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**THE REGULATION OF
ALTERNATIVE TRADING SYSTEMS
IN EUROPE**

A paper for the EU Commission

September 2000



1. INTRODUCTION

Background

2. DEFINITION, CHARACTERISTICS AND CURRENT DEVELOPMENT

Definition and characteristics
Development of ATs in Europe

3. CURRENT REGULATORY TREATMENT OF ATs

Europe
United States
Canada

4. ATs : ISSUES AND POTENTIAL REGULATORY IMPLICATIONS

Potential benefits of ATs operations
Regulatory objectives
The issues

5. OPTIONS FOR RESPONDING TO THE ISSUES

Option 1 Status quo
Option 2 The introduction of a self-standing ATs regime
Option 3 Additional regulatory requirements for ATs operating as investment firms
Option 4 Replacement of the "regulated market" regime by "a trading system regime".

Alternative Trading Systems: issues and regulatory implications.
A paper for the EU Commission



1 INTRODUCTION

BACKGROUND

1. In December 1999 FESCO published "Standards for regulated markets under the ISD"¹. The focus of that paper was on the standards to be expected of markets listed as 'regulated markets' under the provisions of article 16 of the Investment Services Directive (ISD). Since all ISD regulated markets are exchange-based markets, the emphasis fell on standards appropriate to exchanges. However, in the foreword FESCO members recognised that further consideration needed to be given to the emergence of new trading platforms, often referred to as "Alternative Trading Systems" (ATs), and their impact on market regulation and efficiency. The role of ATs has also been identified by the European Commission as a topic for discussion in considering possible changes to the ISD. FESCO therefore established an Experts Group to examine the issues raised by the development of ATs.
2. The emergence of ATs is part of the process of rapid and fundamental change through which capital markets are presently moving. In Europe the emergence of a European capital market, advances in technology and the advent of electronic trading, both domestically and across national borders, are fuelling far-reaching changes in both market structures and participants' roles. In particular, as trading technology becomes cheaper and extends markets' reach, markets are becoming more contestable. This has led not only to increased competition and restructuring in the world of exchanges (e.g. Euronext, iX, virt-x), but also to an expanding role for trading platforms operated by non-exchange entities. These ATs can deliver a range of services, from the bringing together of buyers and sellers to complete trading platforms which offer similar functionality to that provided by exchanges, but within a different regulatory framework
3. Competition and innovation in trading systems are to be welcomed. They are likely to lead to more efficient markets that benefit all participants, including investors. But regulators need to ensure the maintenance of an appropriate regulatory framework, that not only supports competition and innovation but is also capable of addressing any new risks to investor protection, market integrity and financial stability that might arise.

Purpose and scope

4. This paper therefore seeks:
 - to understand the drivers for change and assess the extent to which they may differ across markets in Europe;
 - to identify and assess the benefits and risks associated with the emergence of ATs;
 - to set out the high level regulatory objectives for markets, and consider whether potential risks to those objectives posed by ATs are adequately addressed by existing regulatory frameworks;
 - to assess the pros and cons of different steps that could be taken in relation to the European regulatory framework (underpinned by the ISD) for trading

¹ 99-FESCO-C



systems, and reach a common understanding among FESCO members about how they should approach the future regulation of ATSS.

5. FESCO will submit this paper to the European Commission to contribute to its preparation of a Green Paper on possible ISD amendments, which it expects to publish later this year.
6. As well as being competing venues for exchange traded securities, ATSS are also potential competitors to exchanges for new products to trade. The scope of the paper therefore extends to cover all ATSS that trade instruments covered by the ISD, whether or not those instruments are currently admitted to trading on a regulated market.
7. In preparing this paper the expert group invited market participants (firms, exchanges, and trade, consumer and other representative bodies) to respond to a 'request for information', which was followed by a workshop with interested parties. That consultation revealed very varied expectations of the likely development of ATSS in Europe, and different views on the appropriate regulatory response. But it nonetheless proved useful in seeking to clarify the options for change.
8. This paper continues in four further sections, which cover the following subjects:
 - Section 2: Definition, characteristics, and current development of ATSS in Europe.
 - Section 3: Current regulatory treatment of ATSS in Europe, the US and Canada
 - Section 4: Issues arising, and potential regulatory implications.
 - Section 5: Options for responding to the issues.

2. DEFINITION, CHARACTERISTICS AND CURRENT DEVELOPMENT OF ATSS IN EUROPE

DEFINITION AND CHARACTERISTICS

9. The definition of an ATS is not straightforward. Different terminology is used in different jurisdictions and the same term is often capable of bearing different interpretations. The term is currently used for: bulletin boards, automated trade matching systems, electronic communication networks, proprietary trading systems (broker-run ATSS) as well as for broker-to-client automated linkages. A clear understanding of the defining characteristics of an ATS is therefore essential.
10. Present European law appears to provide little assistance on this issue. It neither considers the concept of an ATS nor defines with any precision those activities from which ATS activity might be distinguished, and thus potentially carved-out for regulatory purposes. For example, relevant EU directives accept the concept of an exchange as given rather than defining it; the ISD definition of a regulated market also takes the market concept as given; and the ISD offers no firm basis for distinguishing between the activities of broker dealers and ATSS.
11. The experts group has agreed that, for the purpose of this paper, the following definition of ATS should be used: "An ATS is 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."

