



# EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

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Secretary General

via Email/Internet

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## **Comments on CESR's Paper on Market Abuse Directive Level 3 – preliminary CESR guidance and information on the common operation of the directive (CESR/04-505)**

### **Response by EFFAS European Federation of Financial Analysts Societies**

Dear Mr Demarigny,

The European Federation of Financial Analysts Societies, EFFAS, is the European umbrella organisation of national analysts societies. It comprises 23 members representing more than 14,000 investment professionals mainly in the areas of Equity and Bond Research, Asset and Portfolio Management, Investment Advice.

In the following, EFFAS comments on those issues which are relevant for the members of EFFAS.

#### **1. Accepted Market Practices**

The discussion of Accepted Market Practices clearly shows that one ought to distinguish between markets in which institutional and/or professional participants act and retail investors directly or indirectly constitute a negligible market force (Bond trading Austria and Germany and LME in the UK), and markets which serve retail investors. The markets for professionals and their practices can be safely left to the rules and regulations established by those markets. The discussion for these markets conveys the impression that the Market Abuse Directives (Level 1 and Level 2) or their current interpretation have inflated practices a problem which is deflated by the accepted market practices. The normal relation of rule and exemption is reversed and forces a meaningless bureaucracy upon the markets, their participants and regulators. If such markets tolerated truly abusive practices, they would be avoided by professionals and institutions and would disappear.

The same conclusion is not justified for those markets in which retail investors participate in relevant numbers. Retail investors are not in a position to properly detect and assess abusive practices. Potentially abusive practices are also of concern to financial analysts

and asset managers alike in the interest of their clients. We think that the format of the table assessing AMPs presented by CESR is a good tool.

This format forces the national regulator to present the relevant aspects of the Market Practice, and shows the strength and weakness of arguments. A case in point is Annex 1c (Germany - Formation of first Exchange price). According to EFFAS, this market practice may artificially influence the market price. The German regulator justifies this practice basically with two arguments:

- a) This practice prevents partial order fills.
- b) The underwriter acting according to this practice would act the same way when dealing on his own account anyhow, when and if this practice were prohibited.

Furthermore, the legitimacy of this practice is subject to the condition that the underwriter's balancing order is not the overwhelming or prevailing order in relation to the total turnover.

Beginning with this latter condition, the format should require an explicit statement whether such a condition is a quality or quantity assessment. In either case, the regulator ought to indicate what it considers to be prevailing or overwhelming (percentage of turnover or quality elements).

The argument under b) presented by the German regulator is surprising. It seems that the order balancing function of the underwriter is based on the underwriter's formal or informal obligation vis-à-vis the issuer or the exchange. If this assumption is correct, the underwriter will step in regardless of whether it considers the first price obtained in the order balancing transactions beneficial to its own profits. This is quite different from dealing on one's own account, where the institution will order only on the premise that it will eventually profit from the transaction. If both activities, underwriter's balancing and dealing on own account, are equal, one might ask why does this market practice exist? Institutions would in any case create a balanced order book and a fair price by dealing on their own account.

Assuming further, that the argument under b) is not valid, the question is whether this practice of underwriters to balance the order books may be justified by different arguments. A distorting influence, if any, on the market is very short. It affects only the first price. Thereafter, market influences will prevail without the underwriter's order book balancing. It may well be that the benefits of stabilising the first price outweigh the disadvantages. Such order balancing will prevent even the temptation for other market participants to abusively manipulate the prices to their advantage. This risk may be relatively high for an instrument which is a newcomer on the exchange. The first price stabilisation will allow the smooth entrance of a new issue into exchange trading.

## **2. Market abuse and reporting obligation**

We support CESR in emphasising that signals for abusive transactions should not automatically trigger a suspicious transaction report. Such signals should be a starting point and a reason to check with and query the client on the legitimacy of the order. Contrary to the situation in cases of suspected money laundering, in which an institution is prohibited to discuss the suspicion with the customer, the prevention of abusive market practices should not lead to an informer environment disseminating distrust among market participants and clients. Therefore, we support CESR's position that a financial service firm or institution must thoroughly analyse each case before reporting. It may not delegate its own responsibility to the regulator by reporting each and every signal as suspicious

transaction. Signals are an indicator triggering a duty to query and to investigate, not to report. The decision to report or not report should be made only at the end of this process.

EFFAS thinks that the paper reflects an appropriate and successful approach towards promoting a uniform enforcement of the market abuse provisions in the different jurisdictions.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'F. Rau', with a stylized flourish at the end.

Fritz H Rau  
Chairman of EFFAS