THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

Ref.: CESR/02-287b

CESR Market Abuse Consultation

FEEDBACK STATEMENT

DECEMBER 2002

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1. On 27 March 2002, the European Commission requested CESR to provide technical advice on possible implementing measures in connection with certain aspects of the Directive on Insider Dealing and Market Manipulation (Market Abuse). This feedback statement will provide a short overview of the process which CESR followed in finalising its advice to the Commission. It will also discuss the main points which were made by respondents to the consultation process and explain the policy options which CESR has selected, following careful consideration of the points raised.

2. Five substantive areas were covered in the Commission's Provisional Mandate to CESR. These were as follows:

   - The definition of inside information
   - The definition of market manipulation
   - The disclosure of inside information by issuers
   - The fair presentation of research
   - Safe harbours for share buy-backs and stabilisation

3. CESR undertook a number of steps prior to the publication of its first consultation paper. Firstly, it published a Call for Evidence (Ref: CESR/02-047) inviting all interested parties to submit views on what CESR should consider in its advice to the Commission. The issues raised in response to the Call for Evidence were taken into account in the preparation of the consultation document.

4. Secondly, CESR's Expert Group on Market Abuse, chaired by Pr. Stavros Thomadakis, Chairman of the Hellenic Capital Market Commission and supported by Mr Nigel Phipps of the CESR secretariat, developed proposals for consultation with market participants and other interested parties. CESR's Expert group was assisted and advised in this task

by a newly-established Consultative Working Group (CWG) comprising a broad cross-section of EU market experts.

5. On 1 July 2002, CESR released its consultation paper *Advice on possible Level 2 Implementing Measures for the proposed Market Abuse Directive* (Ref: CESR/02.089b) setting out its proposals for technical implementing measures in the areas identified in the mandate, with a deadline for comment of 30 September. An initial public hearing was held in London on 6 September, as well as a number of bilateral meetings and national open hearings.

6. Over 100 responses were received in response to the consultation. These came mainly from European and national federations, representing financial services providers, as well as individual banks, investment services firms, asset managers, regulated markets and exchanges, financial analysts and rating agencies. These groups accounted for well over half of all responses received, but there was also considerable input from issuers, investor representatives, academics, lawyers and the media. The number of responses varied per country, with some countries channelling the majority of their input through a small number of national federations, while others had a greater mix of federations and individual responses. Six responses were received from European federations. All responses which are public can be viewed on the CESR website.

7. In the light of responses received in the consultation, CESR reviewed its first draft of the technical advice. A revised text was released and a further open hearing, to obtain comments on the revision, was held in Paris on 21 November. Some participants followed up points made orally in the course of this session with written submissions after the meeting. CESR finalised its advice following the second open hearing and consideration of the further written input.

8. The remainder of this feedback statement will focus, firstly, on the general points which emerged during the consultation process and secondly, on the substantive points which were raised in each of the five technical areas in which CESR was requested to provide advice.

General Observations

9. As a preliminary general observation, CESR received a significant number of comments which were not directly applicable to the Level 2 measures being proposed in the consultation paper but, rather, related more generally to the Level 1 text. On some occasions, this appeared to stem from a lack of understanding of the exact scope of the mandate which the Commission had handed down to CESR. On others, it seemed that respondents were aware that the solution was not within CESR's power, but nevertheless considered it useful to register their concern about the Level 1 measure, via the CESR consultation process. CESR would reiterate that its advice to the Commission must remain firmly within the parameters of the mandate. This feedback statement will similarly restrict itself to the relevant material.

10. The remainder of this introductory section will highlight the most frequently recurring general points made by respondents. Where applicable, further discussion of these points and CESR's proposed response will then be taken forward in the relevant section later in the feedback paper.

11. Firstly, a key point emerging from a number of responses concerns the balance between Level 2 and Level 3 measures. Many respondents considered that Level 2 measures should be relatively light. They suggested that the level of detail proposed by CESR at Level 2 was too extensive and prescriptive. Some respondents suggested that many of the areas included in the Level 2 advice were more appropriate for treatment at Level 3. Others supported the idea that detailed Level 2 measures could help in achieving a more uniform Single Market.

12. In the light of the comments received, CESR has sought to review, where possible, any excessively detailed measures proposed for Level 2 and to propose, where appropriate, a higher level approach. Where appropriate, detailed rules could be developed at Level 3. Nevertheless, it is CESR's view that in some cases the Level 2 measures do need to contain a sufficient level of detail to build upon the high level principles set out at Level 1 and to ensure adequate legal certainty for cross border activities in the Single Market.

