WILMER, CUTLER & PICKERING

# EU Financial Services Group Briefing

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## YOU CAN'T SAY YOU WEREN'T WARNED! CP 153 - ALTERNATIVE TRADING SYSTEMS

*GOING BEYOND THE STANDARDS*

In October 2002 the FSA released CP 153, setting out its proposals for the regulation of Alternative Trading Systems ("ATSs").[1] This followed the release by CESR of its final paper[2] proposing Standards for the regulation of ATSs in July and articulates how the FSA proposes to implement at national level the recommendations of CESR in this area, pending full scale revision of the ISD, the latest version of which has just been released. The FSA has requested responses to consultation by 31 January 2003.

The purpose of this paper is to review and comment on CP153 and, in particular, the approach being taken by FSA to imposing a new and potentially onerous regime on a category of service providers who are currently regulated with a light touch in this particular area of their activities. The paper questions the risks for regulated firms resulting from a lack in rule making precision and also raises a material jurisdictional question as to the true extent of the FSA's rule making powers and its ability to override by rule making duties owed to third parties.

### 1. Background

#### 1.1 The CESR Standards Paper

The CESR Paper set out seven Standards and three conduct of business comments (to guide variations to COB Rules in particular jurisdictions).

The CESR Standards were the result of work commissioned by FESCO, commenced in 1999, and represented the result of two processes of consultation and numerous meetings with interested parties. The CESR Standards have also been commented on by the Commission.

Right from the start, CESR has adopted an expansive view of how ATSs should be regulated. Put at its simplest, CESR seems to regard ATSs as de facto exchanges and has determined to regulate them as such. It produced as justification for this approach the perceived potentials for ATS to destabilise markets and

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1 A regulatory definition of an "ATS" is set out in prargraph 1.3 below.

2 CESR - Standards for Alternative Trading Systems, July 2002, Ref: CESR/02-086b.

trading and the lack of transparency with alleged impact on the process of price formation, but did not adduce tangible evidence for the proposition that the current level and style of regulation had created or perpetuated threats to market stability or orderly operation of markets.[3]

CESR's initial paper received a hostile response from some market participants. It was referred to by one as a "protectionist knee jerk reaction," possibly motivated to protect traditional exchanges from new, high technology start ups.[4]

CESR has done little to answer the fundamental question of why ATSs should be regulated as exchanges. It certainly doesn't seem to be taking the opportunity taken by the SEC when it introduced ATS specific regulation (which CESR itself identified in its 2000 paper) of reducing the level of regulation of exchanges to create a common middle ground. Even though the FSA's own statistics show that the great majority of equity and bond trading is still on-exchange, it has simply restated its proposition that there are regulatory risks "potentially posed" by ATSs and set those against "potential benefits[5]" for consumers from increased regulation.

Having adopted this position, CESR has framed its standard to ensure that system users (e.g. participants, rather than "end clients") are adequately protected and that the integrity of the market is protected. However, because CESR has not identified any specific ills caused by the current modes of regulation in relation to which it could expressly create specific and precise rules, its standards are either couched in the language used in regulating exchanges or are imprecise and relatively subjective.

It sought to achieve its objective by specifying standards in four areas:

- Notification to regulators (of the system, price formation mechanics, clearing and settlement and the types of instrument to be traded);
- Transparency (which CESR recognised could vary depending on the market);
- Reporting rules (to enable monitoring by regulators);
- Prevention of market abuse.

CESR also stated that it proposed its standards should only be applied to ATSs which provide a trading service in relation to instruments listed in Schedule B to the Annex to the ISD.[6]

Showing some response to comments made during the consultation process, CESR stressed that its standards should not unnecessarily hinder financial innovation or competition in financial markets (one might identify an English author writing with a view to Section 2(3) of the Financial Services and Markets Act 2000!). CESR was also at pains to recognise that ATSs should be regulated in a differentiated way depending on various factors (including, in particular, the extent to which users were exclusively market professionals). In this context, CESR expressly refers to "users" of qualifying systems (to distinguish them from "clients" who will generally be "clients" or customers of the "user").

