

CESR CONSULTATION 06-562

Market Abuse Directive Level 3 – Second set of guidance

Response of the French Association of Investment Firms (AFEI)

Summary

- AFEI welcomes CESR's Level 3 guidance on market abuse, especially the section dealing with **insider lists**. On this issue, the proposal to introduce a mutual recognition system at European level is interesting, although considerable progress will need to be made in terms of harmonisation in order for such a system to work properly (see §21 and 22, and Annex).
- Regarding the **definition of inside information**, AFEI considers not only that CESR has failed to clarify the issue but that it may even have created confusion. The definition and criteria set forth in Level 1 and Level 2 legislation allows financial intermediaries to determine whether information qualifies as inside information whereas, in practical terms, CESR's input is likely to complicate this process:
 - o AFEI considers that CESR's **broad interpretation** of "precise nature" is neither suitable nor timely, especially as regards **public offerings of securities**.
 - o The assessment of whether information is inside information must and can only be made by systematically examining **the four basic criteria on a case by case basis**.
 - o The **"reasonable investor test"**¹ must remain the benchmark for assessing the "significant price effect" criterion.
- AFEI hopes that the issues raised in its response to the **Call for Evidence** (CESR / 06-078, *AFEI 06-48*) will be taken into account in CESR's future work programme.

1. CESR recently submitted its second set of guidance on the Market Abuse Directive (2003/6/EC) for consultation until 2 February 2007.

According to CESR, the consultation is intended to complement its recent Call for Evidence on the evaluation of the market abuse regime, to which AFEI submitted a number of comments (*AFEI 06-48*). At the time, AFEI drew CESR's attention to the fact that Member States had divergent interpretations and practices concerning insider lists. We therefore welcome CESR's initiative in proposing a mutual recognition system for insider lists, but we regret that it has not adopted a more comprehensive solution in terms of harmonisation (see §21 *et seq*).

¹ Under Article 1 of Directive 2003/124/EC, ISPs are required to consider the question of price impact from the point of view of an average, or "reasonable" investor (the "reasonable investor test").

2. AFEI supports the initiative set out in the second set of guidance on the implementation of the Market Abuse Directive (MAD). As we have often stressed, preventing market abuse is a major concern for AFEI members; it is also vital for achieving an integrated financial market in Europe. Consequently, the harmonisation process set in motion by the MAD must be pursued. In this regard, CESR's first set of guidance on accepted market practices and the reporting of market abuse suspicions is useful in at least two ways: it makes the legislation on market abuse more understandable and easier to implement in a harmonised manner.

AFEI hopes that CESR will organise a consultation in the near future for a third set of guidance, dealing with topics not addressed in either the first set (*CESR 04-505*) or the second. These include investment research, the choice of competent authority for suspicious transaction reporting, and, more, importantly, stabilisation programmes for financial instruments (*AFEI 06-48*).

The guidance under review in this consultation concerns Articles 1 to 6 of the MAD and deals with the definition of inside information. It goes on to propose the mutual recognition of insider lists.

3. Responding to CESR's questions, AFEI wishes to submit comments on both these topics.

➤ **What constitutes inside information?**

4. In line with the MAD definition of inside information, CESR identifies four characteristics of inside information. Information may be considered "inside information" if:

- o it is of a precise nature (1)
- o it has not been made public (2)
- o it relates directly or indirectly to one or more issuers of financial instruments
- o were it made public, it would be likely to have a significant effect on the prices of [...] instruments or the price of related derivative financial instruments (3)

CESR provides additional clarifications for each of these criteria.

(1) Information of a Precise Nature

5. CESR starts by saying that the precise nature of information must be assessed on a case by case basis (see *paragraph 1.5*). It goes on to say that "precise information" stands in contrast to "rumour" or "speculation". As regards rumours, CESR advocates that issuers should be under no obligation to respond to market rumours "*which are without substance*".

It is hard to grasp the exact meaning of a rumour "without substance". Moreover, CESR does not offer a definition. AFEI opposes the use of a concept that is vague and therefore dangerous. In our view, no further reference should be made to it (see §8 for our comment on "rumours").

