

# ISDA

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M. Fabrice Demarigny  
Secretary General  
Committee of European Securities Regulators  
11-13 avenue de Friedland  
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17<sup>th</sup> June 2003

Dear M. Demarigny

## **Market Abuse: Additional Level 2 Implementing Measures**

We welcome the opportunity to respond to CESR's consultation paper on additional level 2 implementing measures under the Market Abuse Directive. In this letter we set out our comments on the proposals which are most likely to be of direct concern to members of the International Swaps and Derivatives Association (ISDA). These are:

- The definition of "accepted market practices".
- The definition of "inside information" in relation to commodity derivatives.
- The implementing measures concerning suspicious transactions.

The International Swaps and Derivatives Association is an international organisation whose members include more than 600 of the world's largest commercial, universal and investment banks as well as other companies and institutions with extensive activities in the area of swaps and other individually negotiated derivatives transactions. Additional information on ISDA can be found at our website (<http://www.isda.org/>).

### **1. Accepted market practices**

We believe that CESR's proposal follows broadly the right approach. In particular, we consider that:

- the guidelines should follow a high level approach, rather than attempting to detail particular practices; and
- the process should remain flexible to deal with the circumstances of individual cases and to respond to innovation.

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***Question 1: Is the proposed approach appropriate, focussing both on the characteristics of particular market practices and the procedures that Competent Authorities should follow?***

As stated, we broadly agree with the proposed approach. The regime established by the Directive must remain flexible to deal with the particular circumstances of individual cases. As the Commission itself suggests in its mandate, it is necessary to recognise that there is a broad range of existing market practices that are "reasonably expected" in financial markets and that should be accepted by competent authorities. It is also necessary to ensure that the approach is sufficiently flexible to recognise practices that become accepted practices in the future. The approach must also recognise that there are varying practices in different markets (for example, practices in the equity markets differ from those in the commodity derivatives markets).

It is simply not possible for any competent authority to catalogue or describe all the acceptable market practices that exist today, let alone comprehensively update any such catalogue or description to ensure that it is current at all times. There is too great a diversity of possible practices. It will also often be easier to say what is not acceptable than to say what can be accepted in an abstract context.

The question of whether or not a particular practice is acceptable can, in many cases, only be determined on the basis of the particular facts in a concrete case. The guidelines should make clear that decisions on whether to accept a particular practice are usually best made in the context of individual cases having regard to the circumstances of the case and practices that were reasonably expected at the time.

We welcome the requirement for transparency as to the conclusions reached regarding the acceptability of market practices (second bullet point of paragraph 36). However, the competent authorities should also publish any general guidance that they issue in relation to the acceptability of market practices.

***Question 2: Are the suggested principles, factors and procedures appropriate? Would you consider adding more factors such as the degree to which a practice has a significant effect on prices and in particular on reference prices?***

We have only a few specific observations (in addition to our observation in response to Question 3). In particular:

- CESR should make clear that the statements in paragraph 35 about the likelihood of particular practices being acceptable do not create a presumption that the converse is the case. For example, we agree with the suggestion in the third bullet point of paragraph 35 that widespread practices are likely to be regarded as acceptable. On the other hand, there should be no presumption that practices in illiquid or narrow markets, or new or emerging practices, are unacceptable by reason of that fact alone.
- We agree that it would be useful to stress that practices that do not have a significant effect on prices are unlikely to be considered unacceptable.
- The first bullet point refers to transparency to the "market". CESR should make clear that this should not be construed narrowly. In particular, competent authorities should also take into account the degree of transparency to participants other than just users of the regulated market, especially having regard to the importance of over-the-counter (OTC) transactions.
- It is unclear what the second sentence of the second bullet point in paragraph 35 is intended to refer to. In the context of principal-to-principal OTC or dealer markets, negotiating a transaction

with one participant necessarily implies that others will not participate. We recommend deleting this sentence.

