CFA INSTITUTE | Centre for Financial Market Integrity

The Committee of European Securities Regulators
11-13 Avenue de Friedland
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London, 14th August 2008

Market Abuse Directive

Level 3 - Third set of CESR guidance and information on the common operation of the Directive to the market

The CFA Institute Centre for Financial Market Integrity ("CFA Institute Centre") welcomes the opportunity to comment on "Level 3 – Third set of CESR guidance and information on the common operation of the Directive to the market" (the "Consultation").

We are very supportive of the continuing efforts to prepare ground for convergent implementation and application of the Market Abuse regime. The CFA Institute Centre supports fair and open global capital markets and advocates for investors' protection. Accordingly, we place great importance to the Market Abuse regime, having participated in the consultation process over the past six years, and support the efforts of this further stream of level 3 work, which addresses Insiders' Lists and Suspicious Transactions Reporting.

Our response to the Consultation reflects the collaborative efforts of CFA Institute Centre and a working group of investment professionals, drawn from our membership (collectively, the "Group"). Representatives of the Group[1] span several EU Member States. Consequently, the views expressed herein broadly capture the opinions of our membership, and reflect a cross-section of industry expertise. The contribution of the Group reflects the importance CFA Institute Centre places on this initiative.

On the subject of Insiders' Lists, we feel there is a need for more clarity and guidance on how issuers should exercise control over the flow of inside information within third-parties (such as lawyers, accountants, and consultants). Whilst issuers are currently required to assume full responsibility for an Insiders' List, there exist practical difficulties, having regard to the nature with which information is shared amongst third parties. Additionally, greater clarity over the notion of direct and indirect information (precise information that could affect the pricing of securities in related businesses) would be welcome, especially when applied to concentrated industries or businesses linked through vertical production. In such cases, for example, it is not clear whether possession of inside information on one company prohibits trading in the securities of other companies in the same or related industry. We also believe that specific guidance should be given for private companies that are due to list via Initial Public Offerings (IPOs), having regard to the potential for market abuse in this area. Accordingly, we urge CESR to put forward a more detailed document offering further guidance over control and enforcement measures, in the

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context of the responsibilities of issuers for Insiders' Lists. Clarifications over certain existing measures, as highlighted in our detailed response, would also be welcome.

On Suspicious Transactions Reporting, we support the need for clarity in the criteria for determining notifiable transactions. This need is best illustrated in the case of commodity derivatives, where current evidence (cited by the UK Financial Services Authority and the European Securities Markets Expert Group ("ESME")) suggests that market participants face particular difficulties in both identifying, and determining, suspicious transactions. Consequently, we recommend that CESR consider introducing specific guidance describing what is or is not a suspicious trade in the area of commodity derivatives. Due to the specificities of these markets, strengthened compliance monitoring on the part of issuers and exchanges, and stricter adherence to internal codes of conduct, would be welcome. We believe that such measures would significantly increase the probabilities of market participants correctly identifying, and hence reporting, suspicious transactions in these markets.

For guidance, a suspicious transaction may be recognised as an order to execute a trade that is counter-intuitive to competitive behaviour amongst market professionals. For example, the rapid arrival of significant business from a new customer, business granted on favourable terms, or even business that appears careless towards the customer's self-interest, should raise suspicion. The dilemma, however, is that such business is profitable and thus could itself be instrumental in suppressing suspicious transactions reporting**.**

Overall, we believe that the proposals set out herein will help to produce a more coherent application of the Directive, and will add value to its provisions. We recommend these proposals be taken into account in the next stream of level 3 work already scheduled by CESR.

We attach our response that addresses the questions of the Consultation. Please do not hesitate to contact us, should you wish to discuss any of the points raised.

Yours faithfully,



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The CFA Institute Centre[2] is part of CFA Institute[3]. With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of approximately 95,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 134 countries, of whom more than 81,000 are holders of the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 56 countries and territories.

Our detailed comments follow the order of the Consultation's questions and are presented below.

"Question to the market: Market participants are requested to indicate if there are any further issues for consideration by CESR, providing also the reasons why."

I. Insiders' Lists

Broadly, we feel that more clarity is needed regarding who should be included on an Insiders' List, and how an issuer should exercise control over the individuals on it, in particular having regard to the limitations placed on the issuer over third-party relationships.