However, notwithstanding this statement, CESR also left it open to Home State Regulators to make tighter rules and to expand the scope of coverage to ATSs dealing in a larger range of investments than those

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[3] CESR - The Regulation of Alternative Trading Systems, September 2000, Ref: Fesco/00-064c. Throughout Paris 47, 48 and 49 in which CESR lists potential problems with ATSs, the word used to describe the incidence (or otherwise) of problems is "might". CESR left it open as to whether the risks are "real" (*see* Para 50) and said the issues should be discussed in more detail. We are not aware that they have been. Accordingly we appear to have a structure of regulation based on a drive to meet hypothetical, rather than actual risks - which must be questioned.

[4] *See e.g.* International Financial Review Oct 2000 for critical comment.

[5] CESR July 2002 op cit, par 4.

[6] Transferable securities, units in CISs; money market instruments; financial futures; forward interest rate agreements; interest rate, currency and equity swaps; options to acquire or dispose of any of the above.

within Schedule B to the Annex.[7] The FSA has taken up this invitation.

### 1.2 The FSA approach

The FSA has had regulating ATSs on its agenda from the outset. On 13th June 2000, the day after FSMA got royal assent, Howard Davies discussed ATSs and the impact they were having on exchanges and the fact that he had submitted papers to CESR on the topic of regulating them earlier that month. Regulation of ATSs has been a regular theme in his speeches since then.[8]

Accordingly, the relative shortness of the lead-time between the issue by CESR of its standards and the FSA's own issue of CP 153 should be no surprise. Howard Davies was chairman of the CESR Experts Group responsible for the Standards and has taken an active personal interest in the regulation of ATSs. FSA has clearly played a major part in determining the shape of the CESR Standards.

The FSA has adopted the CESR Standards with little relaxation and, in some areas, a marked extension of what CESR has proposed.

The FSA has followed the general CESR discussion in its approach to regulating ATSs, focusing on three different aspects:

- Issues relating to authorisation of ATSs - in effect determining the "authorisation criteria" which will need to be complied with before an authorised person will be permitted to operate an ATS platform;

- Issues relating to trading on an ATS - requiring (or rather imposing) transaction transparency reporting requirements, monitoring and reporting of trading; and

- Issues relating to the relationship between the operator of an ATS and its users and, in particular, stipulating proposals for the provision of information to users relating to the system itself and the securities traded on it.

The FSA has also taken the view that ATSs should be regarded as most closely parallel to regulated exchanges and should be regulated on the same basis. The FSA has rejected the alternative position which would have left regulation of ATS operators aligned with that of voice brokers who often represent their major competitors and who, in many products, provide the closest alternative trading facility.

The FSA justifies its approach to altering the way in which ATSs are regulated principally by reference to the "market confidence" and "consumer protection" and "reduction of financial crime" objectives imposed on it by the Financial Services and Markets Act 2000. However, just as CESR presented its appreciation of the threats posed by ATSs as "potential," in CP 153 there are references to "possible risks" rather than to any actual risks. This is presented as a fully self justifying proposition by FSA . The assertion has not been supported in CP 153 (either directly or by cross reference) by empirical evidence that the current mode of regulation creates threats to either[9] and though, as mentioned above, their own evidence shows the great bulk of securities trading is on RIEs.

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7 *See* CESR 2002 Paper, para 17. One hesitates to suggest this paragraph was suggested by FSA itself.

8 *See e.g.* to Federation of European Stock Exchange 31 May 2002, to Bond Market Association 26 October 2000, to the London Chamber of Commerce, 13th June 2000.

9 CP 153, Introduction, Paras 2.3 and 2.4. Indeed one can quite plausibly argue that the two justifications cited to demonstrate a possible risk under the head of "consumer protection" are misconceived - the first because it displaces the responsibility for obtaining best execution for private customers from the intermediary dealing on the ATS on behalf of a customer to the ATS service provider, the second because it ignores the fact that the great majority of ATS users are market professionals who are assumed competent to make their own investment decisions and that the environment within which such ATSs operate is a professionals' one - *see* IPC 3.4.2 G. *See* IPC 3.4.3 G and 3.4.4 G on the information obligations between market counterparties. *See* also, particularly for professionals, FISMA 2000, s5(2)(d) - the general rule that consumers should take responsibility for their decisions.

