THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref.: CESR/05-274

Market Abuse Directive

Level 3 – first set of guidance and information on the common operation of the Directive

FEEDBACK STATEMENT

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Introduction

1. On the 28th of October 2004, CESR published a paper entitled ""Market Abuse Directive: level 3 – preliminary CESR guidance and information on the common operation of the directive" (Ref: CESR/04-505)". Comments were invited by January 31, 2005 and thirty written responses were received.

2. The range of comments included contributions from issuers, investment services, individuals and asset managers. The majority of the responses came from banking associations and regulated markets/exchanges/trading systems. Annex 1 contains a full list of respondents.

3. This feedback statement will discuss the main points which were made by respondents in the consultation process on CESR's advice and explain the policy options which CESR decided upon.

4. The Market Abuse Directive itself came into effect on the 12th of October, 2004 (the 23rd in the European Free Trade Area). CESR's work at level 3 is focused on delivering consistent day-to-day regulation within the EU by working on implementation; enhanced co-operation; and identifying and ameliorating regulatory issues.

5. For level 3 of the Market Abuse Directive, CESR has given CESR-Pol responsibility for operational issues. CESR-Pol is the group of senior officials responsible for the surveillance of securities activities, exchange of information and enforcement, chaired by Kurt Pribil.

6. CESR, through CESR-Pol therefore, should seek to facilitate the effective implementation of this new market abuse regime by ensuring a common approach to the directive's operation among supervisors.

7. To help achieve this, a CESR-Pol working group produced the preliminary guidance paper which was designed to enhance convergence in supervisory practice and to provide further clarity for market participants regarding the operational requirements and issues with regard to certain particularly significant areas of the Market Abuse Directive.

8. The guidance paper covered three main market facing issues that CESR members considered were priorities:

   i. The first issue (chapter two) was that of accepted market practices and the key considerations for CESR members when operating the AMP regime. The paper also (chapter three) outlined a common format for the analysis of AMPs to facilitate the consultation obligations placed upon CESR members.
   ii. The second area (chapter four) was to increase clarity for the market on the the types of practices that CESR members would consider constituted market manipulation. These were described in non-legal terms and they were not intended to affect the scope of interpretation of the relevant directives and regulation.
   iii. The third section (chapter five) was the establishment of a common format for reporting suspicious transactions, including appropriate guidance. CESR's aim was to ensure that the directive obligation imposed by the directive on reporting such transactions operates in a proportionate and effective manner.

9. The paper also contained an annex which included four Accepted Market Practices (AMPs) which were being considered in three European jurisdictions. These AMPs were agreed upon by CESR members as indicative of the type of practice likely to be designated AMPs under the new market abuse regime.

10. The AMPs were the following:
    i. Germany: Bond valuation transactions
    ii. Austria: Bond valuation transaction
    iii. Germany: The first price of an IPO when issuing on more than one German exchange
    iv. UK: The obligations on long position holders on the London Metal Exchange (LME).

11. This annex has been removed from the final version of the guidance. Further information upon this can be found in chapter two of this feedback statement on accepted Market Practices.

12. There was general appreciation for CESR's attempt to provide a preliminary set of guidance for these pivotal areas of the Market Abuse Directive. Many respondents stated that it was essential for industry to get a clear sense of the expectations of CESR members with regard to market conduct.

13. Various areas such as research and insiders lists were mentioned as topics where respondents felt that it would be helpful for CESR to issue further guidance. CESR's approach will be to continue to review the operation and implementation of the

directive and to consider the issuance of additional guidance where, in the future, it believes this will be beneficial or is necessary.

14. CESR wishes to continue to encourage market participants to contact CESR or their national securities regulator where they discern issues with regard to the Market Abuse Directive since the succesful operation of the directive depends on the co-operation of all parties involved.

15. CESR's guidance, having been approved by CESR-Pol and the CESR plenary, will be issued as ""Market Abuse Directive: level 3 – first CESR guidance and information on the common operation of the directive".

II Accepted Market Practices (AMPs)

1. The Market Abuse Directive provides a defence when a person is accused of manipulating a market. This is whether or not the transaction was legitimate and in accordance with an Accepted Market Practice (AMP), a market practice which has been accepted by the competent authority, consulted upon and published by CESR as an AMP.

2. The majority of respondents agreed with CESR's approach to guidance upon the operation of the AMP regime. In particular, they felt that it was indeed correct to focus on practices rather than activities.