For example, greater clarity would be welcome in the case of outsourcing the preparation of insiders' lists by an issuer. Para. 17 states:

> *"Issuers may want to outsource the preparation of insiders' lists […] subject to certain conditions, such as the requirement that the issuer retains fully its responsibility."*

When stipulating that the issuer retains full responsibility for the Insiders' List (including where production of the list is outsourced), we recommend that CESR provide guidance on how an issuer should go about exercising control over the list, in order for an issuer to be able to assume full responsibility. Specifically, the limitations faced by the issuer in monitoring the flow of information at third parties, and in exercising control over its dissemination amongst third parties, make application of this proposal difficult.

Control

With regards to exercising control over the flow of inside information, we draw attention to the recent guidance provided by the UK Financial Services Authority (FSA), which has conducted a thematic review of controls over inside information in relation to public

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[2] The CFA Institute Centre develops, promulgates, and maintains the highest ethical standards for the investment community, including the CFA Institute Code of Ethics and Standards of Professional Conduct, Global Investment Performance Standards ("GIPS®"), and the Asset Manager Code of Professional Conduct ("AMC"). It represents the views of investment professionals and investors before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and the transparency and integrity of global financial markets.

[3] CFA Institute is best known for developing and administrating the Chartered Financial Analyst curriculum and examinations and issuing the CFA Charter.

takeovers (FSA Market Watch No.21[4] and No.27[5]). Many of these controls have applicability to the control of inside information in relation to the production of Insiders' Lists. FSA Market Watch No.27 notes examples of FSA regulated firms that strengthened their controls that CESR might use as a benchmark for further guidance. Under the 'need to know' concept, some firms took action over executives' exposure to critical information by limiting attendance at deal meetings or reducing the number of deal executives working on transactions. Others have amended credit committee procedures so that those who do not need to know must now leave the room during M&A discussions. Actions have also been taken at a lower level, such as by strengthening confidentiality agreement clauses with cleaning contractors and reinforcing clean desk policies.

Information Technology is another critical area, as proven by a recent insider dealing case filed by the FSA[6]. Effective information technology controls are essential in restricting the flow of information amongst issuers and third parties (such as lawyers, accountants, bankers, and consultants). Accordingly, they play a key role in exercising control (and therefore responsibility) over Insiders' Lists. Examples of effective information technology controls cited by the FSA included the reduction of the number of people with IT access, the introduction of a new information security policy and specific committees responsible for IT security, and the instruction of an independent firm to undertake an information and physical security review. More specifically, examples included the creation of separate secure server access with password protection for each deal, and actions aimed at improving the ability to observe which individuals have actually accessed specific IT files.

For issuers to be held fully responsible for the production of Insiders' Lists, it is essential that appropriate controls are in place to limit the flow of inside information. CESR may consider recommending some of these procedures to aid issuers exercise control over the flow of inside information.

Enforcement

If the issuer is to be held fully responsible for the Insiders' List, careful guidance is needed as to how this should be enforced in practice. For example, CESR may consider issuer guidance for service-level agreements with third parties, as a means of clearly establishing confidentially clauses and limiting the flow of inside information within third parties. The value of an Insiders' List—its viability—rests in its completeness and accuracy. Accordingly, CESR may wish to consider how best to ensure the viability of these lists, for example, by requiring a 'responsible person' to formally sign-off that the list is accurate and complete to the best knowledge of the issuer.

Direct vs. Indirect Information

A further issue on which more clarity would be welcome is whether possessing insider information about a specific company must prevent trading in the securities of other companies in the same or related industry. This is a point that is acquiring particular relevance as industries consolidate into just a few players.

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[4] See http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter21.pdf

[5] See http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter27.pdf

[6] See http://www.fsa.gov.uk/pages/Library/Communication/PR/2008/063.shtml

The Directive 2003/6/EC, Art. 16 states:

> *"Inside information is any information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments. Information which could have a significant effect on the evolution […]of prices […]could be considered as information which indirectly relates to one or more issuers of financial instruments or to one or more related derivative instruments."*

This would *appear* to encompass situations whereby possessing inside information on one company would preclude trading on the securities of another company in the same industry, *if* it is deemed that this information indirectly relates to other companies in the same industry. However, this guidance is not fully clear. This perception is reinforced from review of the second set of level 3 guidance issued by CESR[7]. Para. 1.16 of this document states:

> *"The Directive definition of inside information also encompasses information which relates indirectly to issuers or financial instruments"*.

