PUBLIC COMMENTS RECEIVED
ON THE
IOSCO TECHNICAL COMMITTEE CONSULTATION REPORT ENTITLED
POLICIES ON ERROR TRADE

OICU-IOSCO

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

October 2005

List of Organizations that have provided comments:

- Bolsas y Mercados Españoles (BME)
- The Brazil Stock Exchange (BOVESPA)
- Gruppo Borsa Italiana
- UBS Group

BME COMMENTS TO THE IOSCO CONSULTATION REPORT ON POLICIES ON ERROR TRADES

Bolsas y Mercados Españoles (BME) integrates the companies that direct and manage the securities markets and financial systems in Spain. It brings together, under a single activity, decision-making and coordination unit, the Spanish equity, fixed-income and derivatives markets and their clearing and settlement systems.

The BME Group is formed by Madrid, Barcelona, Bilbao and Valencia Stock Exchanges, MF Mercados Financieros (which includes the derivatives markets, MEFF and the fixed income and Public Debt markets – AIAF and SENAF –), IBERCLEAR (the securities registration, depository, clearing and settlement institution) and BME Consulting, which is focused in the areas of strategic consultancy, provision of services and exportation of the technological platforms developed by the companies of the Group.

As regards IOSCO Consultation Report on Policies on error trades, we would like to share with you some considerations from the perspective of the securities and derivatives markets managed by BME.

1. First of all, BME shares with IOSCO the importance given to an appropriate policy on error trades, considering it as one of the most important issues to be regulated by an exchange. We also consider that each exchange should find the best way to do so by itself, although it is possible and useful to establish some general recommendations for the design of policies on error trades. In this regard, each one of the recommendations contained in the Report document is very interesting.

2. The Report details successfully the main issues that have to be contained on an error trades regulation without ending up supporting a specific policy. Moreover, its objective is not to value the different policies or to recommend any of them, but a different one. We believe that this approach is helpful as there is not a policy which is better than the others, but all of them have advantages and disadvantages and it will be the philosophy of each exchange as well as the consistency with its other rules what determines the error trades policy that better fits each exchange.

3. Regarding the recommendations, we can say that the emphasis put on prevention is not enough. It is mentioned as the recommendation number 6 when it should be the first one.

   In the equity market we have volatility auctions which are informed in real time as well as static and dinamic ranges calculated according to historical volatility and liquidity for each stock. These dinamic and static ranges are updated and published on a monthly basis. In addition, there are warnings in the trading terminals of the trading system of price and volume and it is required for external applications to put in place price, volume and other filters in the order entry to gain the officially recognised homologation access.

As in the spanish equity market we trade intruments that are underlying of other derivative products calculated on real time (futures, options, and warrants on stock indexes and individual stocks) it is not possible to cancel trades disseminated on line through electronic vendor feed.

The derivatives market (MEFF), in particular, in the description of its error trades policy for the futures contracts, makes mandatory for all Members the use of price and volume filters. This obligation applies to Members that work with MEFF Terminals as well as to those that use a different software. The computer programmes of MEFF are prepared to prevent Members from sending orders if they do not have the filters set up. The regulation of the derivatives market establishes a maximum limit for the price filter specific for each product.

If all Members have their price filters set up below the upper limit, only a strong movement in the market due to a chain reaction caused by the activation of stop orders could end up, considering liquid contracts, in a chain of error trades. This scenario is in this case better delimited than it would be if Members did not use filters at all.

4. In point 2 of the Report, *comprehensiveness*, the possibility of an action by the exchange different than the cancellation: "… actions taken by the exchange that do not cancel but correct the price" is highlighted as part of the Summary of Responses. Even so, it does not seem to be reflected within the main guidelines of the document.

5. We also want to add to this reflection that, in our opinion, it is important that the error trades regulation allow the exchange to act on its own without waiting for the trader who made the error to call. Our experience, specially in options, shows that the trader does rarely find out about the error, and when he does, it is much later. It is always more difficult to apply any error trades policy two hours after the wrong deal happened than it is to apply it in the next minute. Therefore, it is necessary for the exchange to be able to apply the policy based on real time valuation tools, that calculate the fair value for each trade and detect irregularities. In any case, the fact that the exchange detects a potential error trade does not automatically mean that it is. It will be necessary to check afterwards what the fair price on the market is in order to determine whether the trade was erroneous or not.

6. The current policy of errors of the derivatives market (MEFF), although using a “no-bust” range, is based on the non-cancellation and on the price-adjustments of the erroneous trades. This policy is the result of many years of experience in applying a cancellation policy and of many years doing the opposite, combined with great emphasis on prevention. In this last case, we used to make the participants responsible for any losses caused by their lack of filters.