12. This is a broad definition, which captures any trading functionality regardless of whether that functionality operates bilaterally or multilaterally. It captures not only ATSs which contribute to the price discovery process through the matching of priced orders and the lifting of quotes, but also includes crossing mechanisms which match buying and selling interests at a ('reference') price determined elsewhere, e.g. on an exchange .
13. Should 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) be included in the definition of ATS? 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 a market.
14. As the working definition is very broad, and covers many different types of system, the group has categorised ATSs using a functional approach. This enables ATSs to be sub-divided as follows:
 - Quote-driven systems
 - Order-driven systems, subdivided into continuous matching and auction matching systems
 - Price-taking (Crossing) systems
 - Active Bulletin Boards
15. Using this categorisation, the following framework can be set up:

TABLE A

	Quote-driven systems	Order-driven systems		Price-taking (crossing) systems	Active Bulletin Boards
		Continuous Matching	Auction Matching		
Basic Principle	*Display of dealer quotes *Automatic execution against quotes	*Public limit order book *Market and limit orders continuously matched in time and price priority	*Limit orders and "at the opening" orders stored in a batch *Algorithm calculates a single price at a set time to maximize execution	*File of market orders (possibly with min/max execution limits) *System crosses orders at single benchmark prices	*Display of invitations to offer *System declares acceptance of offers

Examples	*MTS France	*Instinet, Bloomberg, Island	*Optimark	*POSIT, E-Crossnet	*Webstock, Tradecross
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16. Different types of ATS may raise different regulatory issues. This is discussed further in Section 4, and will need to be taken into account in any standard setting work undertaken by FESCO as envisaged in Section 5

DEVELOPMENT OF ATSS IN EUROPE

17. To date, ATSS have not been as significant a phenomenon in Europe as they have been in the U.S. This, in part, reflects the modernisation of many EU exchanges during the 1980s and 1990s, leaving fewer opportunities for ATSS to exploit. The group has nonetheless identified 27 multilateral systems operating in the EEA which fit within the ATS definition in para 11². The operators of most ATSS are authorised in the UK (16 ATSS) and in Germany (6 ATSS), with one each being authorised in France, Ireland³, Belgium and the Netherlands. The remaining eleven jurisdictions have not yet licensed or authorised the operator of any trading system falling within the definition of ATS. Instinet and Citicats (Germany) are the longest established systems. Most of the others have been in operation for less than three years and some have just started (e.g. E-Crossnet, MTS France, Tradecross). An increasing number of other initiatives are currently being considered by the industry and/or are at different stages in the regulatory approval process.
18. A notable feature of ATS development is the different roles they are playing in different markets. Where organised central markets already exist, as is predominantly the case with equities, ATSS normally attract business by offering functionality or services that the local exchange does not. After hours trading is typically one of those facilities. It is provided, for instance, by Citicats and Tradelink in Germany and TLX in Italy. Crossing is another key functionality offered by many ATSS operating in the UK, such as E-Crossnet, POSIT and Lattice. ATSS often also offer direct access to institutional investors, which most exchanges currently do not. The tendency in organised central markets is generally, therefore, for competition from ATSS to fragment liquidity.
19. By contrast, in areas where there is no organised central market, ATSS have emerged to offer greater efficiency and transparency in price formation. This is especially true in bond markets. MTS is a key example of this move from OTC bilateral transactions in fixed income instruments, towards a multilateral trading system operated as an ATS. MTS is currently operating as an ATS in four jurisdictions (France, UK, Belgium and the Netherlands) and as a regulated market in Portugal and Italy. Current initiatives underway in the industry suggest that fixed income trading may become a major area of development of

² This number of identified ATSS does not include the bilateral systems as described in paragraph 13.

³ Ireland has authorised one ATS which is not operational in Ireland but passports its activities into the UK



ATs in Europe in the coming years, and the one in which the “next generation” systems propose setting up their business.

20. Some ATs, such as Tradecross in Germany, offer a trading platform for equities that have not been admitted to trading on a regulated market and for which there is no organised central market.
21. Just as ATs are tending to provide a centralising force in European bond markets, so there may be potential for equity ATs to centralise trading in equities on a pan-European basis. The scope for ATs to develop services in this field is likely to depend on how quickly and how successfully exchanges are able to bring to fruition their various plans (e.g. iX, EuroNext and virt-x) for offering a single venue for trading in European equities.
22. It is clear from the above analysis that the European marketplace is moving through a period of major change and that there are considerable uncertainties about its future development. The direction of this development is likely to be significantly influenced by changing technology, investor preferences and by the nature of the competitive response from traditional exchanges. Most industry respondents to the information gathering exercise undertaken by the experts group⁴ agreed that ATs had emerged, and would develop further, where existing market providers failed to offer the type of services that market users were increasingly seeking, and at an appropriately low cost.

3. CURRENT REGULATORY TREATMENT OF ATs

EUROPE

23. As explained in paragraph 17, most of the ATs in the EEA are licensed in the UK (16) and Germany (6), with four jurisdictions each authorising just one. By contrast with the position in the US, and the proposed position in Canada (see below), there is no special regulatory status or regulation of ATs within the EEA, even though there may often be little distinction between an investment firm and an exchange in respect of the trading systems offered (e.g. many ATs and exchanges use electronic limit order books).
24. In most jurisdictions, an entity operating a trading system falling within the ATs definition (set out in para 11) has the choice of being licensed either as an exchange or as an investment firm (provided that it can meet all the requirements of the preferred category). Where an ATs operator seeks investment firm status, it is subject to a regime that focuses predominantly on investor protection. ATs operators that apply for exchange licensing are subject to regulation more focused on market integrity. In practice, the large majority of the newer operators of trading facilities that could have applied for either investment firm or exchange licensing have opted to be regulated as investment firms. While many operators view investment firm regulation as more appropriate to their business model, this is not always the case. Interestingly, Coredeal, an electronic eurobond trading platform, was recognised as an investment exchange in May of this year earlier, and Jiway, a pan-European platform aimed at retail brokers, is also pursuing exchange recognition

⁴ Cf FESCO request for information and workshop.

