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IMPLEMENTING MEASURES FOR THE MARKET ABUSE DIRECTIVE
SECOND MANDATE TO CESR

Initial observations of AFEI

1. The European Commission has given CESR a second mandate concerning implementing measures for the Market Abuse Directive. CESR has been asked to provide technical advice on implementing measures relating to the definitions set forth in that directive concerning:

- Accepted market practices *(Article 1(5) of the directive)*
- Inside information concerning commodity derivatives *(Art. 1(1))*
- Preventative measures related to issuers, corporate managers and professional intermediaries *(Art. 6)*

As part of the timetable drawn up for this mandate, CESR has issued a Call for Evidence in order to collate initial suggestions from interested parties. In response, AFEI offers the following observations.

I - General observations

Towards greater transparency

2. The work done by CESR and industry participants under the first mandate on implementing measures for the market abuse directive provided an opportunity – concretely and for the first time – to implement the Lamfalussy process. AFEI believes it important to make the most of the experience gained on that occasion.

One of the lessons learned from that exercise is that, given the tight timetable, it is important to be able to communicate quickly and easily with CESR and the ad hoc working group.

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For the record, the overall timetable for the work that CESR will be undertaking under the second mandate is as follows:

- Call for evidence: 7 to 28 February 2003
- Publication of consultation paper: April 2003
- Consultation closes: 30 June 2003
- Final paper signed off by CESR: not later than 30 August 2003.

In view of this timetable, AFEI is appreciative of CESR's swift transmission of the mandate given to it.

3. Along the same lines, and to ensure the greatest possible transparency in managing the work to be done, AFEI believes it necessary to know the composition of CESR's working groups and the way in which work will be divided up among sub-groups.

4. AFEI also considers it essential that successive working documents should be posted in real time on CESR's website, as should the observations submitted by the professional bodies of each Member State (unless otherwise specified, on an individual basis).

5. Noting that the summaries prepared by each regulator at the national level of observations submitted by its country's professionals are public reference documents, AFEI believes that these summaries should likewise, as a matter of course, be posted on CESR's website. During the first mandate, it became apparent that these summaries were serving as the basis for CESR's ad hoc working groups. For this reason, they are of some importance.

Importance of working in co-ordination with "legal specialists/linguists"

6. AFEI notes once again that it places particular importance on translating the legal notions at issue. The reference documents are all in English, and the rendering of certain notions of law in other languages must be overseen with vigilance in view of the resulting legal consequences.

Need for better tracking of changes in working documents

7. AFEI requests that the consultation document to be formalised by CESR should be made easier to follow than was the case during the first mandate. It was not always readily apparent which passages of that document were actually part of CESR's own advice and which were external comments.

8. In the context of successive consultation documents, it would also be quite useful to be able to visualise clearly and quickly, within the document itself, the changes in CESR's proposals since the original document. To this end, AFEI suggests that, among other things, the original paragraph numbering should be preserved throughout the duration of the work.

II - Substantive observations

Implementing measures related to the definition of 'Accepted market practices' *(Article 1 of the directive)*

9. On the matter of implementing measures relating to accepted market practices, CESR has already indicated that it will take into consideration existing practices in the different Member States, where these do not impinge unduly on coherence and harmonisation.

A number of practices accepted by the market in France merit consideration at the EU-wide level. As part of these initial observations, AFEI submits the following practices deemed acceptable either by French regulations or by French professionals that are already working in an international environment. (Among other things, these practices relate to the examples of market manipulation appearing in section B of the annexe to the Market Abuse Directive.)

It is not AFEI's ambition at this stage to provide an exhaustive list of these accepted practices. Rather, AFEI merely wishes to put forward a number of points requiring further thought.

- **Matched orders**

10. This practice, is an important one, notably for portfolio valuation and optimisation (e.g. in France, the system of matched buy and sell orders known as *achetés-vendus*). To establish the most appropriate regulatory treatment for such orders, the issue should be examined at the EU-wide level.

- **Combined trades**

11. The practice of "pre-arranged trading", which consists in combining a purchase and a sale that will be executed during the same trading session, is allowed by some exchanges (e.g. Eurex) provided certain formalities are observed. Combined trades of this kind can be considered an accepted practice for certain categories of securities (e.g. options) and certain types of trading (hedging, block trading, arbitrage), provided strict rules are adhered to; for example, disclosure to, and possibly prior authorisation by, the market operator.

Example: a position in a derivative hedged by a position in the underlying.

- **Position limits**

12. This practice is tolerated in certain cases. In France it exists only for derivatives on the MATIF and MONEP markets.