13. Secondly, respondents expressed concern about the uncertainty of the final legal form of the advice. A number of respondents commented that CESR's Level 2 advice was not, as drafted in the consultation paper, capable of direct transposition into law. Many respondents therefore sought greater clarity about the form of the final legal text.

14. As far as this point is concerned, CESR has been mandated to provide independent technical advice to the Commission on a number of implementing measures in specified areas. The Commission has confirmed that it will be its responsibility to consider this advice and decide, in consultation with the Member States and Parliament, on the ultimate form and structure of the binding legal instrument which ensues.

15. Thirdly, some respondents expressed disappointment that CESR has tended to focus, almost uniquely, on disclosure as a tool to achieve many of the Directive's requirements. These respondents highlighted the legitimacy of a number of other mechanisms, in particular those aiming to avoid conflicts of interest, in addressing these issues.

16. CESR is constrained in its Level 2 advice by the Level 1 text which often mandates disclosure as the sole mechanism to satisfy the Directive's requirements. Within this overarching constraint, however, CESR has recognised, where appropriate, the legitimacy of other regulatory tools, in particular Chinese walls, in meeting specified requirements.

17. The remainder of this paper will examine key points raised by respondents in each technical section and will set out CESR's proposed method of dealing with them. References in this paper to the first draft of CESR's advice refer to CESR's proposals as set out in the consultation paper dated July 2002, entitled *CESR's Advice on possible Level 2 Implementing Measures for the proposed Market Abuse Directive* (Ref: CESR/02.089b). Paragraph references in this final feedback statement refer to CESR's final advice to the European Commission, dated December 2002 (Ref: CESR/02.089d).

ARTICLE 1

Inside Information

Introduction

18. Some commentators considered that, as the definition of inside information in the proposed Directive is already quite closely aligned with the existing definition, there is no need for extensive measures at Level 2 to clarify further.

19. In connection with derivatives, it was suggested by some respondents that there was a need for CESR to give a specific proposal relating to the definition of inside information for commodity derivatives.

20. CESR considers that the content and form of the Level 1 text already links the definition to the requirements and characteristics of individual commodity markets. It is therefore the disclosure requirements on those markets which are the reference point for the definition. CESR therefore questioned what else it could usefully say at Level 2 without imposing disclosure requirements on those markets (or raising expectations as to what they should require to be disclosed), which is not within the scope of the mandate.

Factors, which need to be taken into account in deciding whether and when a piece of information is of a precise nature (paragraphs 18 – 20)

21. Some respondents indicated that the use of the word "event" in the first draft of the advice was too restrictive. It appeared to rule out other relevant facts such as, for example, ordinary corporate information and earnings announcements. CESR accepts this point and has supplemented the advice with additional wording to make it clear that other matters are also intended to be caught by this provision.

22. Respondents also indicated that the requirement that the information should be so precise as to allow for a conclusion to be drawn about the direction of its impact on prices was too restrictive. Generally, respondents suggested that the information should be specific

enough to allow a conclusion to be drawn about its likely impact on prices, rather than a conclusion about the specific direction of that impact.

23. CESR considers that there is some usefulness in retaining the notion of the direction of the impact on prices. But, conversely, CESR concedes that this could provide an alibi for non-disclosure. The advice has therefore been modified to require the information to be specific enough simply to allow a conclusion to be drawn about its impact on prices.

24. Some commentators considered that the fact that the event to which the information refers was either true or "could reasonably be expected to become true in the future", was an insufficient test. It was suggested that the event should be true or have a "significant probability" of becoming true.

25. CESR acknowledges these points, but considers that use of this term would need a further clarification of what would constitute a significant probability. CESR has therefore left its original proposals unchanged in this respect.

26. Where appropriate, corresponding changes to the text of the additional guidance (paragraph 20) have been made to reflect the changes made in the Level 2 advice.

Factors which need to be taken into account if and when a piece of information is likely to have a significant effect on the price of those financial instruments (paragraphs 21-28)

27. CESR proposed in the first draft of its advice that a piece of information would be likely to have a significant effect on the price of a financial instrument when it is information which an investor would be likely to take into consideration for his own investment strategy. CESR asked for respondents to indicate whether this hypothetical investor should be of a particular type: reasonable, professional or informed.

28. Some respondents expressed the view that the focus should not be on the investor, but rather on the overall effect of the information on the market. Other respondents were in favour of a "professional investor" test. These respondents pointed out that, if a

professional investor did not act on the information in question, it would not be inside information.