25. A number of jurisdictions (e.g. France, Greece, the Netherlands) have a degree of latitude to prescribe additional conditions for investment firms operating ATSS. There are some exceptions to this overall picture which have their origins in the legislation in force in different jurisdictions. In Italy ATSS are not subjected to licence requirements, though management companies have to notify the regulator of the rules applying to the systems, details of price formation systems and the financial instruments traded. In Spain an ATS has to be approved by the Government in a procedure similar to that of an exchange⁵. The Spanish concentration rules require also that every order received by a broker has to be sent to an exchange⁶. In Portugal the legal and regulatory framework only distinguishes between regulated and non-regulated markets. MTS Portugal is expected to be recognized by the CMVM as a regulated market, a situation which will ensure transparency requirements are met. If an ATS were to apply in Greece, the regulatory authorities would address the application on a tailor made basis. In Finland ATSS seem to be hindered by the tax legislation which imposes a stamp duty on trades outside regulated markets .

UNITED STATES

26. In December 1998, the SEC adopted rules that were designed to establish a regulatory framework for ATSS and more fully integrate them, along with exchanges, into the US national markets system. The rules were adopted on grounds that existing broker-dealer regulation, particularly in the case of ATSS with significant volume, had not been adequate to ensure that investors continued to have fair access to best prices, that there were complete audit trails for and adequate surveillance of trading on ATSS, and that the potential for market disruption due to system outages was minimised.

27. The new rules (known as Regulation ATS) set out a comprehensive framework that allows ATSS to choose whether to register as an exchange or to be licensed as a broker-dealer subject to certain additional requirements (see further below). But the SEC reserves the right, in the public interest, to require an ATS to register as an exchange if, during three of the preceding four calendar quarters, it has traded forty percent or more of the average daily dollar trading volume in any class of securities.

⁵ The approval by the Government is necessary since the enactment of the new Spanish Securities Market Act in November 1998. If applicable the approval is granted on the basis of a proposal by the CNMV. For its decision, amongst other aspects, the CNMV compares the ATS's bylaws, the trading and listing rules with the 'Standards for regulated markets under the ISD' of FESCO.

⁶ According to the ISD (Article 14, para 3) a member state may require that transactions be carried out on a regulated market. If a member state applies paragraph 3 it shall give investors the right not to comply with this obligation and have the transactions carried out away from a regulated market.

28. An important element in the introduction of Regulation ATS was the SEC's wish to level the playing field at both ends. So, in addition to increasing regulation on certain ATSS, it also relaxed certain regulatory requirements for exchanges to enable them to compete more effectively. An important relaxation was the removal of the requirement that an exchange should be a mutual organisation, thus paving the way for exchanges to demutualise and become for-profit organisations.
29. ATSS that choose to register as exchanges must satisfy all the requirements that apply to national securities exchanges. Registered exchanges must be able to carry out SRO functions.
- ATSS that register as broker-dealers must comply with specific requirements (set out in Regulation ATS) depending on the volumes which they trade. If their volume in any particular security is less than 5% certain reporting requirements apply. Where their trading amounts to 5% or more in any particular security ATSS must:

- link with a registered exchange or the NASD, as appropriate, and publicly display their best priced orders (including institutional orders); and
- allow members of the registered exchanges and the NASD to execute against those publicly displayed orders. (Only those orders that would in any case have been displayed to more than one participant in the ATS need be publicly displayed and made accessible in this way.)

As well as meeting the above requirements, an ATS with 20% or more of trading volume in a particular security also has to:

- ensure that its automated systems meet certain capacity, integrity, and security standards; and
 - refrain from “unfairly denying investors access to its system”. This requirement only prohibits unfair discrimination among persons seeking access, and ATSS are free to establish ‘fair’ and ‘objective criteria’, for example in relation to creditworthiness, as the basis for participation.
30. Since Regulation ATS was adopted, two ATSS have formally filed applications to register as exchanges. Other US ATSS continue to be regulated as broker-dealers, subject to the requirements of Regulation ATS.⁷

Canada

31. ATSS have only been allowed to operate in Canada only on a severely restricted basis. They have been allowed to operate only as members of an exchange, and their trading has been limited to certain types of instrument. This position

⁷ As at June 2000. Island applied for registration as a national securities exchange in June 1999, and Nextrade in March 2000. In addition, Archipelago initially applied for registration as an exchange in August 1999, but is currently considering whether to become a facility of the Pacific Exchange, rather than a independent SRO.

reflected concerns that there was already a significant degree of internal fragmentation in the Canadian equity market as a result of trading in the “upstairs market”, and that adverse impacts might flow if any dealers with large volumes of trading were to withdraw from exchange membership and operate as ATSS.