Whilst recognising that the proposed changes "would impose some costs on ATSs," the FSA states it considers those costs to be manageable and would not put ATSs at a commercial disadvantage. Without expanding on why, it also states it foresees significant benefits and that those benefits will outweigh the costs of implementation.[10]

### 1.3 Who is covered?

In terms of scope, FSA has gone wider than CESR. It is intent on extending the net of rigorous regulation to cover not only ATSs operating in the equity and government debt markets, but also ATSs which facilitate trading in repo and FX markets and in the commodity and energy derivative markets. The CP doesn't reflect (because it came out before it) the last revision of the ISD and its exemption of mainstream commodities derivatives traders. In adopting this approach FSA has cast its net wider than any other European regulator and, according to its own data, wider than any other regulator in the world (with the possible exception of CFTC in the US).

The FSA does not provide a specific reason for covering ATSs providing trading facilities in instruments other than ISD investments, other than to say that it believes them to present similar levels of risk and "it sees no good reason to exclude such ATSs [e.g. particularly ones trading in commodity derivatives] from the Standards." It states its costs benefit analysis supports this conclusion. The cost benefit analysis has not, however, been externally benchmarked and one has to question what empirical justification for FSA's position it actually provides.

FSA proposes to regulate service companies, conventional securities firms, OMPs and EMPs who provide ATS facilities in relation to the way in which such firms provide those facilities. It is not proposing to alter the manner in which RIEs are regulated.

With regard to what constitutes providing an ATS service, FSA has adopted the CESR definition. This provides[11] that an ATS is:

> "A system which brings together multiple buying and selling interests in designated investments (other than life policies or stakeholder pension schemes or rights to or interests in life policies or stakeholder pension schemes), in the system and according to non-discretionary rules set by the system's operator in a way that results in a contract, but does not include:
>
> (a) a system which is operated by an RIE or that is a regulated market or an EEA commodities market; or
> (b) a bilateral system."

The definition is left quite open ended thereafter.

### 1.4 How is regulation to be effected?

In CP 153 FSA considered a variety of means of implementation of the CESR Standards. It has presented proposed Rules and also, as an alternative, implementation by variation of the Part IV permission process (which may give it greater flexibility in actual imposition on regulated entities). The substantive text is, though, very much the same. FSA rejected implementation by way of guidance only.

### 1.5 Relationship with ISD Revisions

FSA recognises that revisions of the ISD may impact its proposals. It has addressed this by preempting in certain cases what it anticipates ISD revisions will do. In particular (and again, without substantive justification) it has imposed transparency standards on ATSs that go considerably further than the CESR Standards but which reflect recent FSA thinking

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[10] One has to question the cost benefit analysis estimation of compliance with *e.g.* the reporting requirements referred to below. Certain assumptions as to the costs of system changes are made which may be open to challenge as material underestimates of the actual costs of compliance.

[11] FSA draft glossary amendment.

on ISD transparency. It is worth noting that, in expanding its coverage to include ATSs providing services for commodity contracts, it is going further than the ISD on its latest round, which has excluded commodities traders from regulation under ISD.

## 2. The Proposals in Detail

In this section we look at the individual CESR Standards and the related proposed FSA Draft Rules or other response. We have set out next to each Standard the new Handbook Rule (also without Guidance or unless necessary the related Evidential Provisions). We also comment on FSA's proposals and, in particular, where FSA has diverged from the relative Standard.

### 2.1 CESR Standard 1: Notifications

"Investment firms should be required by their home state regulatory authority to notify the establishment of a qualifying system [*the CESR phrase for an ATS*]. 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."

**FSA Draft Rule:** No specific new rule required. General reliance on information obligations contained in the Handbook and new Guidance in MAR.[12]

This proposal is, of all of them, the least controversial. It appears perfectly reasonable for FSA to be notified not only of the fact of an ATS but also of key features of its operation and changes thereto. The cost impact on regulated firms is nugatory and it permits the FSA to remain aware of the evolution of the larger market that it is responsible for supervising.

### 2.2 CESR Standard 2: Fair and orderly trading

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

**FSA Draft Rules:**

***MAR 5.4.1 R***

An ATS operator must have appropriate arrangements in place to ensure that trading on the system is conducted in a fair and orderly manner.

***MAR 5.4.1 E***

(1) An ATS operator should have appropriate arrangements in place designed to ensure:

(a) efficient pricing and the equitable treatment of direct users;

(b) a trading methodology that is fair and orderly and that enables direct users to obtain the best price available on the system at the time for their size and type of trade and taking into account users' willingness to trade with each other;

(c) sufficient information about quotes, orders and completed transactions is made available to direct users.

