
13. As highlighted in its September 2000 paper, FESCO believes that its objectives can best be met by concentrating on standards in the following areas:
 - **Authorisation/registration:** the investment firm running an AT should provide to the competent authorities information about the price formation process, rules of the system, the process of order execution, system participants, the types of financial instruments traded, and

clearing/settlement and governance arrangements (see especially Standard 1 below).

- **Transparency:** while FESCO recognises that the appropriate transparency arrangements may need to differ according to the nature of trading system, it also attaches considerable importance to the achievement of appropriate levels of transparency (see especially Standard 6 below) and considers that ATSs should comply with minimum transparency requirements: on ownership, possible risks involved, pre-trade and post-trade transparency.
- **Reporting Rules:** additional reporting requirements should be imposed on ATSs to the extent needed to enable competent authorities to monitor ATSs' market share, compliance with market integrity and conduct of business rules and any changes to the information notified at authorisation/registration.
- **Prevention of Market Abuse:** requirements placed on ATSs should make it possible to detect, deter and punish market abuses (e.g. insider trading, price manipulation) with regard to financial instruments falling within the scope of Section B of the Annex to the ISD (93/22/EEC)) and any future amendments presently being discussed on market abuse.

Annex A gives an overview of the specific issues addressed by the proposed standards.

Question 1: FESCO would be interested to receive views on the interaction between the standards proposed in this paper and the FESCO Consultation Paper on the 'Harmonisation of Core Conduct of Business Rules for Investor Protection' (February 2001). which is going on in parallel on the harmonisation of the core conduct of business rules, FESCO would be interested in particular, in comments on the scope for any conflict between its approach to conduct of business rules and any of the standards listed below. If there are possible conflicts, how might they best be resolved (e.g. by further differentiation in the application of the proposed ATS standards.

DEFINITION AND DIFFERENTIATION

14. For the purposes of these standards, FESCO has defined a qualifying system as:

‘an entity which, without being regulated as an exchange, operates an automated system that brings together buying and selling interests – in the system and according to rules set by the system’s operator – in a way that forms, or results in, an irrevocable contract’.

15. FESCO recognises that the above definition of qualifying system is very broad and therefore the standards will be applicable to a wide range of different types of qualifying systems. This has been raised as a concern in some of the responses that have been received on the earlier FESCO paper. FESCO acknowledges those concerns and has considered the position carefully. There is clearly some tension between a broad definition on the one hand and a narrow definition on the other; both have advantages and drawbacks. A broad definition will stand the test of time and will not need to be updated as market structures and trading systems evolve. But it will also mean that a relatively large number of systems will be designated as “qualifying systems”. A narrower definition would ensure a more limited application of these proposed standards, but might quickly be overtaken by developments. The approach FESCO has taken for this consultation is to retain a broad definition, but to indicate how the application of the draft standards will be varied to take account of the different types of qualifying systems, and the risks that they pose to market integrity.

Question 2: Comments are invited on the FESCO definition of a qualifying system, in particular on how the definition could be made more specific while remaining flexible and durable. FESCO would also appreciate some indication as to the number and scope of systems falling within this definition of a qualifying system.

16. While some standards will impose obligations on all operators of qualifying systems (e.g. Standard 1), other standards (e.g. Standard 7 or 8) will be applied in a more differentiated way depending on what type of qualifying system is being considered and thus what particular risk the regulator is aiming to address. When implementing the standards in a differentiated way and determining the exact requirements for each qualifying system, regulators will need to take account of a number of factors, as set out below:
- the extent and nature of those requirements should vary according to the users’ experience, in particular distinguishing between professional and non-professional users, especially in relation to information disclosure to users and settlement arrangements;

- requirements that a firm should operate a system in a manner consistent with the integrity and efficiency of the market in the type of instrument traded means that the appropriate regulatory requirements will vary according to the nature of the market, including existing regulation and widely accepted conventions;
- the susceptibility of the instrument traded to market abuse. Different instruments have different characteristics such as, for example, the liquidity of their markets;
- the extent and nature of the requirements should vary according to the significance of the system in the overall market for the instrument. What will be considered as 'significant' will depend on matters such as (a) the trading volume in a particular instrument conducted through the qualifying system, both in absolute terms and in relation to the broader market in that instrument, (b) the system's impact on the price formation process for a particular instrument, (c) whether or not the system represents the only market in a particular instrument, and (d) the importance of the qualifying system within the broader market. Regulators will need to determine how to measure some of these factors. One issue is likely to be whether the broader market encompasses only the national market or also to other European, or even global, markets;
- the nature of the system should be another consideration which will influence implementation and application of the standards. This might, for example, be in relation to the degree of automation of the system (see below) and trading processes or whether the system operates on a multi-lateral or on a bi-lateral basis³. Application of certain standards will also vary depending on whether the system has, for example, a role in price formation or is a crossing network which takes reference prices from another market.