32. Canadian proposals for a revised approach to the regulation of ATSS were first published in July 1999, and again (in amended form) in July 2000. Assuming they are adopted, these proposals will allow ATSS to compete with exchanges. The Canadian authorities believe that this competition will stimulate innovation and encourage markets to offer better features and services to their members and subscribers, and at lower costs.
33. Under the proposals, any market-place⁸ that meets a definition of ATS will be able to choose one of three options. It could apply for recognition as an exchange. It could choose to become a member of an exchange and be regulated in the same manner as any other exchange member. Or it could register as a dealer and become a member of a self-regulating organisation.
34. A market place could not meet the definition of ATS if it displayed certain characteristics, namely:
 - it provided a listing function ;
 - it set a guaranteed minimum order size for securities traded, for the purpose of ensuring liquidity through intermediaries such as professional market makers ;
 - it set market regulations, such as rules governing the conduct of market participants ; and
 - it disciplined participants over and above the penalty of excluding participants from trading (e.g. levying fines or undertaking enforcement actions).
35. In this case the Canadian authorities would require recognition as an exchange. And, in a similar vein to the SEC, they also propose reserving the right, in the public interest, to require high volume ATSS to seek recognition as exchanges.
36. Certain requirements will apply to all market places (i.e. exchanges and ATSS). In particular, they will all have to:
 - provide best bid and offer information to a ‘data consolidator’ (an arrangement that would be broadly equivalent to the US national market system);
 - afford all non-subscribers equivalent access to the orders displayed by the data consolidator ; and
 - keep certain records, including audit trails of transactions.
37. In addition to the above requirements, all ATSS registered as dealers and exchanges will have to comply with certain basic systems capacity, security and integrity standards. Additional systems capacity, security and contingency

⁸ A ‘market place’ is defined as an exchange, a quotation and trade reporting system, or any other person or company (including an ATS) that (i) constitutes and maintains or provides a market or facilities for bringing together buyers and sellers of securities; (ii) brings together the orders for securities of multiple buyers and sellers; and (iii) uses established, non-discretionary methods under which the orders interact with each other and the buyers and sellers entering the orders agree to the terms of a trade. Dealers who provide market-place services for exchange-traded securities are also – since the July 2000 version of the proposals – included within this definition, to the extent they are not members of the exchange that trades those securities.



standards would apply to ATs registered as dealers that met certain volume trading thresholds, as well as to all exchanges.

38. The Canadian authorities have not yet finalised their policy on ATs.

4 ATs – ISSUES AND POTENTIAL REGULATORY IMPLICATIONS

39. This section focuses on the regulatory issues potentially raised by ATs. These are set against a background of the potential benefits for market users and of the key regulatory objectives for markets.

POTENTIAL BENEFITS OF ATs OPERATIONS

40. Section 2 described how new technology has been harnessed to develop ATs with a view to bringing potentially significant benefits to market participants and/or investors. During the information gathering process, the main potential benefits suggested to the Experts Group were:

- Cheaper and more efficient trading. Competition between ATs and exchanges, and ATs and 'traditional' brokers in the OTC markets, exerts downward pressure on trading costs, potentially leading to lower commissions, smaller 'tick sizes' and narrower spreads. ATs are also capable of making trading safer and more efficient, for example by centralising liquidity in certain securities (as is currently happening in the European OTC market for government bonds), or using state of the art technology that supports rapid execution and processing, including immediate price and transaction confirmation.
- Services better tailored to specific user group needs. ATs support broader choice of execution methods across a market, where these are not offered by traditional exchanges (including continuous auction, limit order book, crossing and order preferencing models). They also support anonymous trading and can be used as a vehicle for reducing the market impact of large trades. This gives greater scope to market users to pick a trading service that is best suited to their trading needs for specific types of transactions.
- Increased opportunities to trade. ATs may offer a different product range or different trading hours. ATs could, for example, act as 'nursery' markets for 'new' European securities (such as internet start-up companies) that have not previously either been admitted to trading on a regulated market, or regularly traded OTC. They may also offer extended trading hours/24 hour trading, both in securities already traded on European regulated markets, and those traded on exchanges outside Europe.

41. Some of these benefits may also be offered by exchanges, and some – longer trading hours – have recently been introduced by some exchanges, no doubt partly in response to the competitive pressure from ATs. As indicated in paragraph 2 the recently proposed mergers and alliances between European exchanges are partially stimulated by the emergence of ATs.

REGULATORY OBJECTIVES

42. While ATs might be capable of delivering greater efficiencies and new opportunities for investors, they also raise issues for regulation. In identifying and examining these issues, the Experts Group has taken as its starting point the prime regulatory objectives of:
- Adequate investor protection.
 - Fair, efficient⁹ and safe markets (overall market integrity).
 - The reduction of systemic risk.
43. These objectives flow from the 'Objectives and Principles of Securities Regulation', published and adopted by the International Organisation of Securities Commissions (IOSCO) in September 1998. They are also consistent with the approach taken by FESCO in drawing up the Standards for Regulated Markets under the ISD, adopted in December last year.
44. The Group has also taken into account the need not unnecessarily to hinder financial innovation or to limit competition in the supply of financial products and services.