6. CESR says that each stage of a multi-stage process might constitute "precise" information. In other words, a takeover bid – even an unsuccessful one – can generate information that would qualify as precise (see *paragraph*). By the same token, a bid can be considered as "precise information", even if the bidder has not yet decided on the price (see *paragraph 1.7*).

7. However, such information must be specific enough to allow a conclusion to be drawn about its impact on prices, which means satisfying the "reasonable investor test", in order to be qualified as an inside information.

Proposed amendment

1.7 In addition, it is not necessary for a piece of information to be comprehensive to be considered precise. For example, an approach to a target company about a takeover bid can be considered as precise information even though the bidder had not yet decided the price. **However, this type of information must in all cases be specific enough to allow a conclusion to be drawn about its impact on prices, which means satisfying the “reasonable investor test”.**

8. AFEI is seriously concerned about CESR's explanations concerning the "precise" nature of inside information because they fail to properly clarify the respective ambits of (1) inside information, (2) rumour and (3) false information.

Broadly defined, in AFEI's view, "rumour" covers three categories of information, depending on the source:

- (i) A rumour stemming from a "leak" at the issuer. This may constitute inside information;
- (ii) A rumour that is patently unfounded, that cannot be traced back to its source at the issuer, and that is spread deliberately in order to mislead. This may constitute false information;
- (iii) A "market" rumour, i.e. an opinion put forward by certain persons, and passed on by others, that spreads through the market. This type of rumour should be explicitly excluded from the definition of inside information.

9. In paragraph 1.8, CESR says that two criteria must be taken into account to determine whether a piece of information is specific enough *"to allow a conclusion to be drawn about its impact on prices"*:

- (1) the information would allow a "reasonable" investor to take an investment decision without risk (or with very low risk),
- (2) the information is such that it is likely to be exploited immediately on the market.

Apart from calling on CESR to specify whether these criteria are cumulative or alternative, AFEI thinks that the focus of the discussion in paragraph 1.8 should shift down to paragraph 1.11 (the section of the paper dealing with the "reasonable investor test") and hence to the criterion of significant price effect, because this is the crux of the issue.

The "reasonable investor test" – that is, assessing the potentially significant effect on prices from the standpoint of a "reasonable investor" – is one of the key factors for identifying inside information. That is why the indications provided by paragraph 1.8, especially the phrase *"without (or at very low) risk"*, are useful and should be added to paragraph 1.11.

Proposed amendment

1.8 As regards whether a piece of information is specific enough to allow a conclusion to be drawn about its impact on prices, CESR Members consider this would occur for example in two circumstances. The first would be when the information is such as to allow the reasonable investor to take an investment decision without (or at very low) risk. The second would be when the piece of information was such that it is likely to be exploited immediately on the market.

[...]

Significant Price Effect

1.10 Article 1 of Commission Directive 2003/124/EC amplifies what is meant by the concept of 'information likely to have a significant price effect' "...information which, if it were to be made public, would be likely to have a significant effect on the prices of financial instruments or related derivative financial instruments shall mean information a reasonable investor would be likely to use as part of the basis of his investment decisions."

1.11 The 'reasonable investor test' set out above assists in determining the type of information to be taken into account for the purposes of the "significant price effect" criterion. **This criterion would be satisfied for example in two circumstances. The first would be when the information is such as to allow the reasonable investor to take an investment decision without (or at very low) risk. The second would be when the information was such that it is likely to be exploited immediately on the market.** In this context it should be noted Article 17.2 of MAD makes clear that implementing measures do not modify the essential provisions of the Level 1 Directive.

(2) Made Public

10. AFEI surmises that the explanation given by CESR in paragraph 1.9 concerns issuers only and entails no specific obligations for financial intermediaries. We ask CESR to confirm this.

(3) Significant Price Effect

11. CESR specifies in paragraph 1.12 that "significant price effect" must be assessed on an ex ante basis. It goes on to say that CESR members refuse to establish fixed thresholds for assessing this criterion (see *paragraph 1.13*).

AFEI totally agrees with this view. Both criteria – "significant price effect" and "precise nature of information" – must be assessed solely on a case by case basis.