29. CESR recognises the validity of this argument, but considers that this would be setting the test at a very high standard. A professional investor would be capable of assessing information in a sophisticated, experienced way. It could prove difficult for issuers – and others using this test – to put themselves inside the mind of an individual with this level of experience.

30. A significant number of respondents considered that this assessment should be made by a "reasonable" investor. CESR believes that this description strikes the right balance for this test and has modified its advice accordingly. To a large extent, this mirrors the approach in the Directive itself – recital 18 makes reference to what a "normal and reasonable" person should know regarding inside information.

31. Following comments made in the course of the second consultation, CESR decided to make one further amendment to the text, in the third indent of the advice, to stress that it is the "reliability" of the source, rather than the "credibility" of the source which should be taken into consideration in assessing the likelihood of a price moving effect. CESR accepted the comment that, as a concept, "reliability" could be more objectively assessed than "credibility" and that, overall, the change would be more consistent with paragraph 33, which draws a distinction between information based on "firm and objective evidence" and "rumours".

32. Some respondents were critical of the decision to include four factors which the investor should take into consideration in assessing the price sensitivity of the information in question, on the grounds that the list was incomplete and was inappropriate for a legal text. Other respondents had particular difficulty with the fourth factor ("all market variables that affect the financial instrument in question"), as it was considered too vague to be helpful.

33. CESR has considered these comments carefully and whether the factors should be moved to the status of additional guidance. However, on balance, CESR is in favour of retaining

these four factors, which it considers to provide useful amplification to the concept of "significant effect" which is used in the Level 2 advice in this area.

Factors which need to be taken into account in deciding whether a piece of information relates to one or more issuers of financial instruments or to one or more financial instruments (paragraphs 29 –36)

34. CESR has suggested that there should be no Level 2 measures set to establish whether a piece of information concerns one or more issuers of financial instruments or one or more financial instruments.

35. The vast majority of respondents were supportive of no Level 2 measures in this area.

Additional Guidance

36. CESR did, however, propose some additional guidance to market participants (paragraph 46) in this section. This comprises a non-exhaustive and indicative list of examples, which could constitute a starting point for the assessment of whether information is inside information.

37. The list drew a wide variety of comments from respondents. Some considered it to be of limited assistance; others suggested that it was useful, but should be shortened. Some respondents pointed out that there is a clear difference in the situations listed, as some are significant by nature, others are not. Some respondents pointed out that the legal status of the list was uncertain. Although it would not have the impact of Level 2 legal text, there was nevertheless a risk that its existence would lead to its use in legal proceedings.

38. Most respondents were supportive, however, of the fact that the list of facts would not be proposed for Level 2 treatment.

39. During the open hearing, the issue of the second indent in the list in paragraph 36, which sets out examples which would usually only concern the issuer indirectly, was specifically raised (*The coming publication of rating agencies' reports, research, recommendations or suggestions concerning the value of listed financial*

*instruments).*Participants were anxious to clarify that ratings agencies' reports, as well as research, when based on publicly available information, would not be considered to be inside information. CESR confirms that this is not its intention in this indent. It is, rather, the fact of being aware of a forthcoming publication of the report of a rating agency or research publication which could have an impact on the value of a listed financial instrument which might, in some circumstances, constitute inside information.

40. CESR considers that this list forms a useful starting point for the assessment of whether information is inside information. CESR has made it clear in the introductory paragraph that the list is indicative and that judgement would have to be exercised about the relative weight of the factor in each individual set of circumstances. CESR has, therefore, retained this section as a non-legislative measure. Some minor modifications have been made to the list as set out in the first draft of CESR's advice, in response to comments received in the consultation.

ARTICLE 1

Market Manipulation

Introduction

41. Within this section, CESR proposed an approach at Level 2 in the first draft of its advice which set out a number of factors which could offer an indication of possible manipulative practice. These were not intended to be exhaustive nor conclusive and would not automatically indicate that market manipulation had occurred.

42. To supplement these factors, CESR proposed a number of "diagnostic flags" which would act as an indication that manipulation might have occurred. CESR also acknowledged that a number of issues arising from its mandate in this area, relating to issues of market structure and liquidity conditions, should be dealt with at Level 3.

43. There was a high degree of agreement amongst respondents that CESR should deal with issues arising from market structure specificities and liquidity conditions at Level 3. A number of respondents also indicated, however, that CESR's proposed Level 2 advice in this area – setting out diagnostic flags which should draw further scrutiny and factors which offer a non-exhaustive list of potentially manipulative behaviours - would equally be more appropriate as Level 3 measures.