THE ISSUES

45. As set out in Part 3, most European jurisdictions currently regulate ATs as investment firms rather than as regulated markets. The regulation of investment firms is primarily concerned with investor protection and the reduction of systemic risk. In the case of regulated markets, on the other hand, the primary concern is supporting fair, efficient and safe markets (i.e. supporting overall market integrity).
46. However, ATs usually fulfil at least some of the core functions of regulated markets, including the conclusion of contracts between participants on the basis of pre-determined rules. The central question, therefore, is whether the type of regulation currently applied to ATs is adequate to address risks that their operations might pose to meeting the regulatory objectives.
47. Looking at each of the objectives in turn, the Experts Group identified a number of risks that ATs might pose for *investor protection*.
- Access to trading. ATs might be structured in a way that effectively denies certain groups of investor access to trading at the best prices available for their size and type of trade.
 - Best execution. To the extent they might fragment previously centralised markets, and not be as transparent in their operations as regulated markets, ATs might make it more difficult and costly for intermediaries to achieve best execution on investors' behalf. Risks might also arise from a lack of clarity as to the duty of best execution that an ATs operator owes to customers using its system.
 - Conflicts of interest. Investors might be disadvantaged where there are conflicting interests within organisations that operate ATs (for example,

⁹ For all market users, including issuers and their investors.

conflict between the duty as a broker to achieve best execution, and the commercial interest in executing the maximum number of orders through the ATS, or giving unreasonable advantage to sub-sets of more commercially important users).

48. These risks are closely linked to those potentially raised by ATSs in relation to *fair, efficient and safe markets (overall market integrity)*.

- **Fragmentation.** Increased competition in the provision of trading services, including the emergence of ATSs, might lead to fragmentation of previously centralised markets into separate pools of liquidity. Inefficient outcomes could result. For example, inadequate order interaction could impact on the reliability of price formation across the market, spreads could widen, search costs could rise and certain groups of investors (such as retail investors) lacking the capacity to access prices across a wider range of trading platforms could be disadvantaged.
- **Transparency.** ATSs might lack transparency (including timely display of orders, market depth and last trade reporting). This has the potential, in the market they support, to inhibit the price discovery process and to create unfair informational advantages.
- **Monitoring.** One of the defining characteristics of exchange-based regulated markets is that trading is subject to a high degree of real-time monitoring by the exchanges, in addition to any monitoring and intervention by the competent authorities. However, if trading in exchange-based instruments were to migrate to ATSs the ability of the exchange to monitor trading activity would be diminished. The ATSs might not be able (for example, because of inappropriate record-keeping arrangements) or willing to step into the breach. This has implications for the effective deterrence and policing of market abuse.
- **Enforcement.** An ATS might be unable or unwilling to set, and enforce against participants/customers objective trading rules for its system that are designed to ensure trading is orderly and fair.
- **Access to trading.** ATSs might allow access to trading by participants who are not fit and proper, or who lack sufficient trading ability, capital adequacy or competence to support the orderly transaction of business through the ATS.
- **Admission to trading.** ATSs might admit securities in which there is not a proper market. (A proper market in a security is, broadly, a market in which there is sufficient information relating to the issuer to enable investors to value the security; and in a derivative, a derivative structure that lends itself to orderly trading.).
- **Systems.** There is a danger that ATS systems, on which the markets might come to rely, might not meet adequate standards of reliability and integrity and thereby pose operational risks to market users (for example, because technical access arrangements are inadequate to support the orderly transaction of business through the system).

49. Finally, risks identified to the objective of *reducing systemic risk* were.
- Performance of transactions. There might not be adequate arrangements for performance of transactions processed through ATS systems. In other words, an ATS operator might organise trading and settlement in a way that increases counterparty risk.
 - Financial resources. An ATS might not maintain adequate financial resources either to mitigate its own risks (particularly relevant to ATSs which have a central counterparty role), or to ensure an orderly wind down and closure of the system, should that become necessary. Systemic risk may also arise from the inadequate financial resources of the trading participants.
50. The extent to which the risks identified above are currently ‘real’ and might require changes to existing regulation in the European context is open to debate and will need to be discussed in more detail. Most of the risks are not new and arise in other contexts. Regulatory principles and standards already in place at the European level (for example, in the ISD and in the Standards for Regulated Markets) should be carefully examined to determine whether they adequately address those risks or whether the particular combination of risks potentially raised by ATSs requires a specific regulatory response.
51. Relevant factors to take into account as part of this process might include:
- The market/systemic significance of an ATS.
 - The type of investment traded through the ATS, including whether organised central markets for that investment type already predominate (as in the case of most listed equities) or not (as in the case of most fixed income products, such as bonds).
 - The type of participants in the market for that investment (there are more likely to be regulatory concerns where retail participation is significant).
52. From amongst the ‘existing risks’ group, the information gathering exercise singled out transparency as a particularly complex issue. Accepted standards of transparency vary between different market sectors. The equity markets have traditionally operated with high levels of transparency. In these markets, some ATSs (for example, ‘price taking’ crossing networks such as Posit and E-Crossnet) have attracted business because their transparency arrangements (lack of pre-trade transparency) are designed to reduce the market impact of large trades. These ATSs are seen as providing a valuable service to the markets, but at the same time participants acknowledge the danger, should such ATSs attract sufficient liquidity, of order-interaction and price discovery being undermined in the market centres from which they feed. By contrast, fixed income markets have not traditionally operated with high levels of transparency. In these markets, increased transparency – at least amongst a specific user group – is seen as a benefit of ATSs.
53. Although most of the issues associated with ATSs fall within the ‘existing risks’ category, the Experts Group has identified a set of risks that it might not be possible to address by adapting existing regulatory principles and standards. These are the risks associated with market fragmentation, specifically:

- overall market efficiency being impaired as liquidity starts to spread across separate, non-interactive, execution venues;
 - 'best execution', as traditionally defined, becoming difficult to achieve (see also paragraph 68); and
 - the ability to monitor overall trading in the market for an investment instrument being impaired, with implications for effective deterrence and policing of market abuse.
54. These risks are not necessarily unique to ATs. There are competing exchanges in some domestic markets (for example, in the UK, where Tradepoint is a direct competitor to the London Stock Exchange). At the European level they might also be associated with competition between domestic exchanges to establish pan-European trading venues.
55. At this stage it is difficult to judge whether market fragmentation will in practice become a sufficiently serious issue (either as a result of ATs or inter-exchange competition) to require legislative or regulatory intervention at the European level (for example to establish a pan-European consolidated tape, or virtual limit order-book). The information gathering exercise indicated that many observers believe that any market fragmentation, even if it does reach serious levels, will be only a temporary phase, and that market-based remedies would quickly arise. Technology already provides the means to re-unite fragmented markets through the aggregation of information from a wide variety of sources. Ultimately, the quest for liquidity could drive the industry either to converge on a centralised exchange model, or become a fully-decentralised electronic web in which all market participants interconnect within an open structure. Should this prove to be the case, risks to market efficiency, best execution and market monitoring might – at least in part - be mitigated. But the US experience has demonstrated that integration to a level that fully mitigates risks associated with fragmentation can be difficult to achieve in practice and that at some point regulatory intervention may be needed.
56. The options for what might constitute, overall, an appropriate legislative and/or regulatory response to ATs in Europe are discussed in the next section. The information gathering exercise highlighted the importance to market participants that, in considering these options, both FESCO and the European Commission take adequate account of the need not to hinder financial innovation or limit competition in the supply of financial products and services. Two themes in particular emerged.
- Level playing field. As a fair basis for competition, established providers of trading services (the exchanges) advocated a levelling of the playing field between themselves and the emerging ATs. One way to do this would be to apply the FESCO standards for regulated markets to all ATs. Alternatively - a view of some exchanges – the playing field could be levelled by lowering some of the regulatory costs on exchanges, as the SEC has done in the US. A regulatory approach more sharply focused on specific functionality might achieve a similar result.

- Consistent approach across Europe. There is concern in the market that the current approach of European regulators towards ATs is not consistent, and that this may hinder the development of a European capital market, inhibit innovation and restrict the ability of ATs to compete effectively.

5. OPTIONS FOR RESPONDING TO THE ISSUES

57. This section focuses on the broad lines of regulatory options for responding to the issues set out in Section 4 and the potential implications of each regulatory course in terms of the kind of changes that might be required to the ISD. In the time available before the deadline for submissions to the Commission the experts group has outlined four main options:

I. Maintaining the status quo

II. Development of a specific, tailored ATs regime in addition to the investment firm and regulated markets regimes, implying the need for legislative underpinning through changes to the ISD.

III. Development of incremental regulation for ATs operating as investment firms, on the basis of standards agreed among FESCO members and within present ISD framework, subject only to some clarification of the relevant definitions

IV. Replacement of the current “regulated market” regime by a “trading system regime” based on an analysis of the functions performed by trading systems of different kinds and the risks attached to each, implying the need for substantial rethinking of the ISD.

58. It should be noted that these options are not mutually exclusive. Option 3 could be adapted relatively quickly, through administrative actions by FESCO members, pending the outcome of a wider review of the ISD.

OPTION 1: STATUS QUO

59. The status quo approach could be defended on the basis that, at this point, the future evolution of market structure in the EEA remains unclear and that ATs currently account for only a very small share (compared with the US) of those markets. That is certainly the case in equity markets in which the potential risks to market integrity are greatest. It might therefore seem reasonable to defer any regulatory change or action and reconsider the issue in the light of further market development in, say, 12 to 18 months' time.

60. This would, however, leave a number of unresolved issues on the table. These include:



- The current differences in member state approaches to the regulation of ATSS;
- Market concern about the lack of regulatory clarity and consistency ;
- A potentially unlevel playing field between exchanges/regulated markets and ATSS;

Therefore FESCO members agree that the status quo is not the preferred option, even in the near future. Some rationalisation and harmonisation of the approaches taken in different member states seems to be required, at least.

OPTION 2: THE INTRODUCTION OF A SELF- STANDING ATS REGIME

61. This option would result in the creation of a new regulatory 'box' for ATSS, based on a definition of ATS functions and/or a size threshold. Such a regime would be in addition to the present regimes for regulated markets and investment firms. As such, it would almost certainly need to be separately categorised in the ISD, with passporting of the ATS service made conditional on appropriate authorisation and compliance with the associated regulatory requirements.
62. In the EU, many member states cater for some degree of choice of regulatory regime for operators of trading systems and the principal issue is more one of whether the regulatory balance between those choices is appropriate. So long as it is considered desirable to permit firms a degree of choice, the question arises as to whether any incremental adjustments to the regulation of ATSS can justify the creation of a self-standing regime.
63. Our information gathering exercise, for instance, indicated that market participants in general do not view the development of a new category of ATS regulation as the preferred approach to developing the regulatory structure in the EEA. The concerns that led to the regulation of ATSS as a unique class of entities in the US do not, in their view, exist in Europe. Creating a separate regulatory regime for ATSS in Europe could introduce unnecessary complexities and, potentially, new disparities in regulation. This critical approach by the industry, partly based on experiences with the US system, corresponds with the concerns expressed by some leading market participants during the SEC consultation on ATSS. The general comment in 1997 was that to the extent that changes in the regulatory approach to ATSS were necessary, such changes would best be adopted under a system of enhanced broker-dealer regulation.¹⁰
64. While a self-standing ATS categorisation of firms has a superficial attraction of clarity, it raises a number of questions concerning:
 - Potential difficulties in the method of measuring any carve-outs, or carve-ins, by size ;
 - Potential inflexibility at a time of continuing market evolution;

