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A revision of the Market Abuse Directive (MAD)

CFA Institute is pleased to comment on the European Commission's consultation concerning proposals for the revision of the Market Abuse Directive (the "Consultation").

CFA Institute, through its members' experience in international markets and different investment disciplines, represents the interests of investors and investment professionals to standard setters, regulatory authorities, and legislative bodies worldwide. CFA Institute promotes fair, open, and transparent global capital markets, and advocates for investors' protection.

The MAD is a key element to market integrity. Without a market abuse regime, unscrupulous participants in the market would take advantage of investors. Consequently investors would either reduce or cease investing. This would severely reduce access to capital for the corporate sector, substantially increase the cost of capital, and reduce economic growth and employment opportunities. Hence as an organisation committed to professionalism and market integrity we welcome the opportunity to comment on proposals to improve the effectiveness of the market abuse regime.

General Comments

The Consultation sets forth proposals under three sections: extending the scope of the directive, enforcement powers and sanctions and the creation of the single rule book.

Extending the scope of the directive

- We see a clear case to extend the scope of the Directive. The introduction of the Markets in Financial Instruments Directive (MiFID) precipitated significant changes to the operating structure of the markets, such as the creation of Multilateral Trading Facilities (MTFs). Securities that trade exclusively on MTFs lie outside the scope of the Directive; we feel this represents a significant risk to investors. The risk is aggravated where securities that trade on regulated markets (covered under MAD) trade side-by-side with securities traded exclusively on MTFs. We are concerned that such

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conditions may create a false sense of security for investors, who may automatically assume that all stocks traded on MTFs fall under the scope of the Directive.

- We also support the extension of the Directive to cover attempts at market manipulation in the cash and derivatives markets, and also the alignment of the general definition of inside information to the commodity derivatives market.

- We do not support an 'adapted regime' for smaller and medium sized enterprises (SMEs) to reduce their regulatory burden. Our analysis indicates that smaller companies have a higher incidence of fraudulent activity than larger companies. Whilst we are sympathetic to reducing the SME regulatory burden, we do not support proposals that create two standards of investor protection.

Enforcement powers and sanctions

- The Directive was founded on the principles of minimum harmonisation, which at the time was compatible with the level of desired integration by Member States. The financial crisis has brought into sharp relief the need for pan-European if not global solutions to defects in the operation of the financial markets. Analysis of the market abuse regime reveals a mixed commitment to enforcement and inconsistent application of sanctions. Hence we support measures that strengthen the effectiveness of the regime across the Union, such as increasing cooperation between competent national authorities, harmonising sanctions, making broader use of civil prosecutions and 'enforceable undertakings' and naming and shaming the perpetrators of market abuse.

- In addition we support proposals to enhance suspicious transaction reporting requirements on market professionals to include suspicious transactions in the derivatives markets and orders in both the cash and derivatives markets. We are also troubled that journalists (who largely fall outside the scope of the regime) have on occasion unwittingly become the agents of abusive activity. We feel this matter needs urgent consideration.

Single Rule Book

- The development of the single rulebook across Europe will be part and parcel of the creation of a single market. To set the necessary framework for this to happen, the revised Directive should make clear statements on the obligations of market operators to better prevent and detect market abuse.

- We are strongly opposed to the measure that would permit the regulator to decide the acceptability of delaying disclosure to the markets where a financial institution is in receipt of emergency support from a central bank. This is material information, whose delay undermines the transparency of the markets. Further, we believe that such a delay cannot be kept confidential and that the regulator is conflicted in making such a judgement.

- We are also uncomfortable with accepted market practices (AMPs) that are acceptable in one market and not in others. It seems invidious to the process of building a single rulebook that the first steps include the codifying exceptions to the rules.

- Lastly on insider lists, we are not convinced that they are either a deterrent to market abuse or an aid to investigation in suspected cases of market abuse. Therefore we suggest that the obligation on issuers to construct and maintain these lists be removed and replaced by an obligation on banks and brokers to have customer records that would aid the investigatory process.

Please do not hesitate to contact us should you wish to discuss any of the points raised.

Yours faithfully,

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With headquarters in Charlottesville, VA, and regional offices in New York, Hong Kong, London and Brussels, CFA Institute is a global, not-for-profit professional association of more than 101,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 135 countries, of whom more than 89,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 58 countries and territories. We have over 11,000 members resident in the European Union.

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<u>Specific Comments</u>

Our response addresses the questions set forth in each section of the consultation paper.