44. On the usefulness, more generally, of an approach based around "diagnostic flags" and "factors", a significant number of respondents found the categories to be unhelpful and confusing. Of those who were more supportive of this approach, a number suggested that CESR should, nevertheless, limit its advice to one category, rather than seeking to differentiate between factors and flags.

45. CESR had intended that there should be a clear distinction between on the one hand diagnostic flags, designed to indicate outcomes which merit further investigation and, on the other, factors which were aiming to give indications of manipulative behaviour.

46. Nevertheless, CESR acknowledges that there could be potential confusion in maintaining the flags and factors dual approach at Level 2. The diagnostic flags are ultimately of more relevance to the regulatory authorities and CESR has therefore removed the diagnostic flags from its Level 2 advice. These have been replaced by a more general paragraph drawing together the essential elements of the concept of diagnostic flags and indicating that these are elements for regulators to consider.

47. CESR has, however, retained a modified set of factors in its Level 2 advice and considers that an approach based on a non-exhaustive list of factors is a flexible and fluid means of capturing possible areas of market manipulation. CESR has nevertheless taken the wide range of comments received into consideration in redrafting and has modified a number of the factors accordingly.

PART 1

Factors which need to be taken into account in deciding (a) whether and when a transaction or an order to trade gives or is likely to give false or misleading signals as to the supply, demand or price of financial instruments; (b) whether and when a transaction or order to trade secures the price of one or several financial instruments at an abnormal or artificial level (paragraphs 46-47)

48. The most common criticism of the factors was that many of them, would, in certain markets, constitute normal and acceptable practice. A number of respondents have suggested that this deficiency could be rectified by the inclusion of some element of intent, or knowledge and purpose, within the Level 2 advice.

49. CESR recognises these concerns, which were expressed by a significant number of respondents. Nevertheless, CESR considers that the central objective of the manipulation section of the Directive is to create an effects-based regime. While intent (or, more precisely, the absence of intent) might be a mitigating factor in terms of investigations and sanctions, it is not likely to alter the impact of a transaction on the market. The factors CESR was asked to consider generally focussed on when transactions might lead

to certain price changes. CESR therefore considered that introducing an intent factor at Level 2 was inconsistent with the objectives of the Level 1 text.

50. CESR has made direct reference in its explanatory text to the existing defence which is available in the Directive itself (in Article 1(2)(a)) when a participant has legitimate reasons for entering into transactions or order to trade and the transaction or order conforms to a particular accepted practice on the market concerned. CESR has also made it clear in the Level 2 advice that factors should not be regarded as conclusive evidence that a particular conduct amounts to market abuse.

51. The factors proposed in the original consultation document have also been redrafted to take on board a number of comments made in response to the original consultation. In particular, they are now more comprehensive, with a greater emphasis on qualitative elements. They also incorporate elements of paragraph 64 of the original consultation paper (which listed those persons who might benefit from artificial price levels), which has now been deleted as a "stand-alone" section.

PART 2

Factors which need to be taken into account in deciding whether and when a transaction or an order to trade employs fictitious devices or any other form of deception or contrivance (paragraphs 48 – 50).

52. In this section, CESR sets out the factors which need to be taken into account in deciding whether and when a transaction or order to trade has employed fictitious devices or any other form of deception or contrivance. Again, it has been emphasised that the factors listed are not intended to be exhaustive. CESR has, however, made it clear that the Article 1(2)(a) defence does not apply here.

53. Limited changes have been made to the factors originally proposed by CESR in this section. The second indent has, however, been shortened, to remove the reference to analysts' compensation. This is dealt with later in the paper under CESR's proposals on research, using disclosure as the primary tool.


CESR

ARTICLE 1

Definition of Financial Instrument (paragraph 69)

54. This section required CESR to draw up implementing measures to specify which existing products should fall within the Directive's list of financial instruments. CESR proposed the following Level 2 advice in the first draft of its advice: *All financial instruments traded on a regulated market should be included within the list of financial instruments*.

55. Some respondents questioned whether any advice was necessary in this area. However, in response to comments made by a significant number of respondents, CESR proposes to retain its advice on this point, but has modified it to read: *All financial instruments admitted to trading on a regulated market should be included within the list of financial instruments.* In doing so, CESR's objective is to align itself to the Investment Services Directive.

ARTICLE 6(1)

Appropriate public disclosure of inside information by issuers

56. This section drew a number of wide-ranging comments. One general question which emerged in some submissions related to how the Article 6(1) requirement should apply to exchange-traded derivatives.

57. CESR considers that this issue is inextricably linked to the interpretation of "issuer" in the Level 1 Directive text. In view of the terms of its mandate in this area, CESR does not consider it possible to issue a definitive interpretation of this point in the context of the Level 2 advice.