¹⁰ - (File No.S7-16-97, Release No. 34-38672) Securities Industry Association (SIA) to the SEC, October 1997.
-(Idem) The National Association of Securities Dealers (NASD) to the SEC , October 10, 1997
-(Idem) The Pacific Exchange Inc. (PCX) to the SEC, October 20, 1997

- the incentive for firms, as a result of the increase in regulatory ‘boxes’ to modify their business structures to minimise regulation;
- A size-based definition would not take into account investor protection. Small ATSs which deliver only niche services might not be covered by such a definition although the representative investors do need the same level of protection as they do when dealing via an ATS with substantial trading volume.
- The potential benefits of such a regime compared to the costs of establishing and operating it, in itself and compared with other options. FESCO recognises, of course, that any action it proposes for the introduction of regulatory requirements it considers appropriate to ATS activities will require a definition of ATS. At this point, however, it has significant reservations about proceeding down a road that is likely to prove inappropriately rigid

65. Against the background of the issues set out above, the view of FESCO members is, therefore, that a separate ATS regime would not offer the optimum solution for the regulation of ATS in the European framework.

OPTION 3: additional regulatory requirements for ATSs operating as investment firms

66. This option would involve agreement by FESCO members on any requirements they consider it necessary for the competent domestic authorities for the authorization and supervision of investment firms to impose on firms operating an ATS. This approach has the attraction, at a time of relatively limited ATS activity and continuing market evolution, of potentially accommodating a reasonably flexible and pragmatic approach. The information gathering exercise indicated that market participants considered that the objectives both of the industry and European market regulation would be best served by such an approach. Moreover, because it would not require any change to the ISD (it should, as discussed further below, be possible to address most ATS issues on the basis of Articles 10 and 11 of the directive), it is an approach capable of being implemented within a relatively short period of time.

67. While FESCO members consider this option as potentially the most practical near-term approach to addressing the regulatory issues raised by ATSs in Europe, they also consider that this approach might be considered as a first step and that option 4 (replacement of the “regulated market” regime by “a trading system regime”, implying the need for substantial rethinking of the ISD) could be considered as a sequential step for the longer term if the ISD were to be amended.

68. Moreover, the basis for the proposed near-term approach is predicated on two key assumptions. The first is that the present ISD definitions on investment services (as set out in Section A of the Annex to the directive, and expanded on in the 13th recital), although drawn up in a period with a different technological environment and therefore mainly directed to investment firms as broker-dealer, satisfactorily embrace the definition of ATS as set out in paragraph 11 of this paper. On this issue further legal clarification may be required, but, having consulted with Commission staff, members of the experts group are confident that

ATs can, in principle, be authorised as investment firms. The second assumption is that all FESCO members have sufficient domestic powers to implement any standards or recommendations that FESCO may agree as appropriate for ATs.

69. If these two assumptions prove to be well founded, and the experts group believes them to be, an appropriate starting point is to analyse the extent to which it might be possible to address the risks identified in paragraphs 47-49 by elaborating – for ATs - on the high level standards for investment firms set out in Articles 10 and 11 of the ISD. Such elaboration, should it be considered necessary (which might depend on the market significant of the ATs, the types of investments traded and the nature of its participants) could be based on relevant provisions from the FESCO standards for regulated markets. For each of the risks set out in paragraphs 47-49, the following three matrices identify the extent to which Articles 10 and 11 might provide an underpin, and which of the standards for regulated markets might be used as a basis for their elaboration:

1. Coverage of investor protection risks

Issue	ISD requirements for investment firms	FESCO Regulated Markets standards
Access to trading (i.e. structure should enable access to best prices for size and type of trade)	Article 10, indent 5 (firm to organise affairs to avoid prejudicing client interests through conflicts of interest) Article 11.1, indents 2 and 6 (firm to act in best interests of clients and integrity of the market, and to avoid conflicts of interest and treat clients fairly)	Standard 7, bullet 2 (trading process should enable users to obtain best price available for a trade, taking into account type of trading system and size of trade)
Best execution	Article 11.1, indent 2 (firm to act with due skill, care and diligence in best interests of client and market integrity)	-
Conflicts of interests	Article 10, indent 5 Article 11.1, indents 2 and 6	-

2. Coverage of market integrity risks

Issue	ISD requirements for investment firms	FESCO Regulated Markets standards
Fragmentation	-	Nothing specific, but