   Nowadays, cancelling trades is more traumatic than ever given that many futures or options trades lead to the automatic execution of trades on the underlying market, or the automatic execution in other futures or options contracts that in many cases are traded in other exchanges. If the exchange on which the error is produced decides to simply cancel the trade, the related trades would not be cancelled, leaving the trader unfairly and untimely unhedged.

On the other hand, putting all the emphasis on prevention and not cancelling any trades can cause big losses to any participant in unforeseen circumstances even if preventive measures are in place. Therefore this policy is also not efficient by itself.

From all this, we have learned that the price adjustment in the erroneous trades, outside a range, is a mid way solution and offers the best protection to the participants at the same time that it does not put in doubt the certainly of the trades, which is one of the main principles of any exchange.

BOVESPA
Brazil's Stock Exchange

Public Comment on Policies on Error Trades

The São Paulo Stock Exchange agrees with the recommendations and arguments on error trades resulting from the survey conducted by the IOSCO.

It does not remain any doubt about the importance of the stock exchanges having clear, objectives and transparent error traded policies, in order to allow that the market carries out its important role of investors' protection and maintenance of a fair and transparent market, reducing, in this way, the systemic risk of investing in the stock market.

A controversial and important aspect is the decision of cancelling a trade executed due to an error trade. This is a critical question which may incur in negative effects over the market, becoming necessary that market users have knowledge in advance about the circumstances under which a trade may be cancelled, the type of trades that may be cancelled, the parties who may challenge the trade, etc. On BOVESPA, for example, the market users know that trades will not be cancelled if this event causes an alteration on opening, highest, lowest and closing prices, as well as a considerable alteration in the traded volume, observed up to the moment of the receipt of the correction or cancellation request.

Beyond the situations described above, BOVESPA is always concerned about the consequences of a trade cancelling over the others trades and over the market participants. If, for example, a trade is responsible by triggering a stop order or a program trading, then this trade will not be cancelled due to the severe consequences of such cancelling over the fairness and integrity of the market.

BOVESPA is also concerned about the decision of cancelling trades on stocks which are cross-border traded, to avoid pricing instability and to maintain market integrity and enhance the ability of market users to price and manage risks.

In our opinion, it will predominate the systems and instruments that minimize the necessity of cancelling a trade. And, in this aspect, the advance of the world-wild trend of closing a trade by an electronic trading systems, which has as characteristics the use of tools that have the purpose of avoiding erroneous trades, such as filters, order confirmation alerts, credit controls, pré-execution checks, error trade prevention alerts and instruments that interrupt the trading before it is closed in case it exceeds the parameters previously disclosed by the market, fulfills with the ability of minimizing the necessity of cancelling a trade.

BOVESPA error trade policy has rules regarding market price fluctuation and closing of trades with the purpose of avoid error in trades. All rules are disclosed to market participants and are available in our website.

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CONSULTATION REPORT

POLICIES ON ERROR TRADES

Thank you for the opportunity to comment on this report regarding the design of error trades policies. We are very supportive of the work that IOSCO and its Technical and Standing Committees have conducted so far and we strongly share the open approach adopted.

With regard to the proposed topics, our comments are expressed below.

a. Need for flexibility

The design of error trade polices should be left to the Exchanges' discretion in the framework of IOSCO's recommendations, in order to take into account the characteristics of each market structure and to quickly and effectively manage emergency situations caused by error trades.

b. Definition of error trades

We share the broad definition of "error trades" including "transactions that are executed in error through malfunction of a trading system".

A mistake in entering orders in a market could depend either on human errors or on malfunction of the intermediary's trading system. Borsa Italiana defines an error regardless of the cause as a transaction which derives from an evident mistake in entering orders in a market. Furthermore, Borsa Italiana also takes into account the theoretical loss and the divergence from a reference price.

We believe that trades originated by disruptions or technical glitch of the Exchange's trading system should be separately addressed in addition with other means such as membership agreements, insurance policies and so on.

c. Role of intermediaries

We strongly share IOSCO's concerns about the role of intermediaries as first line of defence in preventing error trades. In particular, evaluating the admission of intermediaries to trading, the Exchange shall conduct a check, in accordance with non-discriminatory criteria established on a general basis in an ad hoc measure, aimed at ensuring the regular operation of the market and focused in particular on verifying the existence of adequacy of the technological systems used for trading and the associated activities in relation to the nature of the activities carried on and the number and types of interconnections with the markets, and their compatibility with the electronic data processing and telecommunication support systems adopted by the Exchange for the operation of the markets.

Exchanges shall continuously monitor the operation of the technical equipment and transmission networks of the electronic data processing and telecommunication systems and shall monitor operational and informational links to the markets.

But it is as much important that the intermediaries' systems with direct access to the exchanges' trading system are secure.

For these reasons, Borsa Italiana requires its participants to implement and monitor their systems to avoid erroneous trades, such as filters, order confirmation alerts and so on.

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In order to strengthen this kind of Exchanges' provisions, we would appreciate a IOSCO's initiative on the role of intermediaries in preventing error trades.

d. Ability of third parties

The goal of preserving market integrity and the need to preserve trade certainty can lead the Exchange to decide to exclude the ability of third parties whose trades were affected by an error trades to invoke the policy.

Borsa Italiana expressly allows to invoke its policy the Exchange member who committed the error.

e. Predictability

The need for predictability of the process should be balanced with the need for flexibility of the exchanges. Indeed, a very high level of details of the procedure and automatism could encourage operators to exploit the policy thus raising a moral hazard.

f. Timeliness

With reference to timeliness, the establishing of explicit and rigid timeframes for all procedural requirements should not be recommended. Depending on the type of the financial instrument and the type of error, where possible, the exchange could set forth a maximum length of the procedure in order to improve expedition and to increase investors' confidence in the market integrity and transparency.

The procedure should be conducted with timeliness in order to reduce effects on price formation and to re-establish parity of information through investors.

However, specific and inflexible timeframes could undermine and condition the comprehensiveness of the Exchanges' evaluation, especially with reference to extraordinary cases involving a significant number of intermediaries.

We hope that IOSCO will find our comments useful and we remain at disposal for further explanations and details. Moreover we look forward to further cooperate.

Best regards

Milan, 17 May 2005

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UBS

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UBS Group Comments
OICV-IOSCO Consultation Report February 2005

Policies on Error Trades

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1. General Comments

UBS would like to thank IOSCO to be given the opportunity to contribute to Consultation Report on "Error Trade Policy".

UBS in general agrees, that error trade policies and in particular the process by which trades are cancelled have a strong effect to the integrity of markets and the confidence of the participants. Therefore UBS welcomes the approach of IOSCO to provide a framework to exchanges and regulators for error trade policies that will support a consistent and transparent handling of error trades across the markets.

2. UBS comments to the recommendations for the design of Error Trade Policies

1.) Adoption of Policies

- *Exchanges should evaluate the need for and consider adopting error trade policies.*
- *Exchanges should have, and regulators should take into account an exchange's need for, flexibility in the design of error trade policies.*

View of UBS

UBS is convinced that the adoption of error trade policies will have a positive impact on the markets ability to address the effects of error trades. UBS shares the opinion of granting exchanges flexibility in designing the respective policies, however a consistent and reliable approach across the various markets in respect of handling error trades would be welcomed.

2.) Comprehensiveness

- *Exchange error trade policies should be comprehensive in order to promote the predictability, fairness and consistency of actions taken under the policy.*

View of UBS

UBS in general agrees, however would like to point out the following:

- The policy should explicitly include measures for the situation in which the exchange itself is responsible for the error trades. Aside from explicit rules this should also include an independent authority that can be addressed.
- There should be pre-published parameters that define "error trades".
- In regards to the notification, it has to be ensured, that no customer related information need to be disclosed to ensure that banking secrecy will be maintained.
- Taking measures to prevent error trades is important but their possible effects on the business should be analyzed closer by a business case, before implementation (e.g. costs of implementation; possible impact on straight through processing etc.).

3.) Predictability and Timeliness

- *Policies concerning the resolution of error trades should be designed to provide a predictable and timely process.*

View of UBS

UBS also sees the benefits of explicit timeframes for all procedural requirements of error trade rules and suggests that the decision process should be kept in a very tight timeframe and communicated immediately.

4.) Transparency

- *Exchange error trade policies should be made transparent and readily accessible to market users.*

- *Cancellation decisions involving material transactions and resulting from the invocation of error trade policies should be made transparent to market users.*

- *Exchanges should be encouraged to develop and adopt measures to specifically identify or "highlight" error trade messages to market users.*

View of UBS

UBS agrees that a high degree of transparency should be aspired to prevent situations of information asymmetry. UBS supports that exchanges should inform market participants early and comprehensively about deals that have been challenged by a party and taken under review by an exchange and/or subsequently deemed to be a valid error trade and in fact cancelled.

Similar to the comment in Point 2, UBS takes the view, that the revealed information should be transaction related only and no customer related information should be disclosed.

5.) Cooperation with other markets

- *Exchanges should be prepared to share information with other markets when possible concerning the cancellation of trades.*

View of UBS

In favor

6.) Prevention

- *Exchanges should evaluate the need for measures to prevent error trades.*

View of UBS

UBS agrees that measures should be installed to prevent error trades (or prevent them from being completed). However the implementation of such measures should be subject to a cost-benefit assessment taking into account possible consequences of the implementation of these measures for the market participants.

7.) Role of the Market Supervisor

- *Market supervisors should support the implementation of error trade policies that are consistent with the above recommendations.*

- *Market supervisors should take affirmative steps to help ensure that the markets they supervise conduct adequate surveillance to detect whether error trades are related to problematic market activity.*

View of UBS

In favor