- The fourth bullet point in paragraph 35 appears to require market participants to take an unduly broad view of the possible consequences of their actions when participating in one market. It should be deleted or limited in a practical way (for example, it appears to require market participants to have regard to every possible trading venue worldwide, not just those in the EU).
- Similarly, the reference in the fifth bullet point in paragraph 35 to breaches of rules of "comparable markets" creates an unduly burdensome requirement. Firms operating in one market are subject to that market's rules. The reference suggests that, indirectly, they also have to ensure that their behaviour conforms to the rules of other markets. This reference is inappropriate and should be deleted.
- The sixth bullet point should recognise that there are some markets (e.g. the wholesale commodity derivatives markets) where market participants deal with each as arm's length counterparties and take responsibility for evaluating the risks of dealing in those markets. The acceptability of practices in those markets must be assessed in that context.
- The seventh bullet point should also recognise that, especially in commodity derivatives markets, there may be natural concentrations and large positions arising from physical requirements or production levels. Participants need to be able to use these markets to hedge these. More generally, it would be appropriate to include specific wording recognising that practices which are in line with broadly accepted risk management practices (such as the unwinding of hedges when the hedging position is no longer required) should be regarded as acceptable.

***Question 3: The Directive focuses on accepted market practices "on the regulated market concerned", but the prohibitions of the Directive also apply to OTC trading. Is it necessary to make any distinction between standards of acceptable market practices on regulated markets and OTC practices? Is it also necessary to make distinctions between standards of acceptable market practices in different kind of regulated markets or MTFs (e.g. order driven or price driven)?***

The definition of market manipulation in article 1.2(a) of the directive refers to accepted market practices "on the regulated market concerned". The directive applies to transactions or orders entered into or issued on a regulated market. However, it also clearly applies to transactions or orders entered into or issued outside any such market, for example, in relation to OTC derivatives or off-exchange trading in securities.

The definition of accepted market practices in article 1.5 is not limited to practices on a regulated market. CESR should expressly recognise that the accepted market practices defence is capable of being available in relation to OTC transactions where they conform to market practices in the relevant OTC market and where those practices are reasonably expected by a reasonable market participant on the regulated market on which the relevant financial instrument is admitted to trading.

We would suggest the inclusion of the following new bullet point in paragraph 35:

"The extent to which a practice in an over-the-counter or other market outside the regulated market concerned is recognised by market practitioners who use that regulated market."

***Question 4: Do you agree that a practice need not be identifiable as already having been explicitly accepted by a competent authority before it can be undertaken?***

Yes. We believe that it is essential that CESR's advice recognise this possibility. It is simply impossible for competent authorities to catalogue all acceptable practices.

***Question 5: CESR is committed to the future discussion of specific market practices as part of the Level 3 work necessary to increase the harmonisation of accepted practices where appropriate. Please specify any examples of particular practices which you consider could be classified as accepted market practices for the purposes of the Directive.***

We believe that there will be a need for extensive discussion at level 3 in due course. However, much will depend on how CESR proposes to handle the development of level 3 initiatives.

## **2. Definition of "inside information" in relation to commodity derivatives**

We have a number of comments on the proposed definition.

The proposed text overreaches when it suggests that information is "inside information" simply because it is information that will, at some point, become "generally available to market users". This suggests that, for example, all non-public information that will be the subject of press comment (however speculative) or a publicity release is inside information. This inordinately expands the category of inside information (especially if there is no materiality threshold, although having such a threshold would not fully resolve this issue). The issues this presents could be addressed by simply changing the "or" at the end of paragraph 46(i) to "and". (This change would also explain the provisions of paragraphs (ii) and (iii) where the words "to be made generally available" or "to be published to market users" should appear after the word "required" in each case - it is currently unclear what is the nature of the "requirement" to which these paragraphs refer).

On the other hand, CESR may be concerned that this change would unduly narrow the scope of the definition of inside information by potentially excluding certain categories of official statistics which are not required to be made generally available by the rules or customs of a particular market. If that is CESR's concern, CESR's advice should be much more specific about what the proposed text is intended to cover. If this is the intention, we would recommend that the definition be limited to official statistics and other information which are routinely the subject of public announcement, where it would be a breach of confidence to use the information in advance of publication (it is difficult to see how there is an expectation of equal access to use the information if there is no confidentiality prior to publication).

The guidance should also make clear that the definition does not cover information which becomes public knowledge as a result of disclosure obligations unrelated to the regulated market on which the commodity derivative is traded (for example, the disclosure obligations applicable to listed companies. It must be the case that the users of the relevant markets expect to receive the information in question in accordance with accepted market practices on the regulated market concerned.

The guidance should also make clear that information may be generally available even if market participants have to pay for the information.