		Standard 7 transparency requirements should reduce the impact of fragmentation
Transparency	Article 11.1, indent 5 (firm to make adequate disclosure of relevant material information in its dealings with clients)	Standard 7 (must ensure adequate (normally real-time) pre and post trade transparency)
Monitoring	Article 10 , indent 4 (firm to keep adequate records of transactions executed) Article 11.1, indent 3 (firm to have effective resources and procedures for proper performance of its activities)	Standards 10 and 12 (must ensure adequate records to monitor rules, and must be ready and willing to share information and co-operate with other regulators)
Enforcement	-	Standard 7 (must have rules and/or procedures designed to ensure fair and orderly markets) Standard 11 (must have fair and effective arrangements for enforcing rules)
Access to trading	Article 11.1, indent 3 (firm to have effective resources and procedures for proper performance of is activities) Article 11.1, indent 4 (firm must seek information from clients information regarding financial position, investment experience and objectives re. Services being provided)	Standard 13, 14 and 15 (must ensure participants are fit and proper, competent, have sufficient resources, and have controls in place that will not jeopardise either integrity or orderly operation of market)
Admission to trading	Article 11.1, indent 2 (firm to act with due skill, care and diligence in best interests of client and market integrity) Article 11.1, indent 3 (firm to have effective resources and procedures for proper performance of is activities)	Standards 16, 17, 18 ,19 (must only admit to trading securities in which there is a proper market, and must have arrangements where admission criteria are no longer met)
Systems	Article 10, indent 1 (firm to have sound control and safeguard arrangements for electronic data processing) Article 11.1, indent 3 (firm to have effective resources and procedures for proper performance of is activities)	Standard 4 (IT systems must deliver high standards of reliability and minimise operational risks to market and market users) Standards 13 and 14 (technical access arrangements must not jeopardise security, integrity or orderliness of the market)

3. Coverage of systemic risks

Issue	ISD requirements for investment firms	FESCO Regulated Markets standards
Performance of transactions	Article 11.1, indent 2 (firm to act with due skill, care and diligence in best interests of client and market integrity)	Standards 8 and 9 (must ensure clearing and settlement arrangements are adequate, robust, minimise participant risk and allow for settlement in as short a timeframe as possible)
Financial resources	Nothing in the ISD, other than perhaps Article 11.1, indent 3 (firm to have effective resources and procedures for proper performance of its activities), but Capital Adequacy Directive requirements would apply	Standard 5 (financial resources must be adequate to address risks to which market exposed and to ensure orderly closure could be achieved)

70. This analysis shows that it should be possible to use Articles 10 and 11 as an underpin for mitigating most of the risks identified in paragraphs 47-49, and it shows which of the FESCO standards for regulated markets could be drawn on for this purpose. However, the regulated market standards as currently drafted represent an appropriate benchmark for exchange trading systems. It may be inappropriate to attempt to translate certain standards, in particular those relating to enforcement, to ATs generally, or to translate some of the other standards to ATs operating predominantly in wholesale products with professional customers in circumstances where there is no private investor involvement.

71. The expert group considers it likely that most of the investor protection issues associated with ATs will already be addressed by existing elaborations of Articles 10 and 11. Most of the gaps are likely to be in the area of market integrity. FESCO members therefore consider that regulation should focus on the following areas in considering any recommendation of specific measures for ATs:

- Authorization/registration: the investment firm running 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.
- Transparency: while FESCO recognizes that the appropriate transparency arrangements may need to differ according to the nature of trading system, it also considers that ATs should comply with minimum transparency requirements: on ownership, possible risks involved, pre trade transparency (real time disclosure of the best bid and ask prices and the size of possible

transactions at those prices), post trade transparency (disclosure of price and volume of completed transactions) High levels of transparency are desirable and should be achieved.

- Reporting rules: additional reporting requirements should be imposed on ATSS to enable competent authorities to monitor the ATSS market share, its compliance with market integrity and conduct of business rule and any changes to the information notified at authorisation/registration
- Prevention of market abuse: requirements placed on ATSS should make it possible to enforce detect, deter and punish market abuses (e.g. insider trading, price manipulation) in the same way as is currently the case for a regulated market.

72. Some of these additional measures might require adjustments to conduct of business rules. Currently another FESCO group is working on the standards for harmonisation of these rules (implementation of article 11 of the ISD).
73. One area in which co-ordination with this FESCO group is particularly likely to be important is in relation to the 'best execution' rule. According to their current draft standard, investment firms "must obtain the best possible result for the customer with reference to the time, size and nature of the transactions, taking into account the state of the relevant market" . Regulators will need to consider how this should apply to ATSS, in the context of instruments traded on competing trading platforms and those for which the ATS is the sole platform provider.
74. Where instruments are traded on multiple platforms, regulators will also need to consider whether each such platform provides adequate consolidation of data to facilitate best execution and to support fair and efficient trading.

OPTION 4 : Replacement of the “regulated market” regime by “a trading system regime”

75. This option would involve a fundamental shift towards a broader ‘trading system’ regime. It would open up the possibilities of achieving greater regulatory consistency for similar functionality, allowing more specific tailoring of regulation to specific risks and giving market service providers more flexibility in the activities for which they sought licences. This type of regime would cover the activities of exchanges, ATSS and, potentially, other trading systems.
76. Such a change in approach would require significant changes to the ISD. These might well need to be more radical than a re-characterisation of the ‘regulated markets’ regime. Although such a project would need considerable time to put in place, it has the benefit of enabling regulators to start with a largely blank sheet of paper to model a regime that would have the flexibility both to facilitate and respond to continuing market development.

CONCLUSIONS



77. On the basis of the analysis in this paper, the experts group considers that the appropriate short-term solution would be based on Option 3. The additional requirements to be imposed on ATs need further consideration and elaboration, and we will need to consult market participants. FESCO now plans to undertake this further work.
78. But that work does not preclude a more comprehensive review of the ISD which would of course cover issues other than the appropriate regime for ATs. Depending on the nature of the Commission's proposed green paper on the ISD, FESCO members will undertake further work on these issues in due course.

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