

**OBSERVATIONS ON THE CESR CONSULTATION PAPER
“MARKET ABUSE DIRECTIVE: LEVEL 3 – PRELIMINARY
CESR GUIDANCE AND INFORMATION ON THE COMMON
OPERATION OF THE DIRECTIVE”**

January 2005

1. Introduction

The Italian Banking Association (ABI), which represents virtually the entire Italian banking industry with over 800 member banks, appreciates the current consultation procedure initiated by the CESR concerning document 04-5050 with proposed guidelines for the correct implementation of Directive 2003/6/EC on market abuse and its implementing measures.

In general we understand that Level 3 measures, as envisaged by the “Lamfalussy procedure”, are guidelines to interpretation addressed to national supervisory authorities in order facilitate their tasks in transposing Community legislation and must not, accordingly, be considered as specific rules addressed to market participants.

This premised, the current CESR consultation procedure is appreciated all the more highly in that many of the Directive’s provisions on market abuse and the implementing measures give rise to significant difficulties in interpretation and application.

In this light, while ABI concurs on the CESR’s choice of issues treated in the consultation paper, we maintain that with regard to the requirements on reporting of suspected cases of market manipulation and insider dealing as cited in Article 6.9 of the Directive the CESR must indicate quantitative thresholds above which the reporting requirement is triggered.

In addition, we think that a number of specific problems with the proposals set out in the consultation paper are worth signalling.

2. Examples of market manipulation

Below we set out a series of examples of operations which we think should be considered as legitimate. Not only are they justified by solid economic reasons but they also do not appear to undermine the integrity of markets. They should accordingly not be used as examples of “false/misleading transactions” or of “price positioning”.

a) False/Misleading Transactions

Wash trades (4.11 a)

Transactions that have the typical economic purposes of *riporto* contracts and/or stock lending (in securities or euros), even when effected in atypical form via market transactions, must be deemed fully legitimate and must not be treated as market manipulation.

An instance is the case in which it is necessary to perform in the market – although naturally with every possible precaution to ensure maximum neutrality vis-à-vis the price formation mechanism – simple transfers of share packets.

Example

The spot trade of shares by simultaneous entry of PDNs for the same amount but opposite sign and a different limit price during the opening and closing auction phases (or simultaneous entry of PDNs for the same amount but opposite sign and the same limit price during the continuous trading phase) and a simultaneous but opposite transaction in stock futures or OTC put and call options.

These operations may be performed in the market rather than by *riporto* contracts for the purpose of:

- eliminating counterparty risk (in some cases for the spot trade only, in others also for the forward transaction);
- avoiding taxes (the fixed tax on off-market transactions).

Painting the tape (4.11 b)

Considering that some operations which if taken in the abstract may fit the definition of this violation (“series of transactions which are shown on a public display facility to give the impression of activity or price movement in a financial instrument”) are expressly included in the CESR paper’s list of “allowable market practices” in Austria and Germany, it is inconsistent to cite them as examples of “false/misleading transactions”.

Improper matched orders (4.11 c)

Transactions in which the parties simultaneously make a spot trade and a trade in derivatives for a volume such as to make the position “delta neutral” are legitimate and do not constitute market manipulation, not even as possible examples.

Example

An option on 1,000,000 shares of XYZ with delta of 50% and simultaneous spot trade of 500,000 shares of XYZ via simultaneous entry of PDNs of the same amount but opposite sign and the same limit price during the continuous trading phase.

These transactions can be effected on-market rather than on the block trade market, with the purpose of:

- eliminating counterparty risk (in some cases for the spot trade only, in other also for the derivative);
- avoiding taxes (the fixed tax on off-market transactions).

Placing orders with no intention of executing them (4.11 d)

It would be a good idea, in our view, to state that sometimes this kind of behaviour may simply be due to error; in these cases it would be correspondingly difficult to distinguish between an intention to commit market abuse and mere negligence.

b) Price positioning

Marking the close (4.12 a)

In our view transactions, even if performed in the market during the opening or closing auction or near the close, are nevertheless legitimate and do not constitute manipulation when their purpose is:

- to rebalance portfolio positions in response to a change in the proportions of the securities composing the benchmark indices or underlying derivatives;
- to rebalance portfolio positions in response to variations in the so-called greeks of derivative instruments in the portfolio, with special reference to expiry sessions and those immediately preceding; or
- to obtain guarantee of an execution price equal or approximately equal to the opening or closing price or the VWAP.

3. Possible signals of insider dealing or market manipulation

In general, and without prejudice to our earlier remark on the need to set quantity thresholds to trigger reporting of suspect cases pursuant to Article 6.9 of Directive 2003/6/EC, while the list of cases seems to be complete, in our view it is going too far to include those cited in Section 5.9 (“Possible signals of insider dealing” referred to in point c)¹ or in Section 5.10 (“Possible signals of market manipulation” referred to in point a)². The fact is that these are both common market practices.

¹ “The client specifically requests immediate execution of an order regardless of the price at which the order would be executed (this indicator presupposes more than the simple placing of a ‘market order’ by the client).”

² “Transactions with no other apparent justification than to increase/decrease the price of or to increase the volume of trading in a financial instrument. Particular attention might be given to orders of this kind which result in the execution of transactions near to a reference point during the trading day – e.g. near the close.”