Section A - Extension of the scope of the directive

1. *Should the definition of insider information for commodity derivatives be expanded in order to be aligned with the general definition of inside information and thus better protect investors?*

   We support the expansion of the insider information definition for commodity derivatives to include material non-public "price sensitive information" criterion. Our organisation responded to the CESR/ERGEG consultation on Market Abuse in the context of "The Third Energy Package" of August 2008[1]. Commodity derivatives are more commonly subject to market manipulation through cornering. However, our analysis of the transmission of gas and electricity suggests that there is significant opportunity to benefit from inside information concerning transmission utilisation, producer output and capacity constraints brought on by planned maintenance. Such information, which at the time of our analysis was not generally available, is extremely valuable. Hence, we support the inclusion of the price sensitive information criterion.

2. *Should MAD be extended to cover attempts to manipulate the market? If so why? Is the definition proposed in this consultation document based on efficient criteria to cover all cases of possible abuses that today are not covered by MAD?*

   We agree with the Commission's reasoning behind their proposal to extend the definition of market manipulation to include attempts to manipulate the market, which do not require proof that the manipulation was successful.

   The introduction of MiFID has encouraged the development of fragmented markets with significantly smaller average order sizes on the traditional 'lit' exchanges. This

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[1] http://www.cfainstitute.org/Comment%20Letters/20080829.pdf

makes the 'lit' exchange extremely sensitive to above average orders that would be regarded as very small in terms of institutional business. We understand that larger block orders are increasingly transacted in the 'dark' markets, at reference prices determined by the lit markets. Hence, we think it is plausible that a heavy order 'leaning' on the lit market could be used to influence the reference price of a block trade in the dark market. In this case the establishment of a connection between one of the parties involved in the block trade and the order in the 'lit' market could prove a valid reason for further investigation into manipulative behaviour.

With regards to the final part of the question, we are not legal experts so we cannot give a definitive answer, though we believe that the proposal is an improvement.

3. *Should the prohibition of market manipulation be expanded to cover manipulative actions committed through derivatives?*

   Yes, for similar reasons as stated above, in the case of the derivatives market a relatively modest financial outlay can command a substantially larger underlying or related asset. Therefore, transactions and orders in the derivatives market will influence the prices of underlying and related securities in the cash markets. One such example is the relationship between credit default swaps (CDS) and equity securities. The CDS market is relatively opaque and therefore certain transactions in this market could generate false signals over corporate creditworthiness in order to indirectly manipulate prices in the equity market. Whilst there is a legitimate case for hedging and arbitrage activity, suspicions should be raised where ex-ante behaviour by one party could be have been motivated by a desire to influence a reference price for an underlying or a related trade with another party.

4. *To what extent should MAD apply to financial instruments admitted to trading on MTFs?*

   The enactment of MiFID reduced the protective coverage set out in the earlier Market Abuse Directive. We strongly support the extension of MAD to cover those securities solely admitted to trading on MTFs; investors should be offered the same level of protection wherever the trade takes place. At present, there is a risk that unwary investors will be duped into believing that the scope of the directive covers all securities on MTFs, when in fact the MAD only applies to those securities traded on MTFs that are also traded on Regulated Markets. Because both types of securities – those covered by MAD and those not currently covered by MAD - trade side-by-side on MTFs, it is difficult for investors to determine the level of protection provided by MTFs. Not only is this detrimental for investors, it is also potentially disadvantageous for MTFs if investors are discouraged from conducting transactions on these platforms due to uncertainty over the level of investor protection afforded by these venues. We would suggest that MAD uses the MiFID definition of financial instruments (Section C of annex 1) for simplicity, for greater investor protection and for the delivery of a comprehensive solution across markets and instruments. We support the broad and open definition of derivatives and would recommend against a prescriptive definition, as this would encourage gaming of the regulatory principles.

5. *In particular should the obligation to disclose inside information not apply to issuers who only have instruments admitted to trading on an MTF? If so why?*

We disagree; inside information should be disclosed by all public issuers, it is a vital part of the price discovery process.

6. *Is there a need for an adapted regime for SMEs admitted to trading on regulated markets and/or MTFs? To what extent should the adapted regime apply to SMEs or to "companies with reduced market capitalisation" as defined in the Prospectus Directive? To what extent can the criteria to be fulfilled by SMEs as proposed for such an adapted regime be further specified through delegated acts?*

   We are attracted to the concept of an SME regime that reduces the regulatory burden yet maintains a high level of investor protection. In principle, we are in favour of thoughtful measures to reduce regulatory burdens for all issuers. However, we would oppose any measures that reduced the burden of reporting and disclosure for smaller companies, thereby setting up an adapted regime for SMEs. We are aware of a number of studies conducted in the United States that demonstrate a higher incidence of fraudulent activity in smaller companies as measured by a higher frequency of accounting restatements[2] and poor internal controls[3]. Given the inferred higher incidence of disreputable behaviour amongst smaller companies, we feel it is unwise to seek to reduce their regulatory burden at the expense of reduced investor protection.