3. However, while some felt that individual regulators should indeed judge AMPs to preserve flexibility, many more felt that AMPs should be consistent across Europe. This issue of harmonisation was a consistent theme in the comments received.

4. Many felt that once an AMP had been accepted by one regulator then it should then be accepted across the EU. Others believed also, that there should be a uniform list of both accepted and unaccepted market practices.

5. CESR recognises the importance of this area and the strength of opinion upon this topic and has sought throughout this section of the guidance to clarify how the AMP regime will operate. In particular, CESR has inserted a revised section entitled "Process, consultation and disclosure" so that the AMP process, may as respondents asked, be more transparent and understandable.

6. With regard to the pan-European harmonisation of AMPs, the Market Abuse Directive states categorically that it is up to each CESR member to decide whether or not a practice constitutes an AMP . Under 2004/72/EC Article 3, each Member also has a duty to consult. CESR's guidance re-emphasises that this must be done both nationally and with other competent authorities and that they must disclose any market practices that they have accepted. However, a Member does not need to request permission from an another national authority, or from CESR, to declare a practice an AMP.

7. Therefore, what one Member believes is an AMP, may not be viewed as such by another Member. An AMP may well be appropriate for one market but not for another, because of market size or type, for example.

8. The intention of the Directive, however, is of course to increase the transparency and consistency of the market abuse regime in Europe. CESR is obliged to publish all AMPs and will do so on its website. These will be published in the standard CESR format and a link provided to the national legal text. It will therefore be clear which practices are acceptable and where.

9. CESR has an obligation under MAD to review the operation of the AMP regime to ensure that it does indeed work effectively in practice and as it was intended. A sentence has been added to paragraph 2.9 to clarify that CESR will do this: "In the future, CESR through CESR-Pol, will exchange views on both existing and emerging AMPs to ensure that European market integrity is maintained."

10. The intention is that, without over-ruling national discretion, this process will help to ensure that where there are differences between Members' treatment of a practice, that those are justifiable and appropriate.

11. The original paper issued for comment included an annex which contained in preliminary form, Members' initial assessment of AMPs that might ultimately be accepted in one or more jurisdictions. The four AMPs were included as indicative of the types of market practice which it was felt would constitute AMPs but it was noted that apart from the Austrian AMP, the full consultation and approval process had not yet been completed for any of the other three.

12. This annex has been removed as it would be misleading for it to remain a part of the guidance when the information it contains is subject to continual change as decisions with regard to AMPs are made, reviewed and revoked.

13. Information on all practices which have been recognised as AMPs by a Member or Members of CESR (and thus have been consulted upon on a national and pan-European basis) is available via CESR's website www.cesr-eu.org.

14. Since the publication of CESR's initial guidance paper, France has published details of two additional practices which it considers will constitute AMPs. Consultation upon these is ongoing.

Specific points

15. Many respondents expressed surprise at the small number of AMPS. However, it is noticeable that only three new AMPs were proposed, namely:
    a. Use of block trades by small and mid-cap companies
    b. Use of derivatives to cover stock option and convertible/exchangeable bond programmes

c. Stabilisation of non-EU securities.

16. Respondents queried whether CESR planned an appeal process for example with regard to practices which were accepted by non-CESR members but not by a particular CESR member and if so the form which this would take. CESR has not envisaged a formal appeal process since it is a Member's discretion whether or not it rejects or accepts a practice. However, in the interests of pan-European consistency, CESR would be interested in receiving submission from industry upon this. The primary source of contact upon such an issue should, however, be the CESR Member in question.

17. Some respondents sought to link AMPs and legitimate reasons . They attempted to propose the presumption that a practice should be legitimate unless a regulator provides evidence to the contrary. CESR rejects this link as incompatible with the requirements of the Directive. AMPs and legitimate reasons are two separate tests and what might be suitable for one may not be the case for the other.

18. Some requested further guidance on what constitutes a legitimate reason. CESR will not provide explicit criteria for what constitutes a legitimate reason since this must be determined on a case by case basis. CESR has attempted to provide sufficient guidance on what it considers behaviour which might constitute market manipulation.

19. One respondent asked that CESR should make a statement with regard to its guidance plans for AMPs for commodity derivatives markets. As mentioned within the guidance paper, CESR is aware of the need to issue guidance in this area and intends to do so in the near future.

20. Several respondents felt that the factors would benefit from further detail. While CESR has not made the factors themselves more detailed, it has sought to introduce more information upon and a clearer rationale as to why a transaction would constitute market manipulation.

21. A minority of respondents felt that CESR's advice should separate between wholesale and retail markets since the need for protection was different. CESR does not believe that it is necessary to have two separate sets of advice for wholesale and retail markets. For specific instances, where it is necessary or beneficial to differentiate in the guidance between the treatment of wholesale and retail markets, or counterparties, then CESR has done so.

22. It was suggested that CESR should produce a regular publication which would include indications of a regulator's views on the acceptability of practices or approaches and would help give greater pan-European certainty by furthering the

development of a common view. This is regarded as a useful suggestion and the practicality of its introduction is to be given further consideration in CESR.

23. Some respondents requested that open lists of the decisions of regulators and/or courts should be published on CESR's website. It is not possible to have a full, open list of the decisions of regulators and/or courts upon CESR's website given that such a list would not be contemporaneous or fully accurate given the need to wait for the end of the process. However, it will be possible to access a comprehensive European list of those practices which have completed the AMP process and thus a CESR Member has designated them an AMP.

24. Certain respondents asked whether the duty to publicise an accepted market practice should be upon the competent authority or also the regulated market. Under 2004/72/EC Article 3.3, the duty to publish is upon the competent authority.

25. One respondent wanted any list of AMPs produced to be approved by the European legislature. CESR believes that there is no legal or other justification for this to take place.

III Format of the table for assessing AMPs

1. The proposed common formats were generally welcomed. One suggestion made was to change the description of AMP to include the purpose, the conditions under which the practice was acceptable or unacceptable and the types of financial instruments involved or not involved.

2. CESR believes that the format outlined in the paper is a comprehensive and effective approach in this area.

IV Market Manipulation: Types of practice that CESR members would consider to constitute Market Manipulation

1. In this section of the guidance, types of possible market manipulation, instances of which had been identified by CESR members in the past or which were perceived as possibilities, were listed.

2. Each of these, in the view of CESR members would breach the prohibitions on market manipulation contained in the Market Abuse Directive. The examples of types of practice described in the paper were deliberately explained in non-legal technical terms and it was emphasised that the descriptions were not intended to affect the scope of interpretation of MAD.

3. Numerous respondents, however, still expressed concerns about both the list of practices which might constitute market manipulation and the list of signals which might indicate the possibility of market manipulation.

4. While some felt that there was no need for further detail or clarity on the diagnostic flags and examples of manipulative practices, others disagreed. Many commented that the actions listed **might** be a violation but would not always definitely be so.

5. CESR has taken account of these reservations and an additional clause has been inserted in paragraph 4.9 to even more firmly establish that the signals of false or misleading transactions or price positioning transactions should not necessarily be deemed in themselves to constitute market manipulation.
6. Several respondents made the observation that the failure to disclose price sensitive piece of information is not necessarily market manipulation. CESR agrees with this. An explanatory sentence has been inserted into paragraph 4.14 to clarify when such a failure would be market manipulation. This gives the example of an issuer with information which would meet the Directive definition of 'inside information' and which does not disclose that information. The result of this would be that the public is likely to be misled.

Specific points

7. Respondents were concerned that legitimate activities such as intra-day trading or a floor in price patterns might be captured by certain descriptions and thus taken to constitute market manipulation. Again, CESR's revised wording makes clear that the signals are not definitive. However, CESR has also reviewed all of the descriptive paragraphs and where confusion or a unintentional meaning was contained, it has revised them. In particular:

8. For 4.11a) the nature of a wash trade has been clarified by the addition of a clause establishing that "other transactions involving transfer of securities as collateral do not constitute wash trades".

9. In 4.11b), "painting the tape", the wording now is such that a transaction or a series of transactions are captured since one or more might give the impression of activity or price movement in a financial instrument.

10. For 4.11c), improper matched orders, the wording has been changed so that the exceptions are "legitimate trades carried out in conformity with the rules of the relevant trading platform (e.g. crossing trades)."

11. For transactions involving fictitious devices/deception, 4.13c), pump and dump, has been revised. The word "further" has been added to "buying activity" to give additional guidance as to the behaviour which would constitute this practice.

12. It was commented that 4.14b went beyond the scope of 2003/6/EC Article 1(2)c. CESR disagrees since the article covers the dissemination of information "by any other means, which gives or is likely to give, false or misleading signals as to financial instruments". A sentence has been added to explain exactly what such other behaviour designed to spread false or misleading information might be. This is that: "an example might be the movement of physical commodity stocks to create a misleading impression as to the supply or demand for a commodity or the deliverable into a commodity futures contract." An example of this might be the movement of an empty cargo ship.

13. Some respondents requested specific guidance on how the dissemination of false or misleading information by virtue of the internet would be treated. CESR believes that the existing guidance covers this method of information dissemination but will keep this issue under review and if necessary, issue further guidance in this area.

14. One respondent felt that the guidance should differentiate between information on the financial instruments of a given issuer and the issuer itself as the Transparency Directive did. CESR does not believe that this distinction is necessitated in the context of guidance upon the Market Abuse Directive.

V Common format and added guidance for reporting suspicious transactions

1. The Market Abuse Directive requires that market participants report suspicious transactions to the competent regulator.

2. The guidance therefore sets out the indications whereby a transaction or transactions might be deemed suspicious since it or they might involve insider dealing or market manipulation.

3. The paper also proposed a standard reporting format which should be used by market participants to report suspicious transactions to the relevant authority.

4. Respondents had several concerns with CESR's guidance in this area.

5. A substantial number of respondents were concerned that the signals for suspected insider dealing or market manipulation were too broad and not distinctive enough to allow firms to recognise the suspicious element to the transaction.

6. Some respondents, however, expressed support for CESR's comment that "blanket pro forma notifications to the authorities of all transactions conducted through an institution" are not appropriate and recognised that CESR had stated that the signals were not an automatic trigger for report.

7. CESR has added a sentence to paragraph 5.7 of its advice to make clear that "it is recognised that transactions meeting signals may be legitimate and hence not give reasonable grounds for suspicion"; therefore the signals are necessarily broad.

8. Several respondents believed that the decision to report suspicious transactions should only be based on objective factors. CESR believes that an obligation to report based on objective i.e. quantitative factors would result in either numerous or insufficient notifications and would not meet the directive's requirements since, for example, such an approach might not capture someone who was utilising inside information to deal in shares worth only a relatively small amount. The indications therefore should be a useful starting point for firms seeking a method to objectively assess transactions.

9. The guidance is clear that the indications are "neither exhaustive (a particular transaction may be suspicious even if it matches none of the indications) nor determinative (a transaction may not necessarily be suspicious simply because it matches one or more of the indications)." Firms therefore cannot waive the need for them to exercise their subjective judgement and consider the particular circumstances of a case before deciding whether or not to report. This is essential.

10. Many respondents were keen to stress that it should not be the responsibility of the firm to investigate in detail whether or not a transaction is insider dealing or market manipulation. A few, as a consequence, said that CESR should not call its examples a “starting point for consideration” since this suggested an obligation to examine every transaction in depth and that this was not what the level 1 or 2 text intended.

11. CESR does not accept that the firm has no responsibility to decide whether or not a transaction is suspicious since the Directive is clear on precisely this point. However, CESR has always accepted that it would be unduly onerous to expect firms to investigate every transaction in detail to determine whether or not it was suspicious and does not expect this of firms. CESR would characterise the obligation upon firms as not being to examine every transaction in depth but instead to have methods which allow you to determine which of a number of transactions may be suspicious.

12. Some respondents felt that it was entirely the responsibility of the regulator to detect suspicious transactions and that 5.8 and 5.10 would give a regulator, and not a firm, guidance. Such an assertion stems from a misreading of the Directive. 2004/72/EC Article 7 states that "Member States shall ensure that persons referred to in Article 1 point 3 above shall decide on a case-by-case basis whether there are reasonable grounds for suspecting that a transaction involves insider dealing or market manipulation."

13. The vast majority of respondents stated that they did not believe that it was incumbent upon them to develop sophisticated market abuse surveillance systems. CESR would characterise the obligation upon firms as that they should have a method which allows them to determine which, of a number of transactions, might be suspicious. CESR has not placed any requirement upon firms to have transactions surveillance systems. Additional wording has been inserted into paragraph 5.1 to clarify this:

    "Those subject to the requirement clearly need to ensure that they comply with this obligation. However, CESR does not propose in this initial guidance to prescribe how this obligation is discharged, except in respect of the form for reporting suspicious transactions."

14. Many felt that the directive did not impose an ongoing obligation to review transactions retrospectively. CESR agrees with this point and the revised wording to

5.6 now states that firms are not "required to go back and retroactively review transactions" in the period leading up to the event or development that created suspicion.

Specific points

15. One respondent expressed the opinion that a firm would only be able to make a judgement about whether or not a transaction was suspicious for advisory rather than execution only clients. CESR disagrees with this assertion. The relevant signals can be seen in transactions conducted for both advisory and execution clients.

16. Respondents' concern with elements of the wording of 5.8, 5.9 and 5.10 were noted. Specific changes have been introduced to finetune items. In particular:

17. Paragraph 5.9 has been amended since the original wording, namely "the client opens an account and immediately gives an order to conduct a significant transaction" would have captured wholesale clients entering a sizeable order but one which was not suspicious just because of its size. The wording now specifies that it would be where a wholesale client places "unexpectedly large or unusual orders in a particular security – especially if the client is insistent that the order is carried out very urgently or must be conducted before a particular time specified by the client".

18. Another example would be in 5.10i where the original wording of narrowing would have excluded relevant activity and thus the sentence has been changed so the relevant trigger is changing the bid-ask prices.

19. Some respondents in response to 2004/72/EC Article 8's request for "notification without delay" wanted CESR to impose a specific timeframe. CESR does not agree that this would be helpful since a firm may meet or not meet any such timeframe and still have notified without delay. For example, a transaction which takes place on the 20th of June might become suspicious on the 20th of July. A notification on the 20th of July would still, in this instance, constitute timely notification.

20. It was observed that standard reporting was useful but that it should be possible to report with information missing to ensure that notification was helpfully prompt and "without delay". CESR agrees that this would be beneficial and has revised the guidance to encourage those persons with an obligation to report to do so quickly even if all of the required information is not available at that time.

21. A few respondents believed that the obligation to notify was on the company and not the person and so it should not be necessary to include details of the person in the report. CESR disagrees since 2004/72/EC Article 9c requires the notification to

contain "means for identification of the persons on behalf of whom the transactions have been carried out and of other persons involved in the relevant transactions".

22. Several respondents felt that reporting should be through a nominated officer (some believing this should be the compliance officer) and that this should be mentioned in CESR's guidance. CESR believes that allowing flexibility with regard to who, within a particular firm, should be the nominated officer, is the most sensible approach here.

23. Some commented that the obligation to notify should not apply to market operators. A market operator is not subject to the obligation to notify under article 6.9 of Directive 2003/6/EC as they are not a person professionally arranging financial transactions. They are however subject to article 6.6 whereby Members must "ensure that market operators adopt structural provisions aimed at preventing and detecting market manipulation practices".

24. A few respondents felt that there should be explicit protection when reporting with regard to firms duty of confidentiality to clients. CESR believes that, while there cannot be an explicit safe harbour for this, by acting in accordance with the explicit requirements of the regulatory body, firms should be protected from the possibility of legal action for breach of confidentiality.

25. One respondent requested confirmation from CESR that a firm's responsibility was only to report suspicions about transactions executed or arranged by itself and not ones that it has observed. CESR will impose no obligation on firms to report suspicions about transactions which it has observed and has not executed or arranged.

26. One respondent asked if the reporting format could be linked with the format for notifying anti-money laundering suspicions. CESR believes such a link is neither attainable nor practical.

Annex 1

Consultation Responses

Banking

Associazione Italiana Analisti Finanziari (AIAF)
British Bankers Association (BBA)
Danish Bankers Association and Danish Securities Dealers Association
European Association of Public Banks (EAPB)
European Federation of Financial Analysts Societies (EFFAS)
Italian Banking Association (ABI)
Netherlands Bankers' Association
Spanish Bankers' Association
European Association of Co-operative Banks
Zentraler Kreditausschuss

Government/Regulatory/Enforcement

WKO

Individuals

Kelly Barton

Insurance/Pension/Asset Managers

Assogestioni
Irish Association of Investment Managers

Investment Services

AFEI

Assosim

International Swaps and Derivatives Association

Issuers

Assonime

European Association for Listed Companies (EALIC)

IPMA

MEDEF

Regulated Markets/Exchanges/Trading Systems

BME Spanish Exchanges

Borsa Italiana

Euronext

Federation of European Securities Exchanges (FESE)

International Petroleum Exchange (IPE)

London Stock Exchange (LSE)

Luxembourg Stock Exchange

Swedish Securities Dealers Association (SSDA)

TLX SpA