In addition, the definition of inside information in relation to commodity derivatives is clearly intended as a subset of the general definition of inside information even if not directly expressed in those terms. In any event, market users would only have a reasonable expectation of equal access to information which is significant in some sense. Accordingly, the guidance should make clear that only information which is likely to have a significant effect on the prices of the relevant commodity derivatives or on the price of related derivative financial instruments is inside information in relation to commodity derivatives.

We do not consider it helpful to attempt to distinguish between whether and when market users would expect to receive information. Under the level 1 text, the question of when market users expect to receive information is of no real relevance. Paragraph 47 will not assist in the interpretation of the level 1 text.

***Question 6: Has CESR correctly identified all the relevant and material market, product and information factors relevant to the definition of "inside information" for commodity derivatives?***

***Question 7: Is there further information which is material, relevant and disclosable in relation to commodity derivatives markets?***

***Question 8: Does the draft advice accurately reflect the information relating to underlying commodities which commodity derivatives markets users expect to receive?***

***Question 9: Is there any additional guidance that CESR should consider giving in relation to the definition of "inside information" for commodity derivatives?***

See above in answer to questions 6 to 9 inclusive.

### **3. Duty to report suspicious transactions**

As CESR notes, while the directive requires firms to report suspicious transactions to the competent authority, it does not explicitly require member states to provide protection from liability in respect of any such disclosure (compare article 9 of the Money Laundering Directive 91/308/EEC which provides protection for disclosures in good faith). It would better serve the public policy objectives of article 6.9 if firms were not constrained from making reports by the fear of liability to customers or other third parties. Third parties affected by a disclosure might argue that the firm is liable for costs incurred as a result of the disclosure on the basis that, although it was made in good faith, disclosure was not strictly required by law having regard to all the circumstances.

We urge CESR to agree, at the very least at "Level 3", that Member States should provide equivalent protection when implementing this directive where the making of the report was not malicious. There is no reason why CESR should not do this.

In addition, we urge CESR to emphasise, in its advice to the Commission, that this is a desirable step. At the very least, the Commission's implementing measures should include, as a recital, a statement that Member States may choose to provide this protection. This will encourage Member States to take the appropriate action.

Finally, CESR should urge the Commission to bring forward legislation to correct the obvious gap in the law. This could be included in the new Investment Services Directive.

With respect to the detail of the proposals and your questions:

***Question 21: Do you agree with the proposed approach?***

The choice of words in the second bullet point is unhelpful. It suggests that suspicion, without "evidence", is enough to trigger notification (it may be that what is meant is that it is not necessary to have "proof" - the statement that no evidence is required appears to suggest that a report is necessary where there is mere suspicion however baseless). The words of the Directive ("reasonably suspect") should be left to speak for themselves.

However, it should be made clear that the duty to report lies with the firm that professionally arranges the transaction, not the individual employee who acts on behalf of the firm. There would be clear disadvantages to firms and regulators if it were thought that the directive imposed a duty of unsupervised direct reporting by individuals, rather than internal reporting to a central point where all the relevant considerations can be taken into account before a report is made to the competent authority.

***Question 22: Do you think that other possibilities should be taken into account?***

We agree that the directive focuses only on completed transactions not orders to trade. This is particularly important in the absence of any mandatory immunity.

However, it should be made clear that the Directive also only focuses on transactions completed by the firm. The duty to notify should not apply to transactions observed in the marketplace in which the firm is not involved.

The second bullet point should make clear that it only applies where the duty arises i.e. where there is a reasonable suspicion.

The text should make it clear that the duty is to act promptly (rather than "immediately") and that this admits of some internal review of the facts as known to the firm.

***Question 23: Do you think that other elements should be mentioned?***

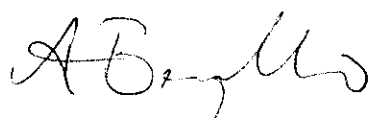
No. If anything, this approach is far too detailed. The firm should not be deterred from reporting by overly prescriptive content requirements.

***Question 24: Do you think that the proposed advice is appropriate?***

Yes. We consider that oral notification should be enough and that written confirmation should only be required upon request.

Please contact me or Mark Harding, Chairman of ISDA's European Regulatory Committee, if you have any questions on the comments in this letter.

Yours sincerely,



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Director of European Policy