

Comments on CESR level 3, third set draft guidance on the common operation of the Market Abuse Directive

1. Authors and background

This paper presents comments on the CESR public consultation paper, CESR/08-717, entitled *Market Abuse Directive. Level 3 – Third set of CESR guidance and information on the common operation of the Directive to the market*, dated October 2008.

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The comments only concern part II of the consultation paper on the twofold notion of inside information.

2. Comments on the consultation paper part II

2.1. The proposition of the consultation

In its consultation paper, CESR wisely abstains from addressing the overall problems raised by the so-called twofold notion of inside information, i.e. that the concept of inside information is applied in two very different settings, that of preventing insider dealing and that of providing a continuous disclosure to the market.

These problems are highlighted by the public comments made available to CESR in earlier consultations and especially by the ESME group in its report, *Market abuse EU legal framework and its implementation by Member States: a first evaluation*, Brussels, 6 July 2007.

As CESR correctly observes, a review is currently being undertaken by the European Commission, and it is better to await the outcome of this process, which is likely to involve an overall assessment of the problems raised.

However, CESR nevertheless endeavours to offer guidance in respect of rumours, where its proposition upon which the public is invited to comment is stated in paragraph 36:

Therefore, if and when the relevant publication or the rumour relates explicitly to a piece of information or information that is inside information within the issuer, the

latter is expected to react and respond to the relevant publication or rumour as that piece of information or that information is sufficiently precise to indicate that a leak of information has occurred and, thus, that the confidentiality of this inside information is no longer ensured. In such circumstances, which should be the exception rather than the rule, a policy of "no comment" by the issuer would not be acceptable. The issuer's reaction or response should be made publicly available in the same conditions and using the same mechanisms that those used for the communication of inside information, so that an ad hoc announcement has to be published without undue delay.

Although it is amicable that CESR wants to offer guidance on this point of no small practical importance, the basis for its proposition needs thorough analysis, and a comment on the proposition thus requires that the whole analytical framework of MAD Article 6 is presented, even if it is generally accepted that such comment should await the review carried out by the Commission. A piecemeal approach in this respect is insufficient.

3. The analytical basis of the proposition

CESR appears to apply a distinction between rumours that reflect, respectively do not reflect, inside information within an issuer. The distinction is well known in most jurisdictions and to make it more operational, a distinction could be made between:

- *A rumour* that does not reflect inside information within an issuer, e.g. speculations, guesswork, fantasies and even manipulation prohibited by MAD Article 5.
- *A leak* that reflects inside information within an issuer, e.g. the inside information has been selectively disclosed to members of the public outside the issuer.

Whereas CESR apparently accepts the proposition made in the various comments on its prior consultations that an issuer is under no obligation to respond to rumours, which is a well-known feature of the law in many Member States, paragraph 36 makes it clear that in the opinion of CESR an issuer would always be under an obligation to respond to a leak. As shall be shown in this paper, this proposition goes too far and is only correct under certain conditions.

It should be noted that from the investing public's point of view there is no difference between a rumour and a leak, because they are in no position to tell the difference. Both may confuse the market as to the proper evaluation of the issuer's securities and may be regarded as equally harmful. Only those who actually know that a leak is

not just another rumour may profit from the information, if they in fact were not prohibited by doing so by way of the ban on insider dealing pursuant to MAD Article 2.

The basis applied by CESR to mandate disclosure in case of a leak appears to be MAD Article 6(2). Considered in isolation, Article 6(2) appears apt because it calls for prompt disclosure by the issuer in case of leaks. However, this would be to overlook that Article 6(2) is subsequent to Article 6(1) and cannot be relied upon until the duty to disclose has arisen according to Article 6(1).

To appreciate the distinction between the applications of these different provisions of MAD Article 6, it is necessary to lay out not only the internal structure of the said article, but of the overall framework of the Directive.

4. The internal structure of MAD Article 6 and the relevance of other provisions

It is immediately apparent from the structure of MAD Article 6 that Subsection 1 on the issuer's duty to disclose inside information to the market is prior to Subsection 2 on the issuer's delay of the said disclosure. Logically, a delay of disclosure of any given set of information cannot occur until the duty to disclose has arisen.

Subsection 1 of MAD Article 6 calls for disclosure 'as soon as possible', which subsequently is to be clarified by means of comitology according to Subsection 10 of the said article. In Article 2(2) of Directive 2003/124/EC on the definition and publication of inside information, the Commission lays down when an issuer is deemed to have complied with the duty to disclose according to MAD Article 6(1):

Member States shall ensure that issuers are deemed to have complied with the first subparagraph of Article 6(1) of Directive 2003/6/EC where, upon the coming into existence of a set of circumstances or the occurrence of an event, albeit not yet formalised, the issuers have promptly informed the public thereof.

Two things should be noticed here, firstly that Article 2(2) of the Commission Directive is by way of implementing the requirement of MAD Article 6(1) prior to the subsequent provisions of the said article, including MAD Article 6(2), And

secondly and equally important that Article 2(2) of the Commission Directive seems to offer a solution to the problem identified by numerous market participants and by the ESME group in their 2007 report about the two-fold notion of inside information.

Analytically, it is correct that the concept of inside information should serve as a common denominator to both the ban on insider dealing and the duty to make con-

tinuous disclosure.¹ The concept of inside information embodies an advantage in respect of the pricing of a publicly traded security as pointed out by the EC Court of Justice in its judgement of 10 May 2007 in case C-391/04, *Georgakis*, inside information represents an advantage for one party over another.² If such an advantage, which by definition is both unavailable to the market investors and of material interest to their pricing of the relevant securities, were acceptable in the market, the negative influence of asymmetrical distributions of information described by Nobel laureate George Akerlof would harm the functioning of the market. Three strategies may be pursued to avoid these harmful consequences:

- An informational advantage may be distributed to uninformed recipients by way of disclosure by the informed party, whereby the informational asymmetry is levelled.
- Where disclosure is not possible, or not yet possible, a ban on using the informational advantage will reassure the market participants that they need not fear suffering from informational asymmetry in the market.
- A ban on market manipulation, including a ban on price fixing by players with a dominant position, will prevent new informational asymmetries from arising.

It is evident that MAD recognises these three strategies in its provisions on insider dealing (Article 2), on market manipulation (Article 5), and on mandatory disclosure (Article 6), respectively.

The problem identified as the two-fold notion of inside information pertains to the first two strategies mentioned above. They both concern the concept of inside information, i.e. information that is not available to market participants and which is of material interest in determining the price of the relevant security, but nevertheless they represent two different strategies with their respective scopes of application.

The prevention of insider dealing should be done from the very moment that a set of information qualifies as inside information. This may be at a time when it is yet uncertain that the information will be realised as is evident from the definition of inside information in Article 1(1) of the Commission Directive:

For the purposes of applying point 1 of Article 1 of Directive 2003/6/EC, information shall be deemed to be of a precise nature if it indicates a set of circumstances which exists or may reasonably be expected to come into existence or an event which has occurred or may reasonably be expected to do so and if it is specific enough to en-

¹ See J. Lau Hansen, *The Trinity of Market Regulation*, 1 IJDG 82 – 96 (2003).

² On the judgement, see D. Moalem & J. Lau Hansen, *Insider Dealing and Parity of Information – Is Georgakis Still Valid?*, 19 EBLR 949 – 984 (2008).

able a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of financial instruments or related derivative financial instruments.

The uncertain nature of inside information is apparent from the wording marked in bold in the quote. It is no excuse of the crime of insider dealing that the insider took a risk that his informational advantage might not be realised as reasonably expected by using his inside information at a time when the outcome was yet uncertain. The protection against insider dealing should be offered from the earliest point in time when the relevant set of information acquires a character that makes it reasonable to expect that it might become a reality at some point later on.

This, however, is very different in respect of disclosure. Disclosure to the market should be done of information that has become a reality, not a mere possibility. To apply the early standard mandated by the desire to prevent insider dealing would be to compel the issuers to comment on issues that might, or might not, become a reality. This would not only be harmful to the issuers and their need for confidential planning, but would also provide a constant torrent of information that would be uncertain and prone to repeated correction resulting in yet more information thereby adding to the confusion in the market rather than enlightening it which should be the purpose of mandatory disclosure. This is the problem of the two-fold notion of inside information, and the ESME group correctly observes on page 6 in its report on the problem of applying the notion of inside information directly on the disclosure regime:

But in this way no listed company may keep any information confidential; no company would choose to be listed any more.

The Commission seems to offer a solution to this grave problem in its directive, in which Article 2(2) effectively restates the definition of inside information contained in Article 1(1) of the said directive but without references to future events, i.e. uncertainty, in that definition (the words marked in bold above). By this provision, the Commission seems to have continued the understanding of the continuous disclosure obligation that was mandated in the Listing Directive, cf. Article 68(1) of consolidated Directive 2001/34/EC, now repealed by the adoption of MAD, in particular its Article 6 on the same subject, whereby the duty for an issuer to disclose only arises when the inside information has become certain.

It would appear that the possible harmful effect of the two-fold notion of inside information has been adverted by the Commission Directive, and that the remaining problem is the lacking understanding in some jurisdictions of the importance that

should be attached to Article 2(2) of the Commission Directive when read in conjunction with MAD Article 6(1), and consequently not all jurisdictions face this problem. The ESME group points to Italy as an example of a Member State that has avoided this problem, and the Nordic Member States, i.e. Denmark, Finland and Sweden, could be mentioned as further examples thereof.³ When the Danish supervisory authority suggested that MAD Article 6(2) be used to determine the time for disclosure, it was overruled by the *Erhvervsankenævnet*, an administrative tribunal on matters of commercial law, which emphasised the priority of Article 2(2) of the Commission Directive over MAD Article 6(2).⁴

Consequently, the duty for an issuer to disclose a set of information that qualifies as inside information according to MAD Article 6(1) arises when the information becomes certain, i.e. the circumstances exist or the event has occurred, cf. Article 2(2) of the Commission Directive.

This does not render the prior qualification as inside information irrelevant. On the contrary, the qualification is important because it obliges the issuer to keep the information confidential, cf. MAD Article 3, and any abuse of the inside information would be punishable as insider dealing pursuant to MAD Article 2. It is thus important not to view the disclosure obligation in MAD Article 6(1) in isolation but to appreciate the interaction between the disclosure obligation, the ban on insider dealing, and the ban on selective disclosure of inside information, respectively. There is no need to prevent insider dealing or the selective disclosure of inside information by bending the application of the disclosure obligation in MAD Article 6, when the Directive provides specific provisions aimed at these problems in Article 2 and 3.

Only when the inside information has become a reality and a duty to disclose has arisen according to MAD Article 6(1), it becomes relevant to the issuer to explore whether that disclosure may be delayed according to MAD Article 6(2). The possibility of delay should be construed narrowly as it is an exemption to the overriding obligation to disclose according to Article 6(1) and should be confined to situations where disclosure may damage the issuer seriously. Where a delay of disclosure is permissible and a leak occurs, the issuer is under an obligation to make a full and prompt disclosure, which should not be difficult as the inside information at this point is a fact and therefore should be easy for the issuer to disclose.

³ Cf. J. Lau Hansen & E. Werlauff, A Stricter Duty to Disclose Information to the Market in Denmark?, *European Company Law*, 2008, Vol. 5, Issue 2, p. 47 – 55, discussing the law of the Nordic countries.

⁴ Decision of 11 September 2008, case no. 2007-0012239. Available in Danish on its homepage www.erhvervsankenævnet.dk.

Finally, when covering the internal structure of MAD Article 6 and its place in the overall framework of the Directive, attention should be given to Subsection 3. This provision requires disclosure in cases where the issuer has made a selective disclosure to an outsider, either intentionally or unintentionally. The provision in MAD Article 6(3) appears to be inspired by Regulation FD from United States federal law. However, it should be noted that US federal law on securities regulation does not carry a disclosure obligation similar to the one known for years in Europe due to the above-mentioned Article 68 of the consolidated directive, which was originally introduced in the appendixes of the Listing Directive. Prior to the development of Regulation FD, disclosure obligations in US federal law were all ad hoc disclosure obligations, i.e. the obligation to disclose was contingent on the occurrence of a fact covered by a specific disclosure obligation. A general disclosure obligation relating to all kinds of inside information was not introduced until Regulation FD came into effect, and even then it was not unconditional like the general disclosure obligation in European law, but conditional on the prior selective disclosure made by the issuer. Consequently, the disclosure obligation in MAD Article 6(3) should be recognised as a disclosure obligation in its own right and different from that in MAD Article 6(1) and thereby also from MAD Article 6(2), which is closely related to MAD Article 6(1), but not to Article 6(3) of the directive.

The disclosure mandated by MAD Article 6(3) should be seen in conjunction with the ban on selective disclosure of inside information in MAD Article 3(a). Where selective disclosure is made that is not covered by the exception in the last sentence of Article 3(a), the disclosure is not only a violation of the ban in the said article, it also triggers an obligation to disclose the selectively disclosed information to the market in general according to MAD Article 6(3).

Three things are noteworthy in this respect. Firstly, the duty to disclose according to Article 6(3) arises from a consideration of the equality of the market participants, i.e. that they should be given a level playing field. Contrary to Article 6(1), the disclosure obligation of Article 6(3) is conditional and is triggered by a selective disclosure in violation of Article 3(a).

Secondly, the disclosure mandated by Article 6(3) is different in scope from that mandated by Article 6(2). The latter requires full disclosure upon a leak, because the inside information in question should have been disclosed earlier according to Article 6(1) of the Directive, but has been delayed. The former only requires disclosure of the inside information to the extent that it was selectively disclosed by the issuer to an outsider. In other words, the duty to disclose according to Article 6(2) is broader and covers all delayed inside information, because disclosure should have taken place earlier according to Article 6(1), but the duty to disclose according to Article 6(3) is

triggered by the selective disclosure itself and consequently only covers the matters that were selectively disclosed. Thus, the scopes of disclosure required by the two provisions are different.

This leads to the third observation, namely that inside information may be subject to disclosure according to Article 6(3) even at a point, where no disclosure is mandated by Article 6(1) as laid down in Article 2(2) of the Commission Directive or by Article 6(2), which is subsequent to Article 6(1), because the triggering event is the selective disclosure and not the inside information itself. Thus, even inside information that is uncertain may be subject to disclosure according to Article 6(3) if selectively disclosed to outsiders in violation of Article 3(a).

5. What to do about leaks

First and foremost, it is important to state the overriding principle that the obligation to maintain orderly markets rests upon the national supervisory authorities of the Member States and they have been equipped with the necessary measures by the various provisions in MAD.

Secondly, it should be noted that an issuer is under no obligation to respond to rumours, although the issuer normally would choose to do so willingly to ensure a proper pricing of its securities. If rumours, which may include active manipulation by criminal elements, contort the market, the national supervisory authority has a duty to respond. It may initiate investigations, which in case of market manipulation would be of a criminal nature in most jurisdictions. It may even call upon the issuer in question to publicly clarify matters if this is necessary to create an orderly market, cf. MAD Article 6(7). However, until called upon to do so, the issuer may rely on its right to refrain from commenting or simply applying a 'no comments' policy.

There would not seem to be any analytical basis for arguing that the situation should be different in case of leaks. The investing public cannot tell rumours apart from leaks, and consequently their possible harm to the market is indistinguishable. Where a leak is concerned, the proper action would primarily be to consider it a violation of MAD Article 3(a) on selective disclosure and possibly of MAD Article 2 on insider dealing, which may warrant investigation by the national supervisory authority and possible co-operation by the issuer whose securities are affected. Only in two special cases would there be a legal basis for applying the disclosure obligations of MAD Article 6.

One legal basis is where a duty to disclose a set of inside information has arisen according to MAD Article 6(1) as laid down in Article 2(2) of the Commission Direc-

tive, but disclosure has been delayed according to MAD Article 6(2). In case of a leak, the issuer is under an obligation to promptly disclose the entire inside information that should have been disclosed earlier.

The other legal basis is where the leak is due to selective disclosure made by the issuer or a person acting on behalf of the issuer in violation of MAD Article 3(a). According to MAD Article 6(3), the selective disclosure would require the issuer to publicly disclose the parts of the inside information that had been selectively disclosed.

A few things should be pointed out in respect of these two provisions. As to MAD Article 6(2), the required disclosure would comprise the entire inside information that was delayed. However, disclosure can only cover such inside information that was subject to disclosure according to MAD Article 6(1), i.e. information of a certain nature, cf. Article 2(2) of the Commission Directive. Information that is not subject to disclosure according to MAD Article 6(1), because it is not yet certain, is not covered by the provision on delay in MAD Article 6(2), and consequently the duty to disclose in case of a leak is irrelevant to such inside information.

In respect of MAD Article 6(3), disclosure may be required even if the inside information is not yet certain, if it does qualify as inside information according to the definition in Article 1(1) of the Commission Directive and the selective disclosure of it has been done in violation of MAD Article 3(a). However, a duty to disclose is dependent on the fact that the selective disclosure was made by the issuer or by a person acting on its behalf or on its account. Selective disclosure made by others would not trigger a duty for the issuer to disclose according to MAD Article 6(3) even if the selective disclosure did concern inside information within the issuer, and the issuer may refrain from disclosing according to MAD Article 6(3) until it has either satisfied itself that the leak did originate within its sphere of influence or is called upon to disclose by the national supervisory authority acting according to MAD Article 6(7). A selective disclosure of inside information by third parties is not governed by MAD Article 6(3), but by MAD Article 3(a) and possibly MAD Article 2 when trading has occurred, and must be handled accordingly. If the issuer is satisfied that the leak did originate within its sphere of influence, it must disclose as soon as possible the inside information that has been leaked, but the issuer is under no obligation to disclose any other related inside information in its possession. The purpose of disclosure according to MAD Article 6(3) is to provide a level playing field for the market participants in respect of the present distribution of information, not to ensure the publication of inside information ripe for market consumption as is the case with disclosure according to MAD Article 6(1). Finally, it should be observed that a duty to disclose according to MAD Article 6(3) in case of involuntary selective disclosure probably does not arise unless the disclosure has an effect on the market. The definition of inside infor-

mation would suggest that such an effect would most often be expected, but if for some reason the disclosure goes unnoticed, a duty to respond should not be necessary.

6. Conclusion

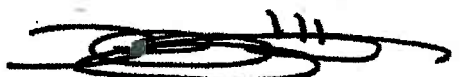
The proposition made by CESR that an issuer, when faced with a rumour that relates to inside information within the issuer, i.e. a leak, is obliged to disclose the inside information is correct, but only insofar as two specific cases are concerned.

The first case is where the issuer has availed itself of the possibility in MAD Article 6(2) of delaying the disclosure of the inside information mandated by MAD Article 6(1). A leak of that inside information would trigger an obligation on the issuer to disclose the information. If, on the other hand, the inside information is not subject to disclosure according to MAD Article 6(1) as laid down in Article 2(2) of the Commission Directive, i.e. it is not yet certain, no disclosure obligation in response to a leak according to MAD Article 6(2) would arise.

The other case is when MAD Article 6(3) applies. According to this provision, the issuer may be under an obligation to disclose the inside information in question even if the inside information is uncertain and as such is not covered by MAD Article 6(1), but that would require the issuer to be satisfied that the selective disclosure originates within its sphere of influence and that the inside information has had an effect on the market, and then the disclosure called for would only be the inside information already selectively disclosed.

In all other cases, the issuer may refrain from commenting on such rumours as is the case with all other rumours or apply a policy of 'no comment'. If the market is distorted by the rumours or if selective disclosure of inside information by others than the issuer is suspected, it is the duty of the national supervisory authority to respond. Such response may call for the active co-operation by the issuer, e.g. to expose persons in possession of inside information as part of a criminal investigation, and the supervisory authority may call upon the issuer to address persistent rumours by way of MAD Article 6(7).

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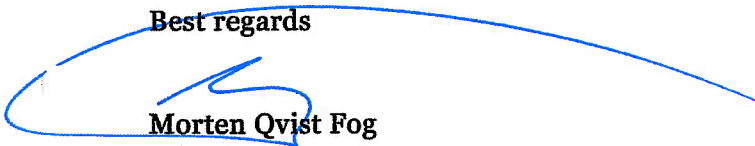
Comments on the CECR public consultation paper, CESR/08-717

In October 2008 CESR initiated a public consultation of the paper "*Market Abuse Directive. Level 3 – Third set of CECR guidance and information on the common operation of the Directive to the market*".

By this letter the Confederation of Danish Industry will give its endorsement to the comments put forward in January 2009 by Dr Jesper Lau Hansen, Dr. Jur., Professor at the University of Copenhagen Law Faculty, and Dr David Moalem, PhD, partner and Attorney-at-Law at Deloitte in Copenhagen.

The Confederation of Danish Industry is a private organisation currently funded, owned and managed entirely by 11.000 companies within manufacturing, trade and service industry.

Best regards



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