The paragraph goes on to state:

> *"There is, however, no legal basis to require prompt disclosure under Article 6.1 of MAD* [addresses public dissemination of inside information], *because this article only applies to issuers and to information that directly concerns them"*

We would welcome efforts to provide greater clarification on this subject. The opacity of the present guidance can lead to uncertainty, and hence inconsistency in the application and enforcement of the guidance. We would specifically welcome clear guidance on this subject in the case of concentrated industries with few players (as noted above) or related businesses linked through vertical production processes. For example, guidance covering *when* information is considered to be 'indirectly' related to issuers (and hence prohibitive in terms of trading) would be welcome. Additionally, guidance on how the use of 'indirect' information differs from situations whereby a market participant may trade on a security using the 'mosaic' approach (the combination of material public information alongside non-material non-public information) would be useful.

Initial Public Offerings

The CFA Institute Centre recommends that CESR consider extending the requirement to produce Insiders' Lists to private companies that plan to list via an Initial Public Offering (IPO). IPOs represent an opportunity for market abuse, as subscription prices may be set either artificially too high or too low by those possessing inside information. The CFA Institute Standards of Practice Handbook[8], which provides guidance to the CFA Institute Code of Ethics and Standards of Professional Conduct[9], to which all our members must

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[7] See http://www.cesr-eu.org/data/document/06_562b.pdf

[8] See CFA Institute, *"Standards of Practice Handbook"* Ninth edition, June 2005, at http://www.cfapubs.org/toc/ccb/2005/2005/3

[9] See CFA Institute, *"Code of Ethics and Standards of Professional Conduct"*, June 2005, at http://www.cfapubs.org/toc/ccb/2005/2005/8

annually attest, advocates placing restrictions on employee equity purchases in IPOs. Insiders' Lists in relation to IPOs may be an effective way to monitor this. Insiders' Lists may also act as a potential deterrent to market abuse and provide a monitoring mechanism for any suspicious post-IPO trading activity in the shares of the issuer. Consequently, we see benefits from extending the requirement to produce Insiders' Lists to cover private companies that plan to list via an IPO.

Pro-forma Lists

Paragraph 4.5 of CESR's second set of level 3 guidance[7] states:

> *"…it is recommended that the relevant competent authorities recognise insider lists prepared according to the requirements of the Member State where the issuer in question has its registered office."*

This language raises concerns that different Member States may adopt divergent practices regarding the creation of these lists. We also note that while Article 5 of Directive 2004/72/EC (implementing Directive 2003/6/EC MAD) sets out the basic components of Insiders' Lists, there is no clearly prescribed format for producing such lists, which may lead to even more disparities in the quality of the information produced.

To prevent confusion, the CFA Institute Centre suggests that CESR consider issuing pro-forma guidance so as to determine commonality of the information presented. This should improve the usefulness of Insiders' Lists, and facilitate ease of production on the part of the issuer, thus reducing administrative costs.

Additionally, producing these lists can be burdensome for issuers, given that under the current legal framework, the potential for different interpretations may force delivery of different lists to multiple jurisdictions. The burden placed on issuers for producing Insiders' Lists under the current regime is highlighted in CESR's second set of level 3 guidance. Paragraph 4.3 of this guidance, which refers to issuers whose financial instruments are traded on regulated markets in more than one EU jurisdiction, states:

> *"…it appears that the same issuer has to comply with the requirement to draw up and maintain insider lists in accordance with the legal framework applicable in each of the concerned jurisdictions. In other words, there may be overlapping requirements with respect to keeping the insider list, in certain circumstances."*

The paragraph continues:

> *"From the competent authorities' perspective, it is considered that overlapping is preferable to loopholes. However, it may be argued that such overlapping could prove "burdensome" for issuers."*

Paragraph 4.6 goes on to emphasise this point. It states:

> *"This recommendation* [that lists are prepared according to the requirements of the Member State where the issuer has its registered office] *does not challenge […] the right for the competent authority from any of these jurisdictions to request such a list"*

This situation is not in the best interests of investors or issuers. The administrative burden arising from the possible requirement to report Insiders' Lists to different Member States in different formats, each potentially unique to that Member State, creates inefficiency and unnecessary additional cost.

