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Dear M. Demarigny,

Re: Market Abuse Mandate: Second Call for Evidence

We welcome the opportunity to respond to your call for comments on the areas which CESR should address in its advice to the European Commission. In this letter, we set out certain preliminary observations on the aspects of the call for evidence 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 (www.isda.org).

1. "Accepted market practices"

The definition of "accepted market practices" is of great importance in the Directive. In particular, a person will not be guilty of "market manipulation" under paragraph (a) of the definition of that term if he can establish that his reasons for his transactions or orders are legitimate and that the transactions or orders conform to "accepted market practices" on the regulated market concerned (article 1.2(a)).

We believe that a high level approach is best at this stage. ***The Commission's guidelines should not themselves attempt to describe particular practices as being acceptable. The guidelines should only indicate a number of factors that competent authorities should take into account when reaching their decision.*** These factors should include reference to the nature and structure of the financial market concerned and the extent to which a practice complies with market rules, other regulatory requirements or self-regulatory standards applicable to the market in question. Also, in determining whether to accept a particular practice on the basis that it is "reasonably expected" in a financial market the competent authority should have regard to the expectations of a reasonable market participant who is familiar with the market in question.

In addition, 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.***

The Commission's guidelines should also require competent authorities to take into account the views of market participants when reaching their decisions on accepted market practices. When reaching decisions on accepted market practices in the context of particular cases, they should take into account evidence presented as to the views of market participants on whether particular practices were reasonably expected in the context of the circumstances of the case. To the extent that they are otherwise considering accepting practices, competent authorities should do so in accordance with effective and transparent consultative arrangements at least as extensive as those adopted for the purposes of article 11 of the directive.

There must also be adequate transparency as to the decisions reached on accepted market practices. The Commission's guidelines should require competent authorities to publish any decisions reached on the acceptability of particular practices.

We would make one final point in relation to the accepted market practices defence. ***CESR should recommend to the Commission that it make clear, through its implementing measures, that the accepted market practices defence is available in relation to transactions or orders in the over-the-counter (OTC) markets, as well as those on regulated market.***

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.

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

We welcome the decision of the Commission to include this subject in its mandate. However, ***we urge CESR to seek additional time from the Commission for the consideration of this issue.*** We do not consider that this issue is quite as urgent as the other issues in the mandate and CESR should be able to give greater priority to those other issues.

In particular, the directive only applies to derivatives admitted to trading on a regulated market, as defined in the current Investment Services Directive (ISD). However, the existing ISD does not apply to commodity derivatives. Therefore, for the time being, until the ISD is amended, there are no commodity derivatives admitted to trading on a regulated market.

Nevertheless, this clearly remains an important topic given the proposals to amend the ISD. In addition, it is possible that member states may choose to apply the directive more broadly at an earlier stage than strictly required. It is also important to ensure that the treatment of commodity derivatives is carefully considered given that the characteristices of commodity derivatives markets are quite different from other markets (such as equity markets).

The Directive itself recognises this by restricting the range of information which is covered by the definition of inside information in this respect and the Commission's implementing measures should recognise that the definition is restricted to a relatively narrow range of cases. This would include, for example, cases where it is the recognised practice of the regulated market itself to disseminate particular information publicly to users of that market in order so as to make them aware of factors that are material to the price formation process (e.g. the stockpiling data disseminated by the London Metal Exchange). It may also include a limited class of official government statistics and possibly other information which would have a significant effect on that market and where public announcement is "reasonably expected" by participants in that market.

However, 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.

In addition, the definition of inside information in relation to commodity derivatives is intended as a subset of the general definition of inside information. Accordingly, the guidance should make clear that it only covers 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.

3. The implementing measures concerning suspicious transactions

At this stage, we only wish to make one observation on this subject. 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). Nevertheless, we would urge CESR to agree, at "Level 3", that member states should provide equivalent protection when implementing this directive where the making of the report was not malicious.

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.

In any event, in many cases, the firm will be under obligations to notify the same transactions to the authorities responsible for anti-money laundering procedures under the Money Laundering Directive, as the transaction may well also involve relevant criminal acts. Where this is the case, it would be incongruous if the extent of liability depended on the nature of the authority to which the report is made.

Please contact me or Mark Harding, Chairman of ISDA's European Regulatory Committee, if you have any questions on the comments in this letter. However, these are only preliminary comments at this stage. We look forward to an opportunity to comment more fully in response to the consultation paper when it is published.

Yours sincerely,

Annalisa Barbagallo
Director of European Policy