(2) In (1), "appropriate" means appropriate having regard to the nature of the system, the nature of the investments traded on the system, the experience of users, the extent to which the wider market for the particular investment involves private customers, the susceptibility of

[12] The Systems form in the application package, AUTH 3.9.13 for new applicants, SUP 6.3 and SUP 15.3.8 G for persons already holding a permission. New MAR 5.3.3. G on when an obligation to notify under SUP would be triggered.

the investment traded to market abuse and the significance of the system in the overall market for the investment.

The draft FSA rules also set out evidential presumptions.[13]

This draft rule raises a number of issues for regulated firms. The key issue (apart from the very real difficulty of knowing, with such a high level of generality in drafting, of whether or not the rule has been complied with when a particular system is put up for a compliance assessment) is how a regulated firm is properly going to know what factors it should take into account in determining what is "appropriate" within (2). The language is highly subjective and non-specific, which for an evidential rule is not helpful as a clear guide to compliance.

While it is perfectly reasonable for FSA to require management of a regulated firm (being a regulated but commercial enterprise) to have regard to what is appropriate in relation to the nature of the system, the nature of investments traded on it and the experience of users, all of these being matters under both managements direct control and within its competence, it is much less reasonable to require management to have regard to the extent to which the wider market involves private investors, the susceptibility of the investment to market abuse and the importance of management's system within the wider scheme of things.

These latter concerns are concerns for the regulator and are not obviously matters which an ATS operator can cater for.

For example, if private customers are not permitted to be system users but, say, only market counterparties, what should management of the enterprise do, according to this rule, if there may be private customers for the investment in the wider market? Does this amount to an indirect and non-specific requirement that the ATS should have complete transparency so that trades that take place in it can be compared by private customers with trades taking place on other venues (even if size, price and other factors are different)? The enterprise's concern is to provide a safe and efficient market for the market counterparties to trade. It should not, without creating possible conflicts or possibly reducing the efficiency (and hence the commercial attractiveness of its service) be forced to consider matters which are extraneous to its commercial purpose. These matters should be for the users of its service.

Similarly, what judgement is required in relation to "the significance of the system in the overall market for the investment." A platform might be the only platform on which a particular contract is traded. This would make it highly significant for that particular investment. Yet the contract could be a minor one, without much larger systemic significance. Again, this is an area for FSA to form a view, as regulator (and if it has concerns, to address them with precise requirements), rather than to impose an undefined obligation on regulated entities without guidance as to how to interpret that obligation.

### 2.3 CESR Standard 3: Publication of trading information

"An investment firm operating a qualifying system providing trading in an investment 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."

**FSA Draft Rule:**

***MAR 5.4.5 R***

(1) This paragraph applies in relation to investments traded on an ATS only if those investments are also traded on a UK RIE, a regulated market or an EEA commodities market.

[13] MAR 5.4.1 (3) Compliance with (1) may be relied on as tending to establish compliance with MAR 5.4.1R.
(4) Contravention of (1) may be relied on as tending to establish contravention of MAR 5.4.1R.

(2) An ATS operator must have appropriate arrangements in place to make publicly available:

(a) information about quotes or orders or both relating to investments traded on the ATS that the ATS displays or advertises to direct users; and

(b) information about completed transactions for investments traded on the ATS that the ATS makes available to direct users.

(3) In (2) "appropriate" means appropriate having regard to the nature of the ATS, the nature and liquidity of investments traded on the system, market conditions and the scale of transactions, the need (where appropriate) to preserve the anonymity of users, and the needs of different market participants for timely information.

This draft rule differs from the CESR Standard and imposes a greater burden than CESR contemplated. Firstly, because FSA is applying its principles of regulating ATSs to ATSs providing trading services for commodity contracts where those contracts are also traded on an EEA commodity exchange, it will be applied to a larger class of operators than CESR contemplated (although, as remarked above, CESR left it open to home state regulators to take this option).

Secondly, CESR admits that ATS operators might be entitled to a reasonable commercial return for the provision of trading data. The FSA has not, in its rule, provided for ATSs operators to have the right to receive a commercial return for the information they furnish - perhaps as a means of recouping the necessary system spend, to say nothing of recognising the intrinsic value of the data. Under the FSA rule, the obligation to furnish data is not qualified by any quid pro quo. The FSA does not mention in its commentary this potentially significant variation from the CESR Standard.

In general, this draft rule would appear to be a further tool to aid FSA's drive for greater market transparency.