17. FESCO additionally recognises that some firms operating qualifying systems, while not exchanges in their own right, are members of an exchange and in certain countries subject to exchange regulation. It is not intended that

3 FESCO asked in its September paper whether systems with bilateral functionality (for example quote-driven systems that display a dealer's prices, and enable customers to trade at those prices against the dealer's principal book) should be included in the ATS definition. It stated: "Such systems might be viewed as automated market-making facilities, rather than as alternative trading systems as such. However, the experts group has included bilateral systems for the purposes of this paper because – depending on the size and nature of their activities – they potentially raise issues of a similar kind to systems with multilateral functionality. High volume bilateral systems are capable, for example, of contributing to market fragmentation by internalising significant order-flow within particular firms and thereby reducing overall order-interaction in the market."

member state regulators will subject these firms to dual regulation in respect of, for example, transparency standards.

Question 3: Comments are invited on the above factors and how they should be applied in practice. FESCO would also be interested in any additional factors that regulators should take into account when applying these proposed standards on a differentiated basis.

18. These standards focus on automated systems in view of the general transition of volume trading towards fully electronic systems. However, regulators may need to consider extending the standards to firms operating semi-automated trading processes where these systems may be significant in a market's price formation process. Such firms might offer, for instance, a matching service involving an electronic display of buying or selling interest but with some human intervention then required on the part of the operator to complete the matching of those interests.

Question 4: Comments are invited on the extent to which national regulatory authorities should have discretion to apply the framework to semi-automated systems.

19. The standards are applicable to investment firms in respect of qualifying systems providing a trading service in instruments listed in Section B of the Annex to the ISD⁴. However, regulators may extend the standards to qualifying systems providing a trading service in other instruments, should they consider it necessary to deal with risks in their domestic markets.

Question 5: Comments are invited on the extent to which national regulatory authorities should have discretion to apply the framework to non-ISD instruments.

Question 6 : Should common criteria be developed to guide the exercise of discretion in regard to question 3 and 4 above?

4 In terms of the services set out in Section A of the Annex to the ISD, firms might be providing the services of reception and transmission, on behalf of investors, of orders in relation to one or more of the instruments listed in Section B, executing such orders other than for own account, or dealing in any investments listed in Section B for own account.

The ISD review

20. Since FESCO submitted its paper, 'The Regulation of Alternative Trading Systems in Europe', to the EU Commission last September, the Commission has issued a Communication on the upgrading of the Investment Services Directive⁵. Public consultation on that communication closed on March 31 and the Commission intends to issue a revised Directive in early 2002. In its November Communication, the Commission addressed the emergence of Alternative Trading Systems and stated that 'users of these systems must be adequately protected and the interaction with the overall securities trading environment must be optimised. The key issue is whether ISD (and national) provisions relating to investment firms are sufficiently responsive to the potential regulatory risks presented by these new entities.'
21. FESCO made a submission in response to the Commission's November Communication. Specifically in relation to the issue of regulated markets and trading infrastructure, FESCO's submission stated that:

"Conditions of fair, transparent and secure functioning of regulated markets and ATs should be clearly established. ... The current legislative framework under which ATs are operating does not adequately address all the potential risks ATs may pose. FESCO therefore suggests that a regulatory framework that can appropriately address these risks should be developed. ..."
22. The services of the Commission will launch a consultation of interested parties in respect of a possible proposal for modification of the ISD in July. These preliminary orientations will include proposals for possible EU-level arrangements for regulatory classification of intermediaries and trading infrastructure providers, including ATs. These preliminary orientations have been informed by the work of the FESCO Experts Group on ATs.
23. Whilst the FESCO consultation on standards for ATs and Commission consultation on preliminary orientations on ISD will cover similar issues, the two processes are complementary. Responses to the FESCO consultation paper on ATs and the final version of the FESCO standards should be available in sufficient time to allow them to be taken into

5 Communication from the Commission to the European Parliament and the Council: Upgrading the Investment Services Directive (93/22/EC)



account by the Commission when finalising its proposal for revision of the ISD.