Section B – Enforcement powers and sanctions

7. *How can the powers of competent authorities to investigate market abuse be enhanced? Do you consider that the scope of suspicious transactions reports should be extended to suspicious orders and suspicious OTC transactions? Why?*

   We agree that the enforcement powers for competent authorities need to be clarified in favour of obtaining telephone and data traffic records with respect, and only clearly in respect, of investigating suspected cases of market abuse.

   Another matter raised at the Commission's public hearing on the MAD on the 2nd July 2010 concerned the use of journalists, as agents of market abuse. The financial crisis has seen journalists broadcasting highly precise information on issuers, which later proved inaccurate. These comments led to significant price movements, which could have been beneficial to the financial interests of the journalist's source[4]. Journalists virtually escape prosecution from being agents of market abuse as they are protected from revealing their sources on the grounds of protecting the public interest. Outside the realm of securities markets this is an important freedom of our Society. However, we feel that journalists should quote their sources when transmitting specific price

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[2] See page 3 of executive summary
http://www.complianceweek.com/s/documents/AARestatements2.pdf

[3] See page 6 "Glass Lewis … "
http://www.cii.org/UserFiles/file/resource%20center/council%20governance%20alert/2009%20Archive/2009%20Alert%2048.pdf

[4] BBC coverage of Lloyds HBOS merger talks
http://news.bbc.co.uk/1/hi/business/7621151.stm

sensitive information on issuers. If they feel they cannot, then they should consider whether broadcasting the story amounts to market abuse, seek a second source to confirm the story, and accept that they must reveal their sources should an investigation follow.

The reporting of suspicious transactions by market professionals is the frontline resource in the fight against market abuse. As experts in the markets, who are exposed to the daily flow of business, they are better placed than supervisors to detect abusive behaviour. Hence, we would support the extension of suspicious transaction reports (STRs) into OTC derivatives, again highlighting how using the MiFID definition for financial instruments could bring greater coverage and clarity to the scope of the Market Abuse Directive. We also support the reporting of suspicious unexecuted orders. As stated above, the presence of a 'heavy' order in one market could be used to manipulate the price in another.

8. *How can sanctions be made more of a deterrent? To what extent need the sanction regimes be harmonised at the EU level in order to prevent market abuse? Do you agree with the suggestions made on the scope of appropriate administrative measures and sanctions, on the amounts of fines and on the disclosure measures and sanctions? Why?*

We agree with the Commission's comment that market abuse *"Sanctions should therefore be proportionate to the gravity of the infringement and the gains realised, and should be consistently applied"*. In practice, the European experience falls well short of this expectation, as clearly demonstrated by Mr. Carlos Tavares, current Vice-Chairman of CESR at the public hearing mentioned above. We believe that a harmonised sanctions regime is a necessary condition to creating an effective European deterrent to market abuse. Whilst the Commission points out that sanctioning authority rests with national regulators, we believe that an inter-government review of best practice, perhaps through a college of supervisors, involving investigation, prosecution and enforcement, with a commitment to adopt a common best practice, would do much to improve the integrity of the market abuse regime. We are particularly supportive of the use of civil prosecutions as a substitute for criminal prosecutions, on the basis that they are faster and reduce the burden of proof to "the balance of evidence" as opposed to "beyond reasonable doubt". Naturally, prison sentences cannot be applied in civil prosecutions, but this does not preclude regulators using 'fit and proper tests' to exclude convicted market professionals.

An alternative remedy is the use of "enforceable undertakings", as applied by the Australian Securities and Investments Commission[5], the Dubai International Financial Centre and others. We believe that these are effective "administrative measures" that the Commission should consider in the context of a pan-European remedy to market abuse. These agreements will compensate persons damaged and control the behaviour of individuals and corporations to maintain future compliance with the law. A suspected breach of an enforceable undertaking is a matter for the Courts, and a

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[5] http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/EU_guide.pdf/$file/EU_guide.pdf

repeated breach of an enforceable undertaking is a contempt of court offence, which is an imprisonable offence.