### 2.4 CESR Standard 4: Monitoring

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

**FSA Draft Rule:**

***MAR 5.4.10R***

(1) An ATS Operator must have arrangements in place that enable the ATS operator to:

(a) monitor adequately compliance by a direct user with contractual rules;

(b) take action against a direct user if there is non-compliance with contractual rules, for example, by terminating the direct user's access to the system.[14]

While the draft rule is not, per se, objectionable, the particular definition of the word "adequate" given as an aid to interpretation by FSA is.

As with the definition of "appropriate" in MAR 5.4.1 (see 2.2. above), FSA requires regulated firms, in determining what amounts to satisfactory arrangements for monitoring contractual compliance by system users, to have regard to "the extent to which the wider market for the particular investment involves private customers, the susceptibility of the investment traded to market abuse and the significance of the system in the overall market for the investment." The language is a straight repeat of the earlier text.

The terms of admission to the system and usage embodied in the access agreement between the user and the ATS operator must be sensible (and relate to the service provided). Such agreements would normally

[14] Adequate means "adequate having regard to the nature of the ATS, the nature of investments traded on the system, the experience of users, the extent to which the wider market for the particular investment involves private customers, the susceptibility of the investment traded to market abuse and the significance of the system in the overall market for the investment." MAR 5.4.10 R (3)

be highly technical, with a significant IT bias. They would also contain representations and warranties, breach of which would legitimately entitle the ATS operator to take sanctions against the user and compliance with which may be, in most cases, relatively easily monitored. One has to ask what type of representation could be required which would bite on the factors mentioned above, which could be effectively policed by the ATS operator. Again, an unclear provision is included which places a peculiar obligation on ATS operators which seems inappropriate to the commercial enterprise and more appropriate for the regulator, given its responsibilities. One might also ask whether a public body has jurisidiction to require a private firm to enforce its private law rights.

### 2.5 CESR 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.

**FSA Draft Rule:**

***MAR 5.4.12 R***

An ATS operator must have arrangements in place to reduce the extent to which the system may be used for a purpose connected with market abuse.

FSA is treating, effectively, ATS operators as equivalent to exchanges and imposing on them substantially the same requirements in relation to monitoring as FSA anticipates will be imposed on exchanges under the Market Abuse Directive. Apart from the threshold question of whether this is the right regulatory approach, there is implicit in this requirement a significant potential system spend, or outsourcing arrangement, that may have material cost implications. This is because the FSA's guidance requires the ATS operator to have software, either of its own or functionality supplied by a third party, to ease identification of suspicious trades or trading trends and for communication of that information "as soon as reasonably practicable to the FSA."

There is a further, potentially much more worrying aspect in this Rule for authorised persons and that lies in the proposed imposition of an obligation to report information about suspected market abuse (which is only a civil wrong, rather than a criminal one) to the FSA as soon as reasonably practicable. This obligation may create very significant potential liabilities for ATS operators to their system users for breach of duties of confidence or other fiduciary duties if information about those users and those trades is so communicated. Furthermore, it is hard to evaluate what is going to be involved in this as the FSA itself has recognised that the market abuse regime is evolving.

It is at this point that the potential problems of treating ATSs like RIEs for regulatory purposes, but imposing obligations by rule-making rather than by statute, become apparent.

Under Part XVIII of FSMA 2000, RIEs have their own recognition regime and may work together with the Authority. The Act expressly recognises that RIEs will be involved in collating market trading information and will share that with the Authority. This is directly alluded to in the context of overseas RIEs as a precondition for overseas applicants to be authorised. Once recognised an RIE has an important protection available to it in connection with communications with the FSA - under s291 FSMA, an RIE will not be liable for anything done or omitted in the discharge of the recognised body's regulatory functions unless it is shown that the act or omission was in bad faith. This means that an RIE may, being in possession of a statutory excuse, communicate information which would otherwise be client confidential to the FSA. The justification for this is that an exchange, in performing this function, is carrying out a quasi-regulatory function.

An entity providing ATS services has no such exemption to take advantage of and could, legitimately, be held to be in breach of its duties to its customers for making these communications to the FSA, or, even

worse and with even greater dangers for the ATS operator, to other organisations.[15] The FSA's Draft Rule contains no such dispensation as is set out in Part XVIII and, even if it were, one would have to question whether the FSA by rule making could override duties imposed by common law or fiduciary principles.