24. Second, FESCO members have determined to move ahead on proposals for incremental regulation of investment firms operating qualifying systems because these standards will be of use to securities regulators and market participants in clarifying the appropriate treatment of ATs in the (potentially protracted) period before any revised ISD enters into force⁶.

⁶ The approach in this paper has been agreed by all FESCO members, except that the Spanish CNMV thinks that national regulators should have the power to require an investment firm operating an ATS, which matches orders, to seek recognition of its matching order platform service if it operates in their respective territories and accounts for a material volume or market share there. Such recognition, in any case, shall be flexible enough in order to take into consideration the peculiarities and circumstances of those ATs, which shall be clearly distinguished from regulated markets.

2. The Standards and commentary

These draft standards set out the requirements that authorities responsible for the licensing and oversight of investment firms operating a qualifying system should impose on those firms, to ensure that users of qualifying systems are protected and market integrity in the instruments traded is secured. The core standards should be read in conjunction with the commentary. This provides guidance on the considerations regulators will take into account in the application of the standards. The commentary also covers the circumstances in which the standards may be applied differentially.

Registration and Notifications

Standard 1

Regulatory authorities responsible for the licensing and oversight of investment firms should require firms to register the establishment of a qualifying system, and to notify them (and, where different, the regulatory body responsible for the oversight of markets,) of its key features and significant changes to its operation.

The operation of qualifying systems may present risks to users that are not adequately addressed by existing conduct of business rules and/or regulatory guidance. In addition, both the nature of the service and the trading itself may have implications for market integrity. Regulatory authorities responsible for investor protection and the operation of markets therefore need to know which investment firms authorised in their jurisdiction operate qualifying systems, the key features of those systems and significant changes to their operation. FESCO recognises that national regulators already collect a large amount of relevant information. The aim of this standard is therefore to provide a more common basis for the type of information being collected rather than to duplicate existing information provisions. This will also assist when new cross-border services are to be provided and the home country regulator notifies the host country regulator of the intention of the investment firm to carry on business in the host country under the requirements laid down in Article 18 of the ISD.

At initial registration, regulators should require information from the operator of a qualifying system relating to the following issues (it is accepted that in some cases there might be nil returns on one or more topics):

- the trading process, including the types of order/quote information to be input into the system and the basis upon which buying and selling interests are matched;
- the arrangements for making pre- and post-trade information available to users and to the general public ;
- system design, the arrangements for the management of the system, and any outsourcing arrangements;
- the types and numbers of users and the access arrangements for users;
- the instruments traded;
- the nature of any arrangements with different classes of user, e.g. contracted liquidity providers;
- the existence of any incentive arrangements to boost liquidity/turnover;
- the arrangements for the settlement of transactions;
- the arrangements for ensuring compliance with any regulatory requirements imposed under the standards set out below (once the precise application has been determined by the relevant regulatory authority).

In addition, subsequent to initial registration, regulators should require information:

- at appropriate intervals, on the volumes and values traded, the numbers of users, and other pertinent statistics (depending, for instance, on the nature of the instruments traded, scale of operation etc);
- with immediate effect, on any material changes to the controllers of the operator(s) of the qualifying system, the trading process, the instruments traded, the categories of system user, the settlement arrangements, and the system design or system management arrangements.

This standard which will be applied to all qualifying systems, will be implemented in a way that provides a sufficient basis for the regulator's understanding of any issues raised by the system. The information will assist the regulator in determining the appropriate application of any of the other standards (set out below) to a qualifying system.

Question 7 : Comments are invited on the notification requirements outlined above. Should the notification requirements be applied equally to all qualifying systems? How can efficient and cost-effective procedures be set up in order to identify qualifying systems when the respective national requirements are first implemented and when new qualifying systems are set up and to provide regulators with necessary information about other material developments? Are there any additional areas on which the

regulators should be given information? To what extent is there any overlap with other notification requirements?

Information for users

Standard 2

Investment firms operating a qualifying system should make clear the nature of the relationship between operator and user.

The investment firm operating a qualifying system must have an agreement with its users which clearly sets out the nature of the relationship between the operator of the system and the user. This obligation does not affect in any way the substance of the obligations imposed on the investment firm by conduct of business rules relating to treatment of customers. These latter obligations fall outside the scope of these standards.

Question 8: Comments are invited on this standard. In particular, FESCO would be interested to receive feedback on whether any other specific features of the relationship between operator and user should be required to be covered in the agreement.

Standard 3

Investment firms operating a qualifying system should supply sufficient information about the system to enable a user to use the system efficiently and to understand any risks arising in using the system.

Investment firms operating a qualifying system must supply adequate information to users on its main characteristics. This information should be sufficient to allow the user both to be able to use the system efficiently and to understand any risks arising in using the system. How much information is required will depend on the sophistication of the users.

The information should cover:

- the operation of the system, including the order handling and order execution processes;
- the status of other users of the system, e.g. professional/ non-professional, domestic/foreign;

- the procedures (if any) to be adopted in the case of trading 'errors' or disputes;
- whether the user has any duty – under national regulation – to have arrangements for reporting to a regulatory authority transactions executed on the system;
- the circumstances in which the operator of the qualifying system could terminate a user's access;
- trading procedures (if any) that may be adopted in the event of system malfunction;
- where appropriate, arrangements for the settlement of the trades.

Question 9: Comments are invited on this standard. In particular, FESCO would be interested to receive feedback on whether there is any additional information that the operator should provide to the user, either generally or for systems with specific characteristics.

Standard 4

Investment firms operating a qualifying system should provide, or be satisfied that there is access to, sufficient publicly available information to enable users to form an investment judgement, taking into account both the nature of the users and the type of instruments traded.

System users need to have sufficient information to understand the characteristics of the instruments traded on the system. The need for this information, and its extent, will depend on the experience of the users of the system and on the complexity of the product. The more complex a product is, the greater will be the need for such information being provided to all users. On the other hand, it may be less important for a system catering for professional users to provide information on, for example, the differences between 'listed' and 'unlisted' securities, or the risks in straightforward future or option contracts.

For securities, system users also need information about the issuer to enable them to make an investment judgement on the instruments traded⁷. The system operator should normally indicate to users where publicly accessible information may be obtained. In the case of unlisted securities, the operator should also indicate that the securities are unlisted, likely to be subject to lesser disclosure requirements and they fall outside the scope of market abuse legislation. Whether these requirements are necessary in all circumstances will depend on the type of user, the type of instrument traded and the conventions in the wider market in that instrument. Where this information is not already publicly accessible, the operator might have to take responsibility for providing appropriate information to users.

FESCO recognises that, in many cases, information requirements are already imposed on issuers, or on investment firms in their normal client relationships. In the former case, for example, there might be requirements on issuers under the POS Directive⁸. Where sufficient information is already available, FESCO would not expect qualifying systems to duplicate it.

Question 10: Comments are invited on this standard. How far is differentiation in the amount and type of information to be provided necessary/reasonable? Is there any additional information that operators should provide or satisfy themselves that it exists? Should operators allow trading in securities where they cannot satisfy themselves that continuous disclosure requirements exist? Do the “Standards on Rules for Harmonising Core Conduct of Business Rules for Investor Protection” provide suitable guidance regarding the content of the information which needs to be provided to users (including dissemination of price-sensitive information affecting the value of the investments)?

Fair and orderly trading

Standard 5

Investment firms operating a qualifying system should establish trading arrangements that result in fair and orderly trading.

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- 7 E.g. basic information on the issuer, recent company news or disclosable events that may affect the value of a company or its securities, or in the case of derivatives, current trading information on the underlying assets.
 - 8 Council Directive 89/592/EEC, coordinating the requirements for the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public.

Investment firms operating a qualifying system should have arrangements in place to ensure that trading by way of the system is fair and orderly. The service should be designed and operated to provide for efficient pricing and the equitable treatment of users.

While the trading arrangements will vary depending on the service being offered to users (e.g. price/time order matching, quote-driven systems, reference-price crossing), the operator should be able to demonstrate that the trading methodology is fair. Where users are non-professional, the operator should be able to demonstrate that the trading methodology enables them to obtain the best price available on the system, at the time and for their size of order. Users should also be able to view information on completed transactions.

In addition, the operator should have arrangements in place to reduce the likelihood of users unwittingly executing trades at prices substantially different from recent prices on the system.

Question 11:Comments are invited on this standard. Should there be explicit differentiation between the requirements under this standard for different types of systems? Or should such differentiation be within the remit of the national regulator to determine, depending on the characteristics of the system?

Standard 6

Where regulators consider it necessary to maintain the integrity of the broader market in a particular instrument, the investment firm operating a qualifying system providing trading in such an instrument should be ready to make publicly available, on a reasonable commercial basis, information about quotes and/or orders that the qualifying system displays or advertises to the system users. Similarly, operators should be ready to make available publicly, on a reasonable commercial basis, information relating to completed transactions that the system provides to users.

It is important that the trading arrangements are consistent with, and supportive of, the integrity of the broader markets in the instruments traded. In this respect, market integrity will normally be enhanced where those wishing to trade can maximise their knowledge of current bids and offers

and recent trades across as wide as possible a range of facilities trading an instrument. Without this information, those wishing to trade will be unable to trade optimally, whether for their own account or for their customers; investors will be deprived of the opportunity to assess the quality of trading venues for themselves; and the overall quality of price-formation may suffer.

Therefore, investment firms operating qualifying systems should be ready to make relevant data available, on a timely basis, beyond their immediate users. They might fulfil this obligation, which they may be able to do on a reasonable commercial basis, by posting data on a web-site, making it available to an information vendor or supplying it to any consolidated quotation system.

The amount of pre- and post-trade information made available in this way, and the timing of its release, should be no more onerous than the standards prevailing in the wider market in that instrument. In other words, where a regulator mandates pre- and post- trade transparency standards for trading on a 'regulated market' in the same instruments as are traded on the qualifying system, those mandated standards will form the benchmark for the qualifying system. If there are no mandated transparency standards, the general convention prevailing in the member state's market for trading that kind of instrument should usually form the minimum acceptable level.

In considering the extent to which they should impose this standard, regulators will have regard to the materiality of business conducted within the qualifying system in relation to the broader market and, in particular, to price discovery. FESCO recognises that the market may well provide its own solutions in this area. It would expect many operators of qualifying systems to have strong commercial incentives to display the prices at which investments may be traded, or have traded, on their systems. Where this is not the case, regulators will need to take action to address any adverse effect on the integrity of the broader market arising from the absence of transparency.

Question 12: Comments are invited on this standard. In particular, FESCO would be interested to receive feedback on the requirements for pre- and post-trade transparency. To what extent do the requirements represent additional costs for qualifying systems and how do they compare to the requirements of the recognised markets in the relevant instruments? Does the standard strike the right balance between the commercial interests of the system operator and the public interest of the wider market? What factors (e.g. volume) should

regulators take into account when considering the importance of a system to wider market integrity?

Standard 7

Investment firms operating a qualifying system should monitor user compliance with the (contractual) rules of the system.

Users of qualifying systems rely on the operator of the system to safeguard their interests by ensuring that all users comply with the rules of the system. These are the rules established under the contract between the operator and users, not by force of regulation. Operators of qualifying systems should therefore ensure that they have adequate arrangements in place to monitor user compliance with the contractual rules of the system. In any event, operators should act in the event of misuse and, for this purpose, should ensure that their contracts with users enable them to do so by, for example, terminating access.

FESCO recognises that not all qualifying systems will require the same capacity to monitor user compliance with the contractual rules and that monitoring can be of greater or lesser intensity. If the system design restricts the scope for user misuse, there might be less need for direct monitoring. Monitoring will be particularly important if non-professional users have access to the system and/or if the system plays an important role in the price formation process for a particular investment. In such cases, the qualifying system should have the ability to monitor user compliance closely to ensure that the scope for misuse is limited and, if it does occur, is identified quickly.

Question 13: Comments are invited on this standard. FESCO would be particularly interested to receive feedback on the system rules that currently exist and whether these are being monitored by the system operator.

Standard 8

Investment firms operating a qualifying system should, where the regulators require it for the purposes of investor protection and market integrity, be able to establish arrangements with the relevant domestic

market authorities to facilitate satisfactory monitoring of the markets in the instruments traded and the detection of market and/or client abuse.

The maintenance of user confidence in markets rests heavily on markets operating in a fair and orderly manner. A key element in sustaining a market environment that commands user confidence is effective arrangements for monitoring market activity with a view to detecting, and deterring, unfair practices and market abuse. In instances where an investment firm operates a qualifying system providing trading in instruments traded on other systems, any unfair practices and market abuse will adversely affect not only users of the qualifying system, but also the wider market in these instruments. In these cases, the operator needs to be able to supply trading data – e.g. transaction reports - to the relevant domestic market authorities.

In determining what arrangements would be appropriate, regulators should take into account both the susceptibility of the instrument to abusive behaviour and the significance of the system in the overall market in that instrument. FESCO recognises that the implementation of this standard could well involve additional costs for the qualifying system. The Member State regulators should consider, with the relevant recognised market(s) and/or trading system(s), how monitoring of the overall market in a particular instrument can best take place to ensure that unfair practices and market abuse are detected and deterred both effectively and cost-efficiently.

Question 14: Comments are invited on this standard. FESCO would be particularly interested to receive feedback on whether any ATs currently have market monitoring arrangements in place.

Systems

Standard 9

Investment firms operating a qualifying system should be able to demonstrate to the relevant regulatory authorities that the system is capable of delivering the proposed service, that there are satisfactory arrangements for the management of the technical operation of the system and that there are satisfactory contingency arrangements in the event of system disruption.

It is important to system users that they can rely on the trading systems they use to perform efficiently and robustly. It is incumbent on any investment firm to be able to demonstrate to its regulator that its systems –

whether operated by the firm's staff or outsourced - are capable of delivering the functionality advertised and that it has arrangements in place to manage operational risk. Regulators of investment firms operating qualifying systems will pay particular attention both to security and system processes, in particular a system's ability to process orders on a timely and equitable basis and to handle substantial variations in volumes.

A firm operating a qualifying system should have satisfactory arrangements for dealing with any disruption to its system. At the least, there should be arrangements for monitoring the system to ensure that it is operating to its specified standards; and there should be adequate provision for the recovery of data in the event of a systems failure. Whether or not regulators consider it appropriate to require the operator of a system to have a standby trading facility may depend on the significance of the system to its users or to the markets in which it provides a trading service.

It is particularly important to users of the system that they are properly protected against unauthorised access to the system which might endanger the confidentiality and integrity of the data. System operators should therefore ensure that access arrangements are properly controlled, whether directly by themselves or by third parties providing links to the system.

This above standard is particularly important for qualifying systems which are integral to the broader market in a particular instrument in one or more Member States. Disruption to such an integral system could lead to financial losses for users, as well as the wider public, and a loss of confidence in the wider financial system.

The sophistication of the users of the system may also play a role when determining the exact requirements placed on a qualifying system under this standard. Retail users might find it more difficult to use alternative ways to conduct their transactions if a qualifying system were to fail. Hence, for qualifying systems which admit retail users, either directly or indirectly, there is likely to be greater regulatory scrutiny in this area. By contrast, sophisticated users can be expected to exert commercial pressure on any operator of a qualifying system in respect of system quality. Hence the need for regulatory requirements under this standard might be reduced. On the other hand, if the ATS were to be a monopoly provider with substantial market power, commercial discipline might not be effective, which would in turn point to a need for increased regulatory scrutiny under this standard.

Question 15: Comments are invited on this standard. This standard is of particular importance for systems which are integral to the broader market in an instrument. FESCO would be interested in views on

whether quantitative thresholds should be set to measure the importance of a system and, if so, what these might be.

Settlement

Standard 9

Investment firms operating qualifying systems should ensure that there is clarity of obligations and responsibilities for the settlement of transactions.

Investment firms operating a qualifying system should ensure that there is clarity as to the respective responsibilities of the operator and the user with regard to effective arrangements for the performance of transactions. However, where the system has retail users, the operator should be able to satisfy its regulator that arrangements are in place – whether or not provided by itself – to ensure efficient settlement.

Question 16: Comments are invited on this standard. FESCO would be particularly interested to receive feedback as to what the respective responsibilities of the operator and user should be, particularly when retail users are involved.

3. IMPLEMENTATION AND NEXT STEPS

25. The standards are directed, in the first instance, at FESCO members responsible for the licensing and oversight of (ISD) investment firms and other entities which are authorised to provide investment services, such as credit institutions (this paper refers to both as investment firms). However, where there is more than one regulatory authority in a Member State, the authority responsible for investment firms will need to develop its approach to implementation of the standards in conjunction with other relevant authorities, most particularly those responsible for the oversight of markets and exchanges. Standard 1, for example, will require careful implementation, potentially including close cooperation between different national supervisors, to ensure that credit institutions which establish ATS platforms to provide investment services are subject to the authorisation requirements that would be imposed on investment firms under Standard 1.



26. FESCO members will aim to include these standards in their regulatory objectives and, when possible, in their respective rules. If a FESCO member does not have the authority to implement a certain standard, it will seek to commend the standard to its government and to the responsible regulatory authority.

27. In the medium term, consideration is being given to legislative changes to the ISD in the area of ATS regulation. The FESCO work, and the feedback received on the consultation paper, will feed directly in to the ISD review work (see above).

28. FESCO is very interested in receiving comments on the questions incorporated in this paper. It is committed to allowing readers sufficient time to respond to the proposals in a considered way and is therefore providing for a 12 week consultation period, closing on September 3, 2001. Comments may be sent in paper (F. Demarigny, Secretary General, FESCO, 17 place de la Bourse, 75082 Paris Cedex 02 – France) or electronic format to the FESCO secretariat [secretariat@europefesco.org]. The consultation responses will be carefully considered by FESCO prior to it determining the final form of the standards. FESCO's aim is to issue a communication on the final standards by the end of 2001.

Annex A Issues addressed by the proposed standards

Coverage of investor protection risks		
Issue	FESCO proposed standards for ATS operated by investment firms	ISD provisions to which Member State requirements on ATS could be linked
Access to trading (i.e. structure should enable access to best prices for size and type of trade)	No Standard proposed at this point as the respective competition authorities will be in a position to consider this issue.	N.A.
Best execution	Standard 1 (registration of ATS and notification of key features and significant changes)	Art. 3 (4), 3 (7) c (submission of business plan)
	Standard 5 (fair and orderly trading/ equitable treatment)	Art. 11, indents 1 and 2 (acting in best interests of clients, due skill care and diligence) Art. 11, indent 6 (fair treatment of clients)
Conflicts of Interest	Standard 1 (registration of ATS and notification of key features and significant changes)	Art. 3 (4), 3 (7) c (submission of business plan)
	Standard 2 (information to user of relationship operator/user)	Art. 11, indent 5 (disclosure to clients)
	Standard 3 (provision of sufficient information about system)	Art. 11, indent 5 (disclosure to clients)

Issue	FESCO proposed standards for ATS operated by investment firms	ISD provisions to which Member State requirements on ATS could be linked
	Standard 5 (fair and orderly trading/ equitable treatment)	Art. 11, indents 1 and 2 (acting in best interests of clients, due skill care and diligence) Art. 11, indent 6 (fair treatment of clients)

Coverage of market integrity risks

Issue	FESCO proposed standards for ATS operated by investment firms	ISD provisions to which Member State requirements on ATS could be linked
Fragmentation	Standard 6 (making available quotes and/or orders that systems displays to users)	Art. 11, indent 7 (regulatory requirements so as to promote integrity of the market)
Transparency	Standard 6 (making available quotes and/or orders that systems displays to users)	Art. 11, indent 7 (regulatory requirements so as to promote integrity of the market)
Monitoring	Standard 7 (monitor user compliance with contractual rules of the system)	Art. 10 (prudential rules which investment firms shall observe at all times)

Issue	FESCO proposed standards for ATS operated by investment firms	ISD provisions to which Member State requirements on ATS could be linked
	Standard 8 (establish arrangements with national authority to facilitate satisfactory monitoring)	Art. 20 (transaction reports to relevant authority) Art. 10, indent 4 (keeping of records)
Enforcement	Standard 2 (information to user of relationship operator/user)	Art. 11, indent 5 (disclosure to clients)
	Standard 7 (monitor user compliance with contractual rules of the system)	Art. 10 (prudential rules which investment firms shall observe at all times)
Access to trading (fitness and propriety, trading ability, capital adequacy and competence of users)	Standard 1 (registration of ATS and notification of key features and significant changes)	Art. 3 (4), 3 (7) c (submission of business plan)
Admission to trading (proper market)	Standard 4 (access to sufficient information about instruments)	Art. 11, indent 5 (disclosures to clients)

Issue	FESCO proposed standards for ATS operated by investment firms	ISD provisions to which Member State requirements on ATS could be linked
Systems	Standard 9 (systems capability, technical operation and contingency)	Art. 10, indent 1 (sound control and safeguard arrangements for electronic data processing) Annex IV, Capital Adequacy Directive 93/6/EEC (contingency for “other risks”)

Coverage of systemic risks

Issue	FESCO proposed standards for ATS operated by investment firms	ISD provisions to which Member State requirements on ATS could be linked
Performance of Transactions	Standard 10 (clarity of responsibilities for settlement)	Art. 11, indent 4 (information from client as regards services required)
Financial Resources	Standard 1 (registration of ATS and notification of key features and significant changes)	Art. 3 (4), 3 (7) c (submission of business plan)

Annex B Costs and benefits

29. This section sets out the framework within which FESCO considers it appropriate to assess the costs and benefits of the proposed standards. It is, however, a conceptual framework and it makes no attempt, at this stage, to quantify the costs or benefits. This is because the balance of actual costs and benefits may differ across Member States. Moreover, some regulatory authorities have a statutory requirement to undertake cost-benefit analysis. However, FESCO's view is that the methodology set out below should provide a sound basis for a generalised approach to assessing the costs and benefits of the proposed standards. As indicated in the question below, FESCO would be interested in comments on the methodology and on the likely actual costs and benefits.
30. FESCO considers it important that any incremental regulation of investment firms in respect of the operation of qualifying systems should be proportionate to the risks involved and subject to consideration of the potential costs and benefits. In broad terms, FESCO considers that appropriate incremental regulation for qualifying systems will serve to underpin public confidence in such systems and facilitate the development of more efficient and competitive trading services. Against those benefits, its preliminary view is that the direct costs of implementation, as well as the wider costs, should not, in general, be significant, provided that the standards are implemented in a way that differentiates between systems on the basis of the risks they pose.
31. While the precise cost/benefit outcomes are likely to vary somewhat between Member States, the overall cost-benefit balance should be broadly similar across the EU. FESCO would be particularly interested in receiving comments and information, especially quantitative information, to help it develop the preliminary analysis contained within the six items set out below.
- **Direct costs** (i.e., the costs to the regulatory authority) : the costs of developing appropriate regulation in compliance with the standards should generally be modest. Incremental supervisory costs should also be modest, given that firms operating a qualifying system will already be subject to regulation. More significant costs could be incurred by regulatory authorities that need to enhance their market monitoring capabilities in respect of trading activity on qualifying systems.
 - **Compliance costs** (i.e., the costs on firms subject to incremental regulation): Although the registration requirement may result in some additional compliance costs, the major part of the requirements under the standards should normally amount to no more than marginal additional

costs to firms. For some firms, more significant costs could arise in one or more of a number of areas, notably ascertaining sources of information on instruments traded on the system, arrangements for disseminating (where required) information relating to current trading, the monitoring of compliance with the rules of the system, and any arrangements to provide transaction reports and assist relevant regulators in respect of regulatory matters relating to trading on the system.

- **Quantity of product sold:** While the need for operators to recover higher compliance costs could have a negative effect in some instances on potential entrants to the marketplace and/or the volumes of business through qualifying systems, it seems unlikely that higher costs are likely to have more than a marginal impact on business decisions. The potential gains to many operators as a result of the likely increase in public confidence flowing from the proposed standards may stimulate further entrants and greater use of such systems over time.
- **Quality of product sold:** The minimum standards being put in place for qualifying systems will ensure that users have an adequate level of information about the operation of the system and the instruments traded on the system. Quality will also be supported by the requirement placed on operators to operate in an orderly manner and to integrate into market surveillance structures in a way that will assist in deterring and detecting market abuse.
- **Variety of product offered:** Potential outcomes here are unclear. To the extent that the standards increase confidence in the operation of qualifying systems, the effect may be to increase the range of trading venues that may be considered by market users.
- **Efficiency of competition:** The standards should assist the competitive environment in a number of ways. The introduction of greater consistency in the regulation of similar functionality (i.e. that provided by an investment firm and an exchange in respect of the operation of electronic trading systems) should serve to reduce some of the current differences in mandated operating costs between systems operated by investment firms and exchanges. By increasing confidence in ATs, the standards should enhance their role in the marketplace, which should serve to increase competition and, therefore, lower trading costs to users. Thirdly, the requirement for some systems to contribute to the transparency of the broader market in an instrument should be expected to enhance the competitive environment by broadening access to relevant trading information.

Question 17: Comments are invited on the methodology set out above. Further observations and any quantitative information on potential compliance costs of the proposed standards would be particularly welcome.

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