In addition to the above, we support the Commission's desire to harmonise and increase to scope of:

i) Administrative measures to put an end to a breach in the market abuse provisions: injunctions to put an end to infringement, temporary prohibition of an activity, correction of false or misleading information;
ii) Administrative sanctions as part of an effective deterrent: fines and periodic payments; and
iii) Minimum administrative sanctions where the fine should be at least twice the advantage gained.

We also believe that the competent authority should publicise every measure and sanction imposed for infringing the provisions of the market abuse regime. We are not supportive of the suggested exemptions, "unless such disclosure would seriously jeopardise the financial markets or cause disproportionate damage to the parties involved". For the former, we are unconvinced that the suppression of such a heinous level of market abuse would be in the public interest. As for latter, we believe that disclosure is proportionate to the level of the sanction. We prefer the public to make their own informed decisions on whether they should conduct business with a particular party who has been convicted of market abuse, unless the sanction is no more than a private censure.

9. *Do you agree with the narrowing of the reasons why a competent authority may refuse to cooperate with another one as described above? Why? What coordination role should ESMA play in the relations among EU competent authorities for enforcement purposes? Should ESMA be informed of every case of cooperation between competent authorities? Should ESMA act as a binding mediator when competent authorities disagree on the scope of information that the requested authority must communicate to the requesting authority?*

Yes, we do agree with the Commission's proposals to narrow the reasons why a competent authority may refuse to cooperate with another competent authority. The proposal seeks to delete the exemption "where: judicial proceedings have already been initiated in respect of the same actions and against the same persons before the authorities of the Member State addressed". Such an exemption appears to be an unnecessary restraint on a separate or parallel investigation by another member state. In this event: cooperation, the pooling of resources and evidence appear to be in the public interest, provided that as a result of cooperation, the case for the prosecuting competent authority is not damaged by the disclosure from the other competent authority.

We believe that the new European Securities Markets Authority (ESMA) has an important role to play in coordinating relations between competent authorities. We envisage that ESMA could take a leading role, by staffing a specialist unit of investigators to support national competent authorities in complex cases of market abuse. We see significant improvements in process and cost savings by creating this unit over the existing network of 27 separate investigatory units stretching the length and breadth of the Union. ESMA should have powers of binding mediation between competent national authorities to maintain the pan-European interest. ESMA should kept informed, as desired, of all investigations to further consistent enforcement and sanctions across the EU on matters of market abuse.

10. *How can the system of cooperation among national and third country competent authorities be enhanced? What should the role of ESMA be?*

We believe that IOSCO's 'Multilateral Memorandum of Understanding' (MMOU) has paved the way for information sharing between Member States and Third Countries. The obstacle to overcome is creating an identity for ESMA where it could become an 'Appendix A' signatory of the MMOU. This would be dependent on ESMA having:

i) The legal power to compel information from persons within its jurisdiction,
ii) The legal power gain information to reconstruct transactions and trace the flow of funds,
iii) The legal power to send information to another competent authority,
iv) The authority to let other competent authorities use this information to enforce compliance in their own jurisdictions, and
v) The authority to keep confidential information received from other competent authorities unless disclosure is required for enforcement purposes.

Section C – Single rule book

11. *Do you consider that a competent authority should be granted the power to decide the delay of disclosure of inside information in the case where an issuer needs an emergency lending assistance under the conditions described above? Why?*

We are strongly opposed to the proposal to empower the regulator to judge when to delay disclosure to the market when a financial institution receives emergency assistance, as the regulator is conflicted. In the first instance, the circumstances by which a financial institution becomes vulnerable are through a failure of prudential regulation or malfeasant behaviour on the part of the management of that financial institution. In either case, the public perception of the competent authority is damaged and it will be natural for the authority to mitigate the extent of that damage through concealment, justified under the principle of retaining the confidence of the markets.

We do not believe these matters can be kept confidential, we know from the behaviour of the interbank market that market professionals can detect distress. If a financial institution is in need of liquidity support from a central bank it obviously faces difficulties on the interbank market. Financial institutions active in the credit markets will be aware of the fact that it is facing illiquidity problems. As a result, deferring public disclosure would disadvantage shareholders and depositors to the benefit of large integrated financial institutions. Such a measure would damage the fairness and efficiency of capital markets.[6]

[6] See our response to FSA's consultation on disclosure of liquidity support. https://www.cfainstitute.org/centre/topics/comment/2008/pdf/080922.pdf

Moreover, since large, systemically important financial institutions (who would otherwise act as lenders in the interbank market) and their counterparties, will very likely know which financial institution is in distress; news that this institution is in receipt of liquidity support from a central bank might actually prevent the stock from collapsing. Without such disclosure, rumour and suspicion of the institution's impending collapse may precipitate heavy selling of the institution's shares, thus exacerbating financial instability. Hence, deferred disclosure under these circumstances would be counter-productive.

