THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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STANDARDS

FOR ALTERNATIVE TRADING SYSTEMS

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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 ('ATSs').

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 this document

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 (the "Commission") decision to review the Investment Services Directive ('ISD'), the broad options for addressing those issues in the context of EU legislation[1]. 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. The paper summarised the regulatory issues potentially posed by ATSs and set these against the background of the potential benefits for market users. As far as the potential issues are concerned, they fall into risks ATSs might pose for investor protection (e.g. conflicts of interest and best execution), risks raised by ATSs in relation to overall market integrity (e.g. fragmentation, transparency) and risks to the regulatory objective of reducing systemic risk (e.g. systems and settlement).

5. At its September 2000 meeting, FESCO mandated the Expert Group to develop proposals to address the risks potentially posed by investment firms operating ATSs. The intention was to develop proposals that FESCO members could implement ahead of any changes in EU legislation. The Expert Group worked up proposed standards for ATSs and published a first consultation paper in June 2001. Given the extent of the responses received, the Expert group revised the proposed standards and CESR published a final consultation paper on 14 January 2002.

6. During this last consultation period, national and multinational open meetings on the proposals were held in different member state capitals. CESR received useful responses from investment firms, exchanges and trade associations. Respondents were particularly concerned about the scope of the definition of a qualifying system and considered that CESR should specify as much as possible which type of trading systems are deemed to be covered by this definition. Many respondents were also concerned about the transparency requirements set out in the standards and particularly the need to bring clarity to the application of pre-trade transparency.

1 The only institution that can provide a definitive interpretation of EC law is the European Court of Justice.

7. Consequently, CESR has both clarified the scope of its definition of a qualifying system and provided more guidance on requirements relating to pre- and post-trade transparency.

Objectives of the standards

8. The standards that CESR sets out in this paper focus on the potential risks posed by ATSs (see Annex A). The standards have been developed with a view to providing appropriate regulation of investment firms[2] operating ATSs under the current provisions of the ISD. The Commission, who is revising the ISD, has been involved in CESR discussions throughout.

9. The need for these additional standards arises because existing market integrity and conduct of business rules (the application of which is not questioned in this paper) do not fully address the particular risks posed by the specific nature of services provided via qualifying systems. CESR is concerned to ensure, in particular, that:

   - users[3] of 'qualifying systems' (defined below) are adequately protected; and
   - the integrity of the market is protected.

10. CESR believes that its objectives can best be met by concentrating on standards in the following areas:

    - Notification: an investment firm operating an ATS 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 CESR 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 3 below) and considers that ATSs should comply with minimum transparency requirements.

    - Reporting Rules: ATSs should be subject to additional reporting requirements to the extent needed to enable competent authorities to monitor their market share, compliance with market integrity and conduct of business rules and any changes to the information initially notified.

    - Prevention of Market Abuse: ATSs should be subject to requirements that ensure that they contribute to the detection and deterrence of 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.

11. It is essential that implementation of these standards does not unnecessarily hinder financial innovation or competition in financial markets. It is therefore important that the standards

[2] Under the term "investment firms" the standards refer both to (ISD) investment firms and other entities which are authorised to provide investment services, such as credit institutions.

[3] 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" will 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, as laid down by member states in application of the general principles provided in Article 11 of the ISD. For further detail on conduct of business aspects see section 2.2 below.

are developed to address potential risks in a way that is proportionate to the nature and materiality of those risks. Paragraph 16 below explains how the standards are to be applied in a differentiated and proportionate manner.

Definition and Differentiation

12. For the purposes of these standards, CESR defines a qualifying system as:

'a multilateral system, operated by an entity, which without being regulated as a regulated market, brings together multiple third party buying and selling interests in financial instruments – in the system and according to non-discretionary rules set by the system's operator – in a way that results in a contract'.

13. The terms used in this definition should be interpreted as follows:

a) Multilateral systems

This expression is intended to exclude bilateral systems. Bilateral systems are those systems where a single entity[4] enters into every trade entered through the system, on own account and not as a riskless counterparty interposed between the buyer and seller[5]. By contrast, a system where multiple participants (e.g. market-makers) act as counterparties to the orders entered through the system would be regarded as multilateral.