A more efficient approach would be to prescribe a common format for reporting (based on a pro-forma list), and for the issuer to report the list to a single recognised authority. The CFA Institute Centre believes that the best mechanism to achieve this is through the creation of a central repository, a concept addressed in our response to CESR's advice on possible level 2 implementing measures in September 2002[10], and also in June 2004[11]. A central repository that could disseminate the same information (e.g a standard Insiders' List) through the appropriate regulator (assumed to be the 'competent authority') in each Member State might create an efficient mechanism for harmonised reporting. Not only would issuers benefit from standardisation of filing requirements through the central repository, they would also benefit from having a single location to which they would submit their lists, with the repository then disseminating the list to the Member States concerned. This would avoid duplication, or "overlapping" suffered by the issuer, hence lowering cost and raising efficiency.

This concept is returned to later, in the context of Suspicious Transactions Reporting.

II. Suspicious Transactions Reporting (STR)

The CFA Institute Centre believes that details on the criteria for determining notifiable transactions are helpful, as they enable parties to identify suspicious transactions, and facilitate the development of best practices. In this respect, CESR may wish to draw attention to its first set of level 3 guidance[12]. This addresses types of practices that would constitute market manipulation along with possible signals of such behaviour, and provides examples of suspected insider dealing. This provides a good reference point for market participants.

As guidance we offer the following approach to recognising a suspicious order. In the context of a highly competitive market for financial services, a suspicious order makes itself apparent by being counter-intuitive to competitive behaviour amongst market professionals. It could manifest itself through the rapid arrival of significant business from a new customer. This is difficult to detect as accounts are opened on the first transaction, with no reference to how long the financial service provider has been trying to develop a commercial relationship with the customer. It could be business granted on favourable terms, or even business that seems careless towards the customer's self-interest. The flip side of such occasions is that it is profitable to the agent or principal who receives the order. Such business exploits the latent conflict between the agent's or principal's personal gain versus his or her duty to the integrity of the financial markets, thereby suppressing suspicious transaction reporting.

[10] See http://www.cfainstitute.org/centre/topics/comment/2002/pdf/02market_abuse.pdf
[11] See http://www.cfainstitute.org/centre/topics/comment/2004/CESRcommentletter.html
[12] See http://www.cesr-eu.org/data/document/04_505b.pdf

Commodity Derivatives

Greater clarity and specific guidance would be welcome in the area of commodity derivatives. Much of the guidance and examples provided in the first set of level 3 guidance is generic in terms of the type of securities it applies to. As noted in CESR's/CEBS's technical advice to the European Commission on the review of commodities business[13], issues of market integrity are of particular relevance in the commodity derivatives market, where manipulators may take advantage of the interplay between the derivatives and the cash market in the underlying commodity.

As noted in the FSA's Market Watch No. 28[14], identifying instances of potential market abuse is more complicated in commodities than other securities markets. The reasons cited are that it is difficult to define misuse of information compared to other markets, and that traders often operate through many different accounts, making it more difficult to understand how a single trade fits into a client's overall proprietary strategy. The FSA notes that the number of suspicious transaction reports received in respect of commodity derivatives has been very low, which may indicate the difficulty of manipulating the market for a commodity. However, the low incidence of STR suggests a need for clearer guidance on suspicious transactions in these markets.

This view is reinforced by the recent ESME report regarding commodity derivatives[15]. The ESME report (section IV.G) notes that significant practical problems exist in defining insider information and in applying the insider dealing regime to commodity derivatives markets. The report cites as reasons the specifics of, and diversity between, different businesses, along with the fact that participants operate to varying degrees in both physical and derivative markets. This latter point has particular relevance, since it is often difficult to determine whether specific information held by participants in physical commodity markets could be 'mis-used' if those participants acted upon it in the derivative markets. Market participants in physical commodities are typically endowed with fundamental information that can shape the price formation process in the derivative markets. In these circumstances, it may be possible to utilise this information under the 'mosaic' approach to form an investment strategy. Equally, however, the nature of the 'fundamental' information may be such that acting upon it in the derivatives market would constitute an abusive practice. Often, the distinction between these two scenarios is opaque. These factors can complicate the identification, and hence reporting, of suspicious transactions.