The greater the size of the open interest in derivative instruments, the greater the number of securities that will be bought or sold to unwind those open positions. The open interest should not become so great that it causes price discrepancies in the market for the underlying. This is the rationale for the existence of position limits, which are set at 20% of the open interest on MATIF and MONEP. In order to limit large price swings in the security, an intermediary may not take a position beyond this percentage. The limit may be exceeded under certain conditions, however.

Limits inspired by this system might be contemplated for equity markets as well.

- **Marking the close**

13. Although prohibited in principle, this practice can be considered an accepted one in certain very specific cases. In France, exceptions to the rule are contemplated for employee investment funds and other mutual funds.

The practice entails placing orders at the close of a trading session. Since the closing (or clearing) price generally serves as the basis for calculating the following day's change in the share price, any action affecting this price can give the appearance of a rising or falling market. The over-the-counter market is particularly sensitive to practices of this genre.

In Belgium, "trading at last" (TAL) is allowed. In the United States and the United Kingdom, "market on close" (MOC), in which the client asks for a market order to be executed at the closing price, is likewise an accepted practice.

- **Non-disclosure of material facts or significant interests**

14. It should be noted that the withholding of such information, although prohibited in principle, is considered acceptable in France in certain instances. In fact, not only is a financial institution not always required to divulge all that it knows about its client's interests, it is even duty-bound in some cases to preserve the confidentiality of those interests.

- **V-WAP reference prices**

15 Although contested by some in France, this practice is accepted in other European countries, and for certain clients it meets a real need. This is consequently another item that should be examined at the EU-wide level.

Definition of inside information for commodity derivatives *(Article 1(1) of the directive)*

16.AFEI questions the timeliness, at this stage, of a specific definition in this case.

Implementing measures regarding some preventative measures related to issuers, corporate managers and professional intermediaries *(Article 6 of the directive)*

Article 6(3) and 6(10-4) of the directive

17. The directive imposes an obligation on entities that act for their own account to draw up and keep up to date a list of persons working for them who have access to inside information ("insiders' list" of "sensitive" persons). CESR is asked to take implementing measures in this domain. Market undertakings and issuers are the actors primarily concerned by this obligation.

Concerning market intermediaries

18. Circulation of inside information within market intermediaries is already more than adequately identified and controlled, as is the identity of sensitive persons.

All of the following are taken into consideration for this purpose:

- The person's job function
- The transaction in question
- The degree to which the person is actively participating in the transaction
- Whether the person has received non-public information
- Whether the person has knowledge of the transaction price

Concerning issuers

19. The situation is altogether different for issuers since there is currently no regulation in France of inside information or sensitive persons within issuing entities.

It would probably be appropriate to contemplate drawing up regulations for issuing entities modelled on those applicable to financial institutions. It would also be desirable for the compliance monitoring function to be generalised within issuing entities (as is already the case in practice at many issuers) and made subject to a set of rules.

Article 6(4), 6(9), 6(10-5) and the last point of the directive

20. Article 6(9) imposes an obligation on financial institutions to declare suspicions regarding transactions in financial instruments. ("Member states shall require that any person professionally arranging transactions in financial instruments who reasonably suspects that a transaction might constitute insider dealing or market manipulation shall notify the competent authority without delay").

21. It is fundamental that the institution concerned should be solely responsible for the procedure for declaring such suspicions.

22. It must furthermore be clearly understood that such notification has a declarative purpose only. It is not up to the financial institution to halt the transaction in question.

Every such declaration must also be strictly confidential, as should any use that might be made of it by the regulator of each Member State. The financial institution must not find itself in a delicate situation because of the duty of confidentiality to which it is bound with respect to its client. The institution must be relieved of any liability in this regard if it reports a suspicious transaction.

23. The terms used in Article 6(9) of the directive (quoted above) call for several further remarks.

24.“Reasonably”: Assurance is needed that this term is understood to mean that the operator has been put in a position to know of the transaction and has been able to evaluate it.

25.“Insider dealing”: The duty of vigilance owed by the intermediary that carries out the transaction must be limited to such research as that intermediary can materially perform with regard to the direct originator of the order (since for investment firms in the chain of intermediation, the direct originator of the order is not necessarily the ultimate customer).

26.Article 6(10-5): Concerning actual implementation of these controls and declarations, CESR is asked to determine the characteristics of a transaction that should be reported as specified by a number of criteria, “including its size”.

A threshold monetary amount above which suspicion should be aroused would not appear to be a probative criterion. The threshold would have to be quite different for orders from institutional clients as opposed to orders from individual investors. Criteria other than the size of the transaction in itself ought to be contemplated. For example, a transaction could be classified as sensitive when there is