The criteria for when information should be regarded as having been publicly disclosed and the appropriate channels for disclosure (paragraphs 52-58)

58. In this section, CESR proposed in the first draft of its advice that inside information should only be considered as having been publicly disclosed when it is disclosed through an officially appointed mechanism. CESR further suggested that disclosure should be made in the jurisdictions of all regulated markets where an issuer has requested that its financial instrument be admitted to trading.

59. CESR requested, in particular, views on the disclosure obligations when a financial instrument is traded in more than one EU jurisdiction and whether the EU needs to have a fully harmonised officially appointed mechanism for the dissemination of information as envisaged under this provision.

60. A number of respondents agreed that, in the interests of equal treatment of investors, the disclosure obligation should apply in each of the jurisdiction(s) where the financial instrument is listed.

61. Some respondents suggested that the equality of treatment of investors should not only require disclosure in each jurisdiction, but "simultaneous" disclosure in all jurisdictions in which the financial instrument is listed.

62. Respondents were divided on the question of whether there should be a fully harmonised, officially appointed mechanism for the disclosure of information.

63. Of those in favour, some suggested that there should be one single mechanism which would cover all the EEA. One respondent favoured a centralised database managed by the competent authority in each member state, with hypertext links between all the competent authorities.

64. Other respondents agreed with the idea of some degree of harmonisation, but did not consider that there needed to be a single mechanism. These respondents tended to favour an official mechanism, appointed and controlled on a national basis, in each jurisdiction. They considered that this would guarantee fair and equal treatment for investors in each jurisdiction, guaranteeing fast access and uniformity of dissemination of information, as envisaged by the Directive. Other respondents suggested that there needed to be harmonisation at a pan-European level of the standards used for disclosure and dissemination of information.

65. Some respondents indicated their direct opposition to making provision within European law for an officially appointed mechanism to satisfy the Directive's disclosure requirement on issuers. They indicated that this was unnecessary and likely to be costly and cumbersome. These respondents preferred a solution based around information being widely available through commercial news dissemination operations, rather than an appointed specific channel.

66. A few respondents suggested that it should be sufficient for issuers to post relevant information on their websites.

67. Finally, some respondents indicated that CESR needed to co-ordinate any proposals in this area with other relevant Directives which are currently under negotiation – ISD, Transparency Obligations and Prospectuses.

68. CESR has carefully considered the range of responses made on this issue and has maintained the requirement that information should be disclosed through an officially

appointed mechanism, as this will offer greater certainty to the market than solutions based around web-based disclosure. In proposing this solution, CESR is not stipulating that there must be a monopoly structure for the officially appointed mechanism, as there may be one or more per jurisdiction. CESR is also requiring that issuers should not disseminate information through other channels before it is disclosed through the officially appointed mechanism.

69. A general concern raised on the Level 2 advice in this area related to the position regarding use of material which was generally in the public domain, if CESR stipulated that information could only be considered to be publicly disclosed when disclosed through an official mechanism. These respondents argued that this publicly available information might be interpreted as having not been publicly disclosed for the purpose of Article 1 and therefore would not be capable of being used.

70. CESR did not ever intend that this should be the effect of its advice in this area and made this clear in paragraphs 70-71 of the consultation paper. The information can be publicly known for the purpose of Article 1 of the Directive. The issuer would, however, be liable to charges of failure to disclose under Article 6(1), if the issuer had not made the required disclosure via the appropriate mechanism. CESR has reiterated this point in its explanatory text. Following the second public hearing, CESR has also made it clear in the Level 2 advice that the officially appointed mechanism is specifically related to Article 6 of the Directive and is not intended to be used to decide whether information is publicly known for the purpose of Article 1.

71. As far as the timing of disclosure is concerned, when a financial instrument is traded in more than one EU jurisdiction, CESR recognises the difficulties presented by this issue. If the required disclosures are to be effected via nationally recognised officially appointed mechanisms, this will mean that simultaneous disclosure in each jurisdiction is likely to be adversely affected by the current operational differences between these mechanisms. There is also the issue of what is to be done when the officially appointed mechanism in a particular jurisdiction is closed.

72. CESR therefore intends, at Level 2, to require that disclosure should be made in a manner which is as synchronized as possible in all the jurisdictions of all regulated markets where an issuer has requested that its financial instruments be admitted to trading. CESR suggests that this recommendation should be supplemented with further work at Level 3, to address the technical requirements of the officially appointed mechanisms. The objective here would be to minimise any discrepancies which may exist between the mechanisms in terms of accuracy, timeliness, input method and access by end users. Work could also be undertaken by CESR to agree criteria to ensure that the Level 2 standard will be met.