We recommend that CESR expand on paragraph 36 of the Consultation, which deals with training of personnel in STR, to cover specifically commodity derivatives. The difficulty experienced by market participants in recognising (and hence reporting) suspicious transactions suggests that training would be beneficial. To this end, we recommend that CESR seek the views of market professionals to determine what practices are acceptable with regard to commodities, and what practices are not. The opinion of market professionals would form an appropriate basis on which to determine a consensus, which

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[13] See http://www.cesr-eu.org/index.php?page=consultation_details&id=111

[14] See http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter28.pdf

[15] See *"Mandate to ESME for Advice - Review under Articles 65(3)(a), (b) and (d) of the MiFID and 48(2) of the CAD and proposed guidelines to be adopted under the Third Energy Package"*, at http://ec.europa.eu/internal_market/securities/docs/esme/commodity_derivatives_en.pdf

should shape further training and guidance. The guidance may also wish to promulgate the importance for market participants to adhere to internal policies, procedures, and codes of conduct, so that participants are aware of their responsibilities, and are better able to exercise their reporting duties when suspicious transactions arise.

The FSA's Market Watch No.28 also stresses the importance of compliance monitoring regarding commodity derivatives, and we recommend that appropriate focus be placed on this issue in the level 3 guidance. The FSA highlights the following as examples of good practice in relation to compliance monitoring:

- firms who receive a large number of client orders review their own trading around large orders to identify any possible front running;
- review of trading activity around key 'risk' periods for market abuse (such as contract expiry periods) to identify any unusual or suspicious trades conducted in these periods; and,
- review of trading patterns of new accounts to check whether there is anything unusual implied by the patterns observed.

The above measures should strengthen the monitoring of potentially suspicious transactions. They therefore raise the probability of market participants successfully identifying, and consequently reporting, suspicious transactions in the area of commodity derivatives.

Another effective mechanism for detecting potentially suspicious transactions is for regulated exchanges and Multilateral Trading Facilities (MTFs) to monitor position reports in commodity derivatives markets. The ESME report suggests that regulated exchanges and MTFs act as "frontline regulators" in this regard. Section IV.G (question 7) states:

> *"Regulated markets and MTFs receive matched trade data of business executed on their markets and can look at open position data to monitor behaviour of market participants and to assist in identifying possible market abuse."*
>
> *"On uncovering possible market abuse, regulated markets consult with their competent authority and agree on the conduct of any investigation, which will include reviewing relevant transactions leading to the build-up of suspect positions…"*

The report notes that, as the centralised collector of position reports, regulated exchanges and MTFs can act as "frontline regulators", and in doing so fulfil their duties under Articles 26 and 43 of the MiFID to monitor for potential market abuses. The ESME report therefore proposes to explore the benefits of position surveillance by regulated markets in the wider context of the Market Abuse Directive. This can be an effective method of detecting (and deterring) abusive practice. We therefore welcome ESME's efforts in this area.

STR Filing

As noted in our comments under section I. Insiders' Lists, the location / jurisdiction of the competent authority to which the issuer reports is an important factor for consideration, having regard to the associated implications for cost and efficiency. This extends to STR,

where under the present regime, issuers face a lack of clarity when filing a suspicious transaction report. Paragraph 26 of the Consultation acknowledges this:

> *"The members of CESR are aware that there are uncertainties in the market as to the decision when to inform the competent authority of suspicious transactions as well as to uncertainties about the content of the STRs. Above that… it was also not commonly clear which CESR member would be [the] competent authority to receive such notifications."*

It is clear that at present, a degree of ambiguity exists regarding the competent authority to report to. This uncertainty may, however, be alleviated by the creation of a central repository, which would be the immediate recipient of all suspicious transaction reports, and would subsequently disseminate the reports to the regulatory authorities in the Member States concerned. We advocate the creation of such a repository on the basis that a single entity standardises filing requirements for issuers, avoids duplication, and reduces cost[16]. Lower costs may also be conducive to increasing the number of suspicious transaction reports received, as it becomes faster and more efficient for issuers to produce and file reports.

14th August 2008.

[16] Our June 2004 comment letter to CESR (Ref. CESR/04-073b), as referenced in note 11 of this letter, sets out a comprehensive list of benefits a central repository (or central "Data Collection Facility") would bring.