12. Nevertheless, CESR provides that financial intermediaries must take a number of factors into account to assess price significance, and in particular "*all market variables that affect the financial instrument in question (These variables would include prices, returns, volatilities, liquidity, price relationships among financial instruments, volume, supply, demand, etc.).*" (see *paragraph 1.13 iv*)

AFEI insists that CESR should state explicitly that the relevance of these variables depends on the type of financial instrument under consideration. For example, volatility is relevant chiefly (but not only) for derivatives, while price is an essential or sufficient criterion for equities and equity related products.

It is also doubtful whether the requirement to recognise "all market variables" is compatible with the "reasonable investor test". Indeed, a reasonable investor is most unlikely to assess each and every one of these factors before making an investment decision. That would be too complex, too technical – in a word, unreasonable.

In any case, it should be remembered that the "reasonable investor test" is the benchmark for assessing whether information is likely to have a "significant price effect".

13. On this point, paragraph 1.14 gives a list of indicators that seem to go far beyond the "reasonable investor test".

The first indicator (*"the type of information is the same as information which has, in the past, had a significant effect on prices"*) is especially problematic. In essence, it would require investment services providers to keep a record of all the information they obtain, which they would have to classify as inside or non-inside (Moreover, the fact that a piece of information is considered "non-inside" in one set of circumstances certainly does not preclude it from being "inside" in another.) Since it is impossible to perform such assessments systematically – a case by case analysis is necessary – and after having carried out a cost/benefit analysis, we have serious doubts about whether this indicator should be kept.

Proposed amendment

1.13 CESR Members are clear that fixed thresholds of price movements or quantitative criteria alone are not a suitable means of determining the significance of a price movement. In determining whether a significant effect is likely to occur, **assuming that the "reasonable investor test" has been satisfied**, the following factors ~~should~~ **could** be taken into consideration:

- i) the anticipated magnitude of the matter or event in question in the context of the totality of the company's activity;
- ii) the relevance of the information as regards the main determinants of financial instrument's price;
- iii) the reliability of the source;
- iv) ~~all~~ **relevant** market variables that affect the financial instrument in question (~~These variables would include~~ **For instance**, prices, returns, volatilities, liquidity, price relationships among financial instruments, volume, supply, demand, etc.).

1.14 **Assuming that the "reasonable investor test" has been satisfied**, some useful indicators of whether information is likely to have a significant price effect that ~~should~~ **could** be taken into consideration are whether:

- ~~the type of information is the same as information which has, in the past, had a significant effect on prices~~
- pre-existing analysts research reports and opinions indicate that the type of information in question is price sensitive
- the company itself has already treated similar events as inside information

Examples of Possible Inside Information Directly Concerning the Issuer

14. CESR provides a list of events that might constitute inside information (see §1.15), explaining that the list is non-exhaustive and purely indicative.

15. AFEI would like it to be made clear from the outset that this list is both non-compulsory and illustrative. The purpose of Level 3 guidance is to spell out the obligations incumbent on various market participants, particularly financial intermediaries. Under no circumstances should it add to these obligations or gold-plate the directive.

16. Special care must be taken to ensure that this type of list does not become a tool for reversing the burden of proof to the benefit of the regulator, which might then rely on one of the items on the list – with no further analysis – to decide that a firm holds inside information.

For example, the regulator might consider that a financial institution is in possession of inside information if it is aware that an issuer is changing its statutory auditor. Firstly, this makes no sense: how does knowing about a change of auditor constitute inside information? Secondly, to determine whether or not a piece of information is inside information, it is vital to examine all the criteria (i.e. precise nature, non-public, price effect) as well as the context, necessarily on a case by case basis.

17. AFEI stresses the need to state clearly and explicitly that the items on the list are given solely as examples. We are proposing an alternative wording for this paragraph in an effort to ensure that the items under consideration do not constitute an expedient for hastily determining whether information is privileged or not. The same comment could be made in regards to paragraph 1.16.

Proposed amendment

Examples of Possible Inside Information Directly Concerning the Issuer

1.15 The following is a non-exhaustive and purely indicative list of events of the type which might constitute inside information **directly concerning the Issuer**. ~~(i.e. The fact that an event does not appear on the list does not mean it cannot be inside information nor does the fact that an event is included on the list mean that it automatically will be inside information. It is only when the information satisfies the other three criteria (i.e. precise nature, not made public, and likely to have a significant effect on prices) that it might constitute inside information.~~

However, as noted above, it is the specific circumstances of each case which need to be considered.