It is also worth noting, in passing, that the FSA does not have a general power to require, through rule making, a regulated firm to deliver up all the information it has and to breach duties of confidentiality owed to clients. This is made clear by the fact that, in the context of the FSA's use of its investigatory powers, Parliament has given individual firms an express right to retain client confidential documents unless certain narrow criteria are fulfilled. These criteria would not be fulfilled in circumstances of a general feed-back to FSA of suspicions in relation to market abuse.[16]

It is not the place in this note to consider the potential ramifications of this concern in the more general assumption by the FSA that it is entitled to know everything that a commercial regulated entity does, including about matters which are confidential as between the entity and its customers.

### 2.6 CESR 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.

**FSA Draft Rules:**

None proposed. FSA's expressed view is that current rules under SYSC, Principle 3 and the Threshold conditions for authorisation will be adequate.[17]

This does not give rise to any particular issues (other than the rather imprecise nature of the obligation).

### 2.7 CESR Standard 7: Clearing and Settlement

Investment firms operating a qualifying system should ensure that there is clarity of obligations and responsibilities for the clearing (where applicable) and settlement of transactions.

**FSA Draft Rules:**

FSA is proposing to deal with this issue in two ways, the first dependent on whether the ATS operator has private and/or intermediate customers as system users, or whether the ATS operator only has market counterparties.

For ATSs proposing to have private customers as permitted system users, FSA proposes in AUTH (3.24.1G) requiring an applicant for authorisation to demonstrate to FSA that it has clearing and settlement arrangements in place which will ensure efficient clearing and settlement. For those ATSs operators proposing to have private customers and intermediate customers as permitted system users, FSA proposes that terms of business include information relating to respective responsibilities in relation to clearing and settlement.[18]

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[15] *See* MAR 5.4.13E - where, apart from citing the litany concerning "appropriate" - *see* footnote 5 and replace the word "adequate" with the word "appropriate," the FSA is proposing to require "appropriate arrangements in place to enable system monitoring, detection of possible instances of market abuse (*e.g.* suspicious patterns of trading) and communication of information about suspected market abuse as soon as possible to FSA ***and other appropriate organisations"*** [emphasis added].

[16] In exercise of its powers, FSA has a general interrogatory power to require authorised persons to provide "specific" information or information "specified description" - *see* FiSMA Section 165 (1) and this might arguably be coupled with powers under Section 175(1). However, Section 175(5)(a) and also the various statutory instruments made in connection with the disclosure of confidential information (*e.g.* The Financial Services and Markets Act 2000 (Disclosure of Confidential Information) Regulations 2001 Statutory Instrument 2001 No 2188) make it clear that Parliament has recognised the importance of confidentiality and normally provides express powers when it is to be overriden. The tests generally require specificity if confidentiality is to be overriden by a public interest claim.

[17] SYSC 3.1.1R; SYSC 3.2.19G, Threshold condition 4 and Principle 3.

[18] COB 4.2.17E(7).

For ATSs proposing only to have market counterparties as permitted system users, FSA proposes that firms should take reasonable steps to ensure that respective roles are made clear to counterparties. Typically, FSA suggests this obligation be met by saying firms should consider complying with the COB information requirement.

Again, the proposed implementation of this principle does not appear to give rise to material issues of concern (other than the duty to ensure that customer documentation correctly, where applicable, complies with COB or MAR).

### 2.8 CESR Statements relating to the application of conduct of business rules to ATSs

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

(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 from using the system.

(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 types of instruments traded."

**FSA Response**

FSA deals with (a) and (b) together. It distinguishes between ATSs that have private customers or private and intermediate customers and those that only have market counterparties. For the former class, FSA proposes a variation to COB 4.2 (terms of business), adding a requirement to provide detailed information relating to the ATS function and relationship. The details are set out in COB 4.2.17E.[19]

For ATS operators servicing only market counterparties, FSA proposes only guidance, rather than a new rule.[20] Its suggestion is that these operators consider what of the information provided under COB 4.2.17E should also be provided to market counterparties.

For ATS operators regulated as Service Companies, Oil Market Participants or Energy Market Participants, FSA proposes to apply the relative rules which would apply to mainstream participants in relation to issues (a) and (b).

In relation to issue (c), FSA proposes:

***MAR 5.4.15 R***

(1) An ATS operator must provide, or be reasonably satisfied that users have access to, sufficient publicly available information to enable users to make a reasonably informed judgement about the value of each investment traded on the system and the risks associated with that investment;

(2) in (1) sufficient means sufficient taking into account the nature and experience of users of the system and the type of investment traded on the system.

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[19] Information to be included is as follows: - (1) how the system operates (including order handling and execution processes); (2) the regulatory status of other system users and their domicile; (3) procedures for trading errors; (4) reporting obligations of users (if any); (5) circumstances under which system access may be terminated; (6) trading procedures to be adopted in event of system malfunction; (7) arrangements for clearing and settlement; (8) if unlisted investments are traded, the fact that information on those is less than in relation to listed investments and where information may be obtained; (9) if investments fall outside the market abuse regime, that fact and the effect of the regime not applying.

[20] MAR 3.4.10 AG - *see* supra.

NB - the FSA goes on to add that if sufficient information is not already available to users in relation to an investment, an ATS operator may have to take responsibility for providing appropriate information to users or require another person, such as an issuer, to make available appropriate information to users.[19]

There are a number of points which should be noted with these proposed solutions. The first is the FSA's proposed definition of "user"-- being the class of person whom ATS operators have to consider when determining whether there is sufficient information available. A "user" includes not only the "direct user" with whom the ATS operator has a contractual relationship, but also that direct user's client -- being the person for whom the direct user is acting when he uses the system. Under MAR 5.4.1 R, an ATS operator has to form a view about the information available relating to the contracts traded on its system available not just to counterparties trading, but also to their clients - whom it may well not know. It will not be able to assume that they are market professionals, capable of forming their own view. It will also not be able to assume that its direct users (who may well be market professionals with their own duties to the underlying client) have properly performed their duties (*e.g.* of ensuring suitability, if applicable), or otherwise to compling with COB Rules in relation to their clients and are discharging their mandates properly.

This is putting a potential burden on ATS operators which is unjustified (and, in passing, is not a burden contemplated expressly by the CESR COB suggestions or related commentary).

Secondly, one has to ask why this rule should be required if the only users are market professionals who carry out their transactions within the auspices of the Interprofessional Code. For ATS operators catering to this market, there appears to be no justification for excluding the general principle embodied in IPC 3.4 that a market counterparty need not do more than ensure its communications are clear and not misleading and that it has no duty to advise counterparties or ensure they are informed.

There are further definitional issues:

(a) what is meant by "understand any risks"? Will this require a compendious narrative of all the things that may go wrong, mandating production of "risk warnings" which go unread. Will FSA produce a "standard risk warning"?

(b) what will be required to enable users (note the wide definition) to make a reasonably informed decision as to the value of an investment traded on the system? This may be extremely difficult and require a high degree of knowledge which only a limited community may be aware of. Without guidance to confirm that "sufficient" in the case of specialist contracts traded by market counterparties in a professionals' only market place means a very minimal amount of information, this is another potentially unmanageable obligation.

Again it is possible to argue that in imposing this obligation on ATS operators, FSA is putting an ATS operator into the role of an authority which can determine the conditions for admission to trading on its system of particular instruments in circumstances where admission to trading is contingent upon the furnishing of significant amount of information on the security concerned (or the underlying investment). For ATS operators, they may be simply responding to a commercial incentive to create a contract for which they know there will be a professionals' market but no formally

[21] MAR 5.4.17 G.

issued equivalent of a prospectus or listing document - particularly in the area of financial instruments or energy or commodity contracts.

### 3. Conclusion

FSA seems to have taken CESR's Standards (for the bulk of which one may assume that it is primarily responsible) and is using them to impose a degree of regulation on a business sector which may not be justifiable by reference to external commercial scandals or business failures. In moving in this direction, FSA is treating ATS operators like regulated exchanges. This approach falls down in certain instances and, in particular, even though the FSA states it will adopt a graduated approach recognising a professional market place, it is not clear that this is the case from the proposed draft rules and it is in the context of providing trading facilities for inter-professional dealing that the parallels with exchanges are least valid.

We would urge ATS operators to respond to CP 153 before the close of the consultation period. From the perspective of entities currently operating ATSs, the FSA's proposed approach raises not only the spectre of a potentially heavy regulatory burden, but also of rules which are couched at such a high level of generality that it will be very hard to tell whether or not they have been complied with.

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