Technical factors which need to be taken into account in determining whether a disclosure is complete, immediate or prompt and not misleading (paragraphs 59-61)

73. CESR has proposed that there should be no level two implementing measures in this area. CESR believes that work in this area can be more effectively taken forward through regulatory guidance, rather than legal rules.

74. A small number of respondents were in favour of a further definition of these terms, particularly the term "complete". However, most respondents agreed with CESR's proposed approach, which CESR intends to maintain.

Factors to be taken into account in determining whether a disclosure of inside information has occurred as soon as possible (paragraphs 62-67)

75. In this section, CESR proposed in the first draft of its advice that disclosure should take place as soon as the event occurs, regardless of whether it is already formalised.

76. Following consultation, CESR intends to supplement this advice with a requirement that disclosure should also allow a complete assessment of the information to be made. In addition, any changes to the disclosed information should be notified through the same mechanism, as soon as they occur.

Factors to be taken into account when delaying the publication of inside information (paragraphs 68-71)

77. In this section, CESR has proposed a Level 2 approach based on examples of situations that would enable an issuer to delay disclosure. This approach was preferred to the possible alternative, which would have been to suggest a definition of the issuer's "legitimate interests" as set out in Article 6(2). As set out in its original consultation paper, CESR did not believe that this would be the best approach, since the definition would have to be extremely accurate, in order not to widen the scope of the article. Furthermore, by setting down a precise definition some flexibility would be lost, with the risk that new situations could arise which would not fall within the definition. Respondents were divided on this issue, with a number of respondents agreeing with CESR that this term would be very difficult to define, without modifying the scope of the original term.

78. Some respondents were not supportive of the proposed indicative presentation of examples of situations at Level 2. These respondents pointed out that an indicative list cannot grant legal certainty. Many of these respondents indicated that the examples constitute measures which could be taken into account at Level 3.

79. Others were more supportive of this approach. Of those in this category, respondents considered it particularly important to include matters in the course of negotiation within the indicative examples.

80. Some respondents considered that the advice in this section needed to be modified to take account of the two-tier system in operation in some Member States. Within this structure, decisions made by the Management Board will often require approval by the Supervisory Board. Respondents sought clarification that there would be no obligation on issuers to disclose information once it had received Management Board approval, but prior to Supervisory Board sign-off. These respondents considered that, if this measure was not modified to reflect the two-tier arrangements, there would be a danger that issuers could be obliged to release significant amounts of information to the market. This information

might subsequently prove to be misleading or erroneous, if the decision did not subsequently receive ratification by the Supervisory Board.

81. CESR has carefully considered the arguments from each side in this debate and, on balance, believes that it would be useful to maintain the approach set out in the consultation paper. CESR accepts the comments made in relation to two-tier company structures and has amended the original advice. The modified text now makes it clear that disclosure may be delayed in two-tier company organisations in certain specific circumstances, namely, when disclosure before it has been approved would be likely to prove misleading to the public.

82. To respond to concerns raised at the second open hearing, CESR has extended its additional comment on this advice (paragraph 71) to make it clear that the examples given in the advice do not automatically permit the issuer to delay disclosure. Moreover, the list is not exhaustive. In all cases, an evaluation of the specific situation must be made in the light of article 6/2 of the Directive.

Measures to prevent the abuse of information, when disclosure is delayed (paragraph 72)

83. Respondents were generally supportive of CESR's approach in this area and, as a result, CESR proposes to leave its Level 2 advice unchanged from the original consultation proposals.

ARTICLE 6(5)

Research

Introduction

84. CESR's original proposals drew a significant volume of responses in this area. Generally speaking, respondents indicated that they found the CESR proposals to be too detailed. A number of respondents suggested that a principles-based regime governing the fair presentation of research and the disclosure of particular interests, or conflicts of interest, in research would be preferable to detailed rules. They suggested that excessively detailed disclosure obligations would inhibit transparency and increase market volatility. These respondents suggested that CESR should restrict itself to a high-level principle approach at Level 2.

85. CESR has debated this point at length in the expert group. In view of the high-level nature of the Level 1 provision, coupled with the fact that disclosure is the only tool which is available in the Level 1 text for dealing with conflicts of interest, CESR considers that the Level 2 advice could not be narrowly restricted to high level principles. CESR has, however, attempted to find alternative means for those within the scope of this provision to satisfy the detailed Level 2 requirements, for example through website disclosure, where disclosure within the relevant material would be disproportionate.