➤ **When do client orders constitute inside information?**

18. CESR recalls that the MAD states "*For persons charged with the execution of orders concerning financial instruments, 'inside information' shall also mean information conveyed by a client and related to the client's pending orders [...]*".

CESR considers that guidance would be useful in helping intermediaries understand more clearly the circumstances in which information about a client's pending orders may constitute inside information. The main problems connected with pending orders seem to concern two of the three criteria: significant price influence and precise nature. CESR offers lists of sample indicators for both of these (*see paragraphs 3.13 and 3.16*).

19. In AFEI's view, CESR's guidance does not really clarify the basic concept of a "pending client order".

In accordance with ongoing discussions on the Markets in Financial Instruments Directive, especially those regarding best execution, dealers who make markets in products such as bonds and derivatives are not charged with order execution because, in a market making situation, the client does not give an order as such but asks for a quote or an expression of interest. For this reason, the phrase "*persons charged with the execution of orders*" would not apply to market making ISPs. Because the majority of fixed income and derivative products do not give rise to a pending "order", they do not come within the scope of this provision, even though they may generate inside information if the conditions set forth in paragraph 1 of Article 1.1 of the MAD are satisfied.

20. In sum, AFEI notes that:

- (1) The notion of "pending client order" excludes the majority of transactions in non-equity products (bonds, derivatives, etc.).
- (2) Information relating to a client's pending order may constitute inside information if the execution of that order is likely to have a significant impact on the price of the financial instrument being traded (see paragraph §3.13).

CESR stipulates the conditions in which "*the test for the precise nature of an order's size, price limit and execution period*" are likely to be satisfied (§3.16). Here again, the test seems to be relevant for equity orders only.

➤ **Introducing a mutual recognition system for insider lists in Member States**

21. CESR notes that regulations on insider lists vary from country to country. It points out, however, that the requirement to draw up these lists applies firstly to the issuer who asked for its financial instruments to be admitted to trading on a regulated market in a Member State of the European Union (EU).

To compensate for these regulatory divergences, CESR makes two proposals:

- a regulator should recognise insider lists drawn up in accordance with the standards of another EU regulator,
- for third parties in relation to the issuer (e.g. an intermediary acting as an advisor), the list to be drawn up must comply with the same standards as those applicable to the issuer's own list, regardless of the nationality or location of these third parties.

22. These proposals confirm CESR's announcement at the open hearing on 17 October 2006 that it was introducing a system of "mutual recognition" for insider lists. While this initiative is certainly welcome, it should be noted that unless the contents of the lists and the arrangements for informing listed persons are properly harmonised, firms with bases in several countries will continue to face exactly the same problem of managing "intragroup" insider lists².

At this stage, even a "mutual recognition" mechanism would not enable these companies to introduce uniform procedures in this area.

CESR's proposed solution of mutually recognising insider lists is a major step forward. However, it solves only some of the problems identified by AFEI in its response to the Call for Evidence on the market abuse regime. The other problems relating to insider lists should be dealt with at the same time (see the extract from AFEI 06-48 in the Annex).

² Cf. AFEI 06-48 "The persistence of domestic practices and different interpretations by Member States of the European framework stand in the way of harmonisation. In particular, they prevent companies with operations in several countries from optimising processes to successfully combat market abuse. Procedures must be simplified and harmonised as far as possible to ensure that efforts to prevent abuse are effective. However, the current market abuse regime does not always allow for such harmonisation. For example, when European regulators ask for different information on insider lists, they have to prepare as many list formats as there are different regulations. This makes procedures more complex and harder to manage and also generates additional costs. Combined, these problems ultimately make systems less effective and the European market correspondingly less secure. This is especially true for large companies operating across the EU, which not only represent a large majority of participants, but are also the most active on the markets."

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ANNEX: Extract from "CESR Call for Evidence – Evaluation of the market abuse regime - Joint response French Association of Investment Firms (AFEI) and French Banking Federation (FBF)

➤ **Insider lists**

1. The content of insider lists should be more broadly harmonised

2. Article 5 of Directive 2004/72/EC deals with the obligation to draw up lists of insiders, setting out the requirements in relation to content, updating the lists, and providing information to people on such lists.

However, the directive merely specifies the minimum content for insider lists. It indicates that the list should state "the identity" of insiders, without saying what information is required. This has resulted in widely differing interpretations by European regulators as to the mandatory content for insider lists. Germany's BAFin, for example, requires extensive information, including personal details such as address and date of birth.

Aside from the fact that interpretations requiring large amounts of information to be gathered raise problems in terms of processing personal data³, AFEI and FBF also wish to point out that these sorts of divergences are undesirable⁴. They are especially unwelcome in this instance because managing insider lists is an extremely burdensome task for companies that have to "promptly update" their lists (Directive 2003/6, Art.6 §3). In any case, collecting detailed information on the people on insider lists does not serve the purpose of these lists, which is to create a tool to supervise the circulation of inside information, and to aid regulators as required.

We note that CESR has proposed a standard reporting format in the related area of suspicious transactions reports (CESR 04-505 b, paragraph 5.12. "suspicious transaction reporting format").

⇒ We therefore ask CESR to consider preparing a standard format for insider lists, stipulating the required level of content detail. The aim of these discussions should not be to align standards with those of the most "demanding" regulators, given that, as mentioned above, it is not necessary to collect exhaustive information on the individuals recorded in the lists to achieve the lists' goals.

2. Harmonising the procedures for providing information to people on insider lists

3. Article 5 of Directive 2004/72 states that the persons in charge of lists of insiders should *"take the necessary measures to ensure that any person on such a list [...] acknowledges the legal and regulatory duties entailed and is aware of the sanctions attaching to the misuse or improper circulation of such information"*.

³ Cf. Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data.

⁴ See Note 2

People on insider lists, then, must be provided with the above information. Nothing in the text of the directive says that this information should be provided on a case by case basis or that people must be provided with individual and personalised information. Yet this is what happens in some Member States, like Italy⁵.

It is extremely difficult from a practical perspective for an institution to personally inform every person who is to be added to or taken off a list of insiders. This is especially true for large groups with long, constantly changing lists. Given that providing individual and personalised information to people on insider lists would create a completely unnecessary additional burden, CESR should give companies latitude in terms of the procedures used to supply information to people on insider lists.

⇒ AFEI and FBF call on CESR to specify the procedures for providing information to people on insider lists.

3. Introduction of mutual recognition arrangements: a welcome initiative, but one that perhaps does not go far enough

4. At the open hearing on 17 October, CESR intimated that it was planning to set up a mutual recognition system for insider lists. While this initiative is to be welcomed because of its potential benefits, it must be stressed that unless list contents and the procedures for providing information to people on the lists are fully harmonised, companies with bases in several countries⁶ will continue to face exactly the same problem of managing intragroup insider lists.

Even a mutual recognition system will not enable these companies to introduce uniform procedures in this area. At the very least, CESR should explain how these arrangements might function in practice. If necessary, it should be possible to introduce a system of this sort without having to amend the Level 1 text of the directive.

4. Insiders classified by function, permanent insiders

➤ *A useful but unharmonised distinction*

5. On 18 January, the French securities regulator, the AMF, published a position on the compilation of insider lists, in response to practical queries from practitioners in France. The AMF's position is consistent with a well-established practice in the industry, authorising companies to draw a distinction between temporary and permanent insiders.

Permanent insiders are people who, by virtue of their function, have regular access to insider information about the issuer, such as compliance officers. Since these individuals have access to insider information because of the nature of their job, they can be included in ad hoc lists that are dealt with separately from lists of people who temporarily become insiders because of a transaction. Temporary insiders, meanwhile, are people who have access to information about the issuer from time to time, say because they are involved in preparing a financial transaction. These are also known as transaction team insiders.

We have learned that this approach is also used in the UK, which is planning to manage the circulation of insider information on an ad hoc basis, according to the function of employees. This distinction is crucial to ensure that the circulation of inside information is managed as effectively as possible.

⁵ According to the article 152-quinquies of Consob Regulation on Issuers each person registered in the insiders' list has to be informed of this fact and the communication must be individual and personal.

⁶ See Note 2

- ⇒ AFEI and FBF therefore call on CESR to consider ways to include the possibility of drawing up ad hoc lists for insiders based on their functions. It is worth recognising the distinction between temporary and permanent insiders, especially given the abovementioned issue of companies with bases in several countries.