In our view, extending the provisions for deferred disclosure to financial institutions receiving liquidity support would mean putting the interest of the issuer above the interest of the market and the individual investor. For that reason, we oppose any proposal in this direction.

We reiterate that timely information is vital to fair and efficient markets. The general interest of individual issuers should not be above the integrity of financial markets and the collective interest of investors.

We also note that the Consultation considers permitting the issuer to declare to the regulator that it has delayed disclosure of inside information and thereby putting the onus on the regulator to decide if the delay was justified. Superficially this would seem to promote self-policing of the system, but we are not convinced. We do not think the regulator is best placed to deliberate whether the information delay was appropriate, because we do not feel the regulator can be both prosecutor and judge, particularly under the disproportionate pressure of issuers and their advisors. We feel these matters are best handled through a judicial process.

12. *Should there be greater coordination between regulators on accepted market practices?*

In principle we support greater coordination between regulators, however we find it difficult, in a single market context, to have accepted market practices (AMPs) in one market, but not in all EU markets. We understand that there are less than a half-dozen AMPs in the EU; we suggest that the policy approach should be to examine whether these AMPs further the goals of the internal market or are in place to protect national interests. If the former then they should be incorporated at a European level, if the latter then they should be discouraged. The Commission's proposal is to redefine the meaning of AMPs as "market practices that are reasonably expected in one or more financial markets (covering both regulated markets and MTFs) and are accepted as being legitimate by the competent authority in accordance with binding technical standards." Our concern is that this proposal will give more freedom to competent authorities to create new AMPs, which would be against the spirit of the internal market and the creation of a single rulebook.

13. *Do you consider that it is necessary to modify the threshold for the notification to regulators of transactions by managers of issuers? Do you consider that the threshold of Euro 20,000 is appropriate? If so why?*

We do not consider it necessary to modify the threshold for the notification to regulators of transactions by managers of issuers. The administrative burden is relatively small and the disclosure is useful to the market. We recognise there is some merit in raising the threshold of notification from 5,000 Euros to 20,000 Euros, reflecting the growth of executive remuneration since the original threshold was set in the 2004 level 2 Directive (2004/72/EC). We question whether raising the threshold will reduce the number of notifications. Wealth as well as remuneration has risen in the intervening period, therefore the average transaction size will have increased, but this will not have affected the number of transactions. With this in mind, we favour leaving the current threshold unchanged, the size and number of manager transactions conveys important information to the market.

14. *Do you consider that there are other areas where it is necessary to progress towards a single rulebook? Which ones?*

Yes, with reference to insider lists. We are not convinced that they are either an aid to the investigatory process, or an effective deterrent to insider trading. We have raised concerns over the practicability of insider lists in previous consultation responses on MAD[7]. Since expressing these concerns, we have not become aware of any developments that have materially improved the administrative efficiency and utility of these lists.

An investigation into insider trading generally begins with a suspicious transaction. Identifying the counterparties and their relationship and interest in the issuer follows in short order. Identifying the employer of the counterparties effectively supersedes the value of the insider list. Combined with the afore-mentioned concerns over their practicability, we therefore suggest removing the obligation on issuers to construct and maintain insider lists. In place of this requirement we would prefer that an obligation be placed on all banks, brokers and other organisations that facilitate securities transactions on behalf of clients, to have on record for individual customers a note of current and previous employers over the last two years, and for corporate clients, a record of directors, significant owners and the names of the people authorised to place orders (if such record-keeping obligations do not already exist). We feel this would be a more effective deterrent to insider trading and of greater use to the investigatory process in cases of suspected insider trading.

15. *Do you consider that it is necessary to clarify the obligations of market operators to better prevent and detect market abuse? Why? Is the suggested approach sufficient?*

A clear policy statement from a European level on the obligations of market operators to prevent and detect market abuse will assist in increasing the harmonisation framework amongst member states to encourage the building of a single rulebook.

We believe that suspicious transactions reporting should be conducted through one pan-European reporting portal managed by ESMA, with direct access for national competent authorities so that they may promptly begin their own investigations. Such a centralised reporting mechanism would facilitate cooperation between competent

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[7] See CFA Institute's August 2008 comment letter to CESR on the MAD: http://www.cfainstitute.org/Comment%20Letters/20080814.pdf

authorities on suspected cases of market abuse for transactions that influence securities and related securities in more than one national market.

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