86. Secondly, the issue of the scope of this section recurred frequently. This included the question of to whom the CESR proposals should apply and the extent to which the rules being proposed by CESR should be differentiated according to each category of persons.

87. CESR is of the view that the scope of the Directive in this area is widely drawn. Article 6(5) refers to "persons producing or disseminating research concerning financial instruments or issuers of financial instruments or persons producing or disseminating other information recommending or suggesting investment strategy, intended for distribution channels or for the public…".

88. CESR has concluded, therefore, that research reports produced by investment firms and credit institutions, as well as credit reports produced by credit ratings agencies, research reports produced by independent analysts and some articles published in the press would be covered by the Article 6(5) requirement. Nevertheless, CESR recognises that its advice needs to accommodate some differentiation of the different persons relating to the profession concerned. CESR is proposing, therefore, that its advice should consist of a core standard, which would apply to all, followed by a set of more detailed basic and specific rules, which will be differentiated according to profession.

89. In the light of the comments received on scope, CESR also considered that it would be useful to set out its understanding of a number of the different terms used in Article 6(5). This includes definitions of "Research and other information recommending or suggesting an investment strategy" and "Distribution channel", that will complement the definitions of "Relevant Information", "Relevant Persons" and "Relevant Issuer" which CESR uses throughout the advice in this section.

90. A number of comments were received by CESR from journalists and the media on the scope of CESR's advice and how it would or should apply to them. In particular, they made it clear that they considered some of the rules being proposed by CESR in its first consultation to be inappropriate for their profession, on the grounds that self-regulatory standards covering much of the same ground are already in existence.

91. CESR has attempted to address these concerns in two ways. Firstly, the new definition of "Research and other information recommending or suggesting an investment strategy" makes it clear that CESR's requirements will **only** apply to those journalists producing information which "expressly recommend[s] that a person should buy, sell or hold a financial instrument".

92. The second measure being proposed by CESR for that sub-section of the media which does find itself within the scope of the requirements, is an explicit carve-out from CESR's requirements relating to fair presentation, if an equivalent self-regulatory code is already in existence. As far as CESR's requirements relating to disclosure of conflicts of interest

are concerned, the relevant sub-section of the media will be required to ensure that any conflicts of interest are appropriately disclosed. Where the journalist has significant holdings in the financial instrument about which he writes, he will be required to disclose this fact publicly.

93. A number of respondents made reference to developments in the U.S., in view of the recent scrutiny of the role of research analysts and the development of rules which govern their activities.

94. It was pointed out that it would be desirable to avoid overlapping regulations, particularly with the new regulatory regime in the U.S. While some suggested CESR should harmonise its approach with the U.S., others considered that the CESR advice followed the U.S. model too closely already by opting for a rules-based system, without considering the special characteristics of the European markets. Some respondents pointed out that it would be inappropriate to assume that concerns raised about research analysts in the U.S. are equally relevant to Europe.

95. CESR recognises that it is not desirable for firms which are active internationally to have two different and conflicting sets of rules governing research, depending on the jurisdiction in which it is distributed. CESR has taken note of developments in the U.S. and the emerging regime. CESR nevertheless considers that its advice to the European Commission must take as its starting point the specific EU environment and the development of standards and rules which are tailored to the specificities of that market. It would not be sufficient simply to replicate the US rules or to state that compliance with the US rules is sufficient for the purpose of satisfying the EU rules.

96. Finally, in this general overview of the comments received on research, CESR asked in its consultation paper how the proposed implementing measures should be adapted to relevant information which is distributed in non-written form, for example during public appearances, roadshows etc.

97. Many respondents pointed out the difficulties which adapting the information presents, although some helpful suggestions were also received. CESR considers that the proposed

Level 2 implementing measures should be applied to the non-written environment, appropriately adapted.

Core Standard (paragraph 83)

98. The High level principle, as set out in the original consultation paper, has been renamed "Core standard" to distinguish it from the principles-based approach of the Level 1 text.

99. A reasonable care test has been introduced in respect of the requirement to ensure that the relevant information is accurate, clear and not misleading. CESR deemed this to be a more appropriate standard to be met by those within the scope of this article, as it permits a qualitative assessment to be made. Similarly, the reasonable care test has been extended to the requirement that any recommendation can be "substantiated as reasonable", rather than "have an adequate basis in fact".