A "system" for the purposes of the definition includes all electronic and non-electronic parts of a system operated by, or on behalf of, the operator. Non-electronic parts of a system might include any organised business method. The various parts of the system might be provided on behalf of the system operator by a third party under an arrangement with the system operator, for example an outsourcing arrangement.

Price-taking systems such as crossing networks[6] qualify as multilateral systems. CESR is aware however that the regulatory issues presented by such systems are distinct from those systems where the price is formed. For example, pre-trade transparency requirements are unlikely to be applicable to price-taking systems[7].

While bilateral systems are excluded from the definition, CESR considers that bilateral systems may also pose risks to market integrity and the interests of investors. These risks mainly, but not exclusively, relate to market fragmentation and its possible effects on price discovery. With the increasing importance of automated bilateral trading systems in the trading process, CESR believes that it will in due course be necessary to address those risks through a broader review of market transparency and has created a new expert group on Market Transparency and Efficiency[8] to take work on these issues forward.

b) Multiple third party buying and selling interests in financial instruments

"Buying and selling interests" is a broader expression than "orders" and includes quotes and indications of interest ("IoIs"). The "financial instruments" covered are those

[4] By the term 'entity', it is intended to refer both to (ISD) investment firms and other entities which are authorised to provide investment services, such as credit institutions.

[5] A system where one of a number of related entities enters into every trade in that way, is a bilateral system for these purposes. Bilateral systems also include systems on which client orders are crossed on an occasional basis

[6] Price-taking systems are systems which take prices from other trading venues. These systems bring together buying and selling interests in a way to transact at a price which derives from "reference" markets.

[7] See commentary in Standard 3.

[8] Press release CESR/02–042: Major outcomes of the third meeting of CESR/ CESR starts work under the Lamfalussy approach.

instruments mentioned in the Investment Services Directive. Regulators may choose to use the standards as the basis of their national regulatory framework for qualifying systems providing a trading service in other instruments, should they consider it necessary to deal with risks in their domestic markets.

c) Brings together in the system by means of non-discretionary rules set by the system operator

The requirement that the interests be "brought together … in the system by means of non-discretionary rules set by the system operator" means that they are brought together under the system's rules or by means of the system's protocols or internal operating procedures (including procedures embodied in computer software).

The expression "non-discretionary rules" means that the rules (once determined) leave the system operator with no discretion as to how interests may interact. It is not meant to convey that the participants do not have the discretion whether to take up or accept any particular buying or selling interest. Nor does it restrict the ability of the operator, when acting in a different capacity, from determining whether or not to enter a buy or sell interest into the system. In such a case the part of the firm's business that is discretionary will not be part of the qualifying system.

Consistent with this, "bringing together" in this context is broader than automatic matching and is intended to cover any process whereby interests interact under non-discretionary rules with a view to execution of trades. The interests may, for example, interact by way of automatic matching performed by the system operator, whether of orders, quotes or IoIs, or by way of selection of interests performed by the participants in the system themselves, whether for immediate execution or for further negotiation. It is not necessary that the interests be displayed to participants. The fact that, in a case of automatic matching, participants must ratify a proposed trade is not a bar to inclusion. Order routing systems where orders are transmitted but do not interact and hence are not "brought together" are not covered by the definition.

d) In a way that results in a contract

The requirement that the way the interests are brought together results in a contract, requires that execution take place "in the system" in the sense explained above, i.e. under the system's rules or by means of the system's protocols or internal operating procedures. If all the material terms are agreed in the system in this sense, then the use of an unrelated third party trade confirmation service would not disqualify the system.

By contrast, a mere passive bulletin board, other advertising system, the use of e-mail or other electronic communication systems whereby participants contact each other outside the system (i.e. not under the system's rules and not by means of the sytem's protocols or internal operating procedures) to negotiate the material terms of trade will not amount to a qualifying system.

14. A table (see Annex B) gives summary guidance on the type of systems CESR regards as falling within or without the scope of the definition. Moreover, a Contact Group[9] will monitor the application of the standards and will also look at the issues arising from the above interpretation of the definition.

15. While some standards propose obligations on all operators of qualifying systems equally, other standards will be applied in a more differentiated way depending on the particular risk the regulator is aiming to address. The following factors have been identified as those which should be taken into account by regulators:

[9] Please refer to paragraph 24 of the paper.

- The users' experience, in particular distinguishing between professional and non-professional users, especially in relation to information disclosure to users and clearing and settlement arrangements;

- The extent to which the wider market involves non-professional investors;

- the nature of the instruments traded on 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 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. One factor is likely to be whether the broader market encompasses only the national market or also other European, or even global, markets;

- the nature of the system. This might, for example, be in relation to the trading processes and whether the system has, for example, a role in price formation or is a crossing network which takes reference prices from another market.

16. CESR additionally recognises that in some countries firms operating qualifying systems, while not regulated markets in their own right, may be members of a regulated market and operate qualifying systems subject to regulated market regulation. It is not intended that member state regulators will subject these firms to duplicative regulation.

17. The standards relate to the activities of investment firms in respect of qualifying systems which provide a trading service in instruments listed in Section B of the Annex to the ISD[10]. However, as is currently the case, regulators may choose to use the standards as the basis of their national regulatory framework for qualifying systems providing a trading service in other instruments, should they consider it necessary to deal with risks in their domestic markets.

The ISD review

18. Since the publication of the last CESR paper in January 2002, the European Commission has continued its public consultation on possible revisions to the ISD[11]. CESR notes that its

[10] 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.

[11] The approach in this paper has been agreed by all CESR 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 ATSs, which shall be clearly distinguished from regulated markets.

definition of a qualifying system is reflected in the definition put forward by the Commission in its 2nd Consultation Paper for the proposed new core ISD service.

19. The CESR definition of ATS, focusing on multilateral systems, captures those trading systems which would be subjected to similar market integrity/ efficiency disciplines under the revised ISD proposal currently under consultation.

20. CESR standards will be of use to regulators and market participants in clarifying the appropriate regulation of investment firms operating qualifying systems in the period before the revised ISD enters into force. CESR does not think that it is appropriate to await the implementation of a revised ISD before tackling the issues raised by multilateral ATSs. It might well take some time to finalise and implement a revised ISD and CESR is concerned that there are issues, both in terms of market integrity and competition, which it thinks need to be dealt with before.

2. THE STANDARDS AND COMMENTARY

These market integrity standards are promulgated under the current ISD and are therefore based on the principle of home state application[12]. The standards set out the requirements that should be imposed on investment firms operating qualifying systems by the home state authorities responsible for the licensing and oversight of those firms, to ensure that users of qualifying systems are protected, market integrity in the instruments traded is secured and reduction of systemic risk is pursued.

The core standards should be read in conjunction with the commentary. The commentary provides guidance on the considerations relevant authorities will take into account in the application of the standards. The commentary also covers the circumstances in which requirements should be differentially imposed.

2.1 - Market Integrity Standards for Alternative Trading Systems

Standard 1: Notifications

Investments firms should be required by their home state regulatory authority to notify the establishment of a qualifying system. They should also notify the home state regulatory authority (and, where different, the home state regulatory body in that member state 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 and systemic risk. 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. CESR recognises that national regulators already collect a large amount of relevant information. The aim of this standard is therefore to establish agreement among member states as to the information being collected rather than to duplicate existing requirements for the provision of information. This will also assist when the investment firm provides or intends to provide cross-border services in the host country as the home state regulator should notify the registration of the establishment of a qualifying system by the firm to the host country regulator (in line with the normal requirements laid down in Article 18 of the ISD).

At initial notification, home state 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 brought together;
- the arrangements for making pre- and post-trade information available to users and to the general public;
- the 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;

[12] The fact that the standards are based on the current ISD also means that the regulatory responsibility for the application of conduct of business rules continues to be governed by Article 11 of the ISD.

- the existence of any incentive arrangements to boost liquidity/turnover;
- the arrangements for the clearing and settlement of transactions;
- the arrangements for ensuring compliance with any regulatory requirements imposed by home state regulators to implement these standards (once the precise application has been determined by the relevant regulatory authority).

In addition, subsequent to initial notification, home state regulators may 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 operator(s) of the qualifying system, the trading process, the instruments traded, the categories of system user, the clearing and settlement arrangements, and the system design or system management arrangements.

Members will implement this standard in a way that provides a sufficient basis for the regulator's understanding of any issues raised by the qualifying system. The information will assist the home state regulator in determining the appropriate application of any of the other standards (set out below) to a qualifying system.

Standard 2: Fair and orderly trading

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

Investment firms operating a qualifying system should have arrangements in place to ensure that trading by way of the system is fair and orderly (This standard focuses on the requirements for the direct users of the system, including dissemination of pre and post trade information, in contrast to Standard 3 which relates to publication of information to the public and market as a whole.).

In respect of fair and orderly trading[13], the system 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 and orderly. In particular, the operator should be able to demonstrate that the trading methodology enables the users 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 sufficient information on orders and completed transactions. The extent of this requirement will depend on the characteristics of the system, e.g. information on orders may not be appropriate for pure price taking systems.

In considering the way in which regulators should implement this standard, CESR recognises that differentiation should be made between professional and retail users Although fairness is an important basis for the dealings between all market participants, CESR recognises that professional users will be better able to ensure that they are treated fairly. Regulators would not normally need to intervene in properly operating commercial disciplines between purely professional players. However, even where system users are solely professionals, regulation will also need to ensure (when relevant) that the arrangements are consistent with the needs for wider market integrity.

[13] This standard on fair and orderly trading is a market related standard without any specific reference to Conduct of Business Rules and any relevant categorisation of investors under those rules.

Standard 3: Publication of Trading Information

An investment firm operating a qualifying system providing trading in an instrument traded on a regulated market must 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 must make publicly available, 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 a range of facilities trading an instrument as possible. Without this information, those wishing to trade will be unable to trade optimally, whether for their own account or for their clients; 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 which provide trading in instruments traded on a "regulated market" must be ready to make relevant trading data available on a timely basis. 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. CESR recognises that home state regulators may authorise firms to delay such publication in respect of orders that are large compared with normal market size for the financial instruments concerned, where similar arrangements are in existence on the underlying regulated market.

In the first instance, this standard on transparency will only apply to investment firms operating qualifying systems which provide trading in instruments listed in Section B of the Annex to the current ISD. On a domestic basis, home state regulators may choose to apply equally the standard to investment firms that operate qualifying systems providing a trading service in other instruments. Any requirements for pre- and post-trade information, to be made available as stipulated above, should be no more onerous than those imposed on the regulated market in that instrument by the home state of the investment firm operating the qualifying system, or, where there is no relevant regulated market in that jurisdiction, by the national laws of the Member State having responsibility for the relevant regulated market.

In other words, where the competent authorities have implemented pre- and post- trade transparency under the current ISD[14], these requirements will form the overall benchmark for the qualifying system. However, regulators recognise that they will need to adapt such benchmarks to particular market microstructures - for instance, market maker transparency requirements may not be adequate for central order book qualifying systems. Similarly, pre-trade information is unlikely to be appropriate for crossing networks and will be applied to other qualifying systems in a manner that reflects their business model. Overall benchmarking of transparency standards will allow qualifying systems to employ the same flexibility as regulated markets, e.g., with regards to treatment of large orders.

Where the instruments are not admitted to trading on any regulated market, CESR still encourages the member states to move towards an adequate minimum level of transparency. CESR acknowledges that some Member States will have to change their national laws in order to implement this standard fully.

CESR recognises that the market may well provide its own solutions in this area. It would expect at least some 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 should take action to address any adverse effect on the integrity of the wider market arising from the absence of transparency.

[14] i.e., the ISD as in force at the time of promulgation of these standards.

The above guidance is given on the basis of the current ISD and CESR acknowledges that the revision of the ISD which is underway, and the work of the expert group on Market Transparency and Efficiency, may both result in further detailed guidance on transparency issues. Such guidance would have to be taken into account in the application of ATS standards.

Standard 4: Monitoring

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 those rules. In any case, 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.

CESR 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 (or its operator) 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.

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

Investment firms operating a qualifying system should, where their home state regulatory authority requires it for the purposes of investor protection and market integrity, establish arrangements with that authority to facilitate satisfactory monitoring of the markets in the instruments traded and the detection of market abuse.

The maintenance of investor 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 relevant information – e.g. trading data (in addition to the one already required under Article 20(1) of the ISD) - to its home state regulatory authority, which in turn would be able to use this information in its co-operation with any relevant regulatory authorities in its member state and to provide information to the host country regulatory authority in accordance with the information sharing provisions of the ISD or other relevant law.

The home state regulator should consider, with the relevant market authorities, 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.

Where the instruments are admitted to trading on a regulated market, the arrangements to be established by the investment firm operating a qualifying system could be elaborated under three different routes. Relevant monitoring could be done either (i) by the operator itself, (ii) in co-

operation with the exchange operating the underlying regulated market and acting as market authority, or (iii) in co-operation with its home state regulator. The effective level of monitoring should be equal (in markets with similar characteristics) under the three options.

Standard 6: Systems

Investment firms operating a qualifying system should be able to demonstrate to the relevant home state 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 out-sourced - 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.

Standard 7: Clearing and Settlement

Investment firms operating qualifying systems should ensure that there is clarity of obligations and responsibilities for the clearing (where applicable) and 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 clearing (where applicable) and settlement[15].

[15] CESR does not address the issue relating to competition in clearing and settlement services when qualifying systems provide integrated clearing and settlement solutions as such issue is not covered by the current ISD.

2.2 Application of Conduct of Business Rules to ATSs

Investment firms operating qualifying systems will already be subject to existing conduct of business rules established in accordance with Article 11 of the Investment Services Directive. The standards for ATSs are not designed to duplicate, replace, add to or subtract from these existing conduct of business requirements. However, the nature of the activities of operators of qualifying systems may mean that the application of existing conduct of business rules needs to be adapted to take account of the service provided. CESR therefore sets out below its interpretation of the application of the disclosure requirements applying under existing conduct of business rules for those investment firms operating qualifying systems.

It should be noted that while operators of ATSs authorised as investment firms will be required to comply with conduct of business rules established in accordance with Art. 11(1) of the ISD, in their dealings with users, these conduct of business rules must also be interpreted to take account of the professional nature of the user. CESR's "European Regime for Investor Protection" (Ref. CESR/01-14b), (Ref. CESR/02-086b) provide standards in this area as well as on the issues mentioned below. Also, the European Commission has clarified its view on the application of the professional/retail distinction of any cross-border provision of services that might be undertaken by an investment firm operating an ATS (COM (2000) 722).

a) Investment firms operating a qualifying system should make clear the nature of the relationship between operator and user[16].

The firm operating the qualifying system must have an agreement with its users which clearly sets out the nature of the relationship between the user and the operator of the system. 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 users.

b) 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;

[16] Please refer to the above footnote 3 relating to the definition of "user"

- where appropriate arrangements for the clearing and settlement of the trades.

c) 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 should be able to obtain access to available and/or accessible information in respect of prospective transactions in instruments traded on the system, as for example when a prospectus or other disclosure documents is required under law in respect of a security 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 nature 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 straight forward 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 traded[17]. The system operator should indicate to users where publicly accessible information may be obtained. This obligation could be considered satisfied where the securities have been subject to a public offering for which a prospectus has been made available or, have been admitted to official listing on a an EEA stock exchange. In the case of unlisted securities, the operator should indicate that the securities are unlisted, likely to be subject to lesser disclosure requirements and 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.

CESR 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 Directive[18]. Where sufficient information is already available, CESR would not expect qualifying systems to be required to duplicate it.

[17] 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.

[18] Council Directive 89/592/EEC, co-ordinating the requirements for the drawing-up, scrutiny and distribution of the prospectus to be published when transferable securities are offered to the public.

3. IMPLEMENTATION AND NEXT STEPS

21. The standards are directed, in the first instance, at CESR 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 co-operation between different national supervisors, to ensure that credit institutions which establish ATS platforms to provide investment services are subject to the notification requirements that would be imposed on investment firms under Standard 1.

22. In the medium term, further consideration is being given to the latest Commission's proposed legislative changes to the ISD in the area of ATS regulation.

23. CESR members will include these standards in their regulatory objectives and, when possible, in their respective rules. If a CESR 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.

24. An informal contact group of relevant experts from CESR members (‘”Contact Group”) will be established with the aim to exchange views about the implementation of the standards. It will also observe costs associated with such implementation. CESR considers it as important to follow the actual application of the standards, given that the paper asks for differentiated application by national regulators and in order to ensure consistency in how judgement of differentiation is made. It is also very interested in establishing a continuous dialogue with investment firms operating qualifying systems. CESR is encouraging them to provide their regulator with any relevant information or costs issues arising from the need to meet the standards. Such information may be sent in paper or electronic format to the CESR secretariat (F. Demarigny, Secretary General, CESR, 11/13, avenue de Friedland, 75008 Paris – France/ secretariat@europefesco.org).

Annex A Issues addressed by the standards

Coverage of investor protection risks

Issue	CESR 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 (**notification of ATS and notification of key features and significant changes)	**Art. 3 (4), 3 (7) c (**submission of business plan)
	Standard 2 (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 (**notification of ATS and notification of key features and significant changes)	**Art. 3 (4), 3 (7) c** (submission of business plan)
	Standard 2 (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	CESR standards for ATS operated by investment firms	ISD provisions to which Member State requirements on ATS could be linked
Fragmentation	**Standard 3 (**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 3 (**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 4 (**monitor user compliance with contractual rules of the system)	**Art. 10 (**prudential rules which investment firms shall observe at all times**)**
	Standard 5 (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 4 (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 **Capability, capital adequacy and competence of users)**	**Standard 1 (notification of** ATS and notification of key features and significant **changes)**	**Art. 3 (4), 3 (7) c (**submission of business plan)

Issue	CESR standards for ATS operated by investment firms	ISD provisions to which Member State requirements on ATS could be linked
Admission to trading (proper market)		
Systems	**Standard 6** (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	CESR standards for ATS operated by investment firms	ISD provisions to which Member State requirements on ATS could be linked
Performance of Transactions	**Standard 7** (clarity of responsibilities for settlement)	**Art. 11, indent 4 (**information from client as regards services required)
Financial Resources	**Standard 1** (notification of ATS and notification of key features and significant changes)	**Art. 3 (4), 3 (7) c (**submission of business plan)

Annex B Guidance table on the definition of a Qualifying System

Type of system	Is system a qualifying system ?
Multilateral systems	
Limit order matching book	Yes
Electronic periodic auction system	Yes
Price-taking system/"crossing network"	Yes
Quote screen	Yes, where the conditions for active bulletin boards are met.
Bulletin board	Yes, if execution takes place inside the system, i.e. under the rules of the system or by means of the system's protocols or internal operating procedures. No, where the system is a mere passive bulletin board or other advertising system whereby participants conclude the trade outside the system.
Order routing system	No (assuming orders do not interact and are merely transmitted).
Multiple market makers, i.e. system where multiple participants act as counterparties to the order entered through the system.	Yes
Bilateral systems	
System where the same entity[19] is party to all trades (other than as interposed riskless counterparty)[20].	No

[19] By the term 'entity', it is intended to refer both to (ISD) investment firms and other entities which are authorised to provide investment services, such as credit institutions. The term also includes related entities.

[20] System where one of a number of related entities enters into every trade in that way, is a bilateral system for these purposes. Bilateral systems also include systems on which client orders are crossed on an occasional basis