100. Some respondents pointed out that the requirement for the producer of the information to take reasonable care to ensure high standards of "transparency" and to ensure that the information is "accurate, clear and not misleading" was unsatisfactory. This was on the grounds that "transparency" is unnecessary and potentially confusing (particularly given its use in other contexts, such as the reporting obligations under the ISD) and that "accurate" does not reflect the mixture of fact and opinion which make up research.

101. The issue of "transparency" goes to the heart of the issue of disclosure. Although the issue of disclosure of conflicts of interests is subsequently dealt with in much greater detail in the later advice, CESR considers it important to retain a reference to this essential aspect within the core standard itself. "Accuracy" is simply intended to refer to the factual content of the report. The existence of the revised wording requiring any recommendation to be capable of being "substantiated as reasonable" reflects the recognition that there can be a role for both fact and opinion within research reports.

SECTION A Producers of Relevant Information

Presentation of the Relevant Information (paragraphs 84-87)

102. In recognition of the precise wording of CESR's mandate in this area and to reflect more accurately the fact that CESR's advice relates to the manner in which the relevant information is presented, rather than impinging on the content itself, CESR has renamed its advice in the section "Presentation of the relevant information".

103. As pointed out in paragraph 92 above, CESR has now made specific provision for the category of financial journalists to which its advice applies, to be carved out of the basic rule relating to the presentation of the Relevant Information, providing an appropriate and equivalent self-regulatory regime is in place.

Presentation of Relevant Information: investment firms, credit institutions and credit rating agencies (paragraphs 88-89)

104. In response to comments received in the course of the consultation, CESR has modified its original advice to permit the use of websites to carry a number of the disclosures required in this area, where inclusion of the items in the research itself would be disproportionate in relation to the length of the relevant information being distributed.

Disclosure of interests and conflicts of interest: Basic rule (paragraph 90)

105. One principal change has been made to the basic rule on disclosure of interest and conflicts of interest proposed in CESR's original consultation document. CESR is recommending that disclosure of material interests in the subject of any relevant information must be appropriately disclosed. This modification should provide an adequate degree of flexibility to cover the range of entities within the scope of the Article 6(5) requirement. However, in all cases, the producer of the relevant information must disclose publicly any significant holdings which he has in any financial instruments about which he writes.

Disclosure of interests and conflicts of interest: investment firms and credit institutions: Specific rules (paragraphs 91-99)

106. CESR sought views in its original consultation paper on the appropriate threshold of holding in the issuer which could be "reasonably expected to impair the objectivity" of

the research. CESR also sought comments on the timing of the disclosure, exemptions from the disclosure obligation and the desirability and feasibility of extending this disclosure to instruments other than shares.

107. A wide selection of responses was received. In response to these, CESR has streamlined some of its original proposed advice in this area. In particular, CESR is proposing that credit institutions and investment firms should be required to disclose shareholdings exceeding 5% in the issuer and vice versa, as well as other significant financial interest and significant relationships between the parties.

108. At the second public hearing, some respondents sought further clarification of the exact method by which the proposed 5% threshold should be calculated. CESR did not consider that this level of detail was appropriate for treatment at Level 2. Clearly, however, respondents would find further guidance on this point helpful and this might therefore be an area in which CESR could usefully undertake further work at Level 3.

109. CESR's consultation had also sought guidance on the time periods which it was proposing in its advice. The majority of respondents supported a reduction from three years to twelve months for the duration of specified relationships which would require public disclosure and CESR has modified the time period accordingly.

110. In the course of the second public hearing, some respondents indicated concern about CESR's proposed requirement that investment firms and credit institutions should disclose their policies and procedures regarding reporting structures and their methods of managing conflicts of interest. These respondents argued that this information was of very limited use to the public but could, on the other hand, be of great interest to competitors. CESR has addressed this point by clarifying in its advice that it is the "general nature" of such policies and procedures which should be disclosed under this requirement, not detailed confidential commercial information.

111. In line with amendments made in the Level 2 advice relating to the presentation of the relevant information, which permit certain information to be posted on websites, a similar modification has been made in the disclosure section. This will permit a number of the

required disclosures to be made on an appropriate website, where inclusion in the relevant information itself would be disproportionate and providing investors are made aware of the availability of the information at this source. Certain other required disclosures only have to be made via websites. The starting point for these amendments is to ensure that disclosure is meaningful, while introducing a greater degree of flexibility to CESR's requirements which should permit them to be adapted, as appropriate, to the precise nature of the relevant information.

Dissemination of relevant information produced by a third party (paragraphs 100 – 105)

112. In its consultation document, CESR proposed a differentiated regime for those who simply disseminate information which has been produced elsewhere. CESR has maintained this distinction in its final advice.

Article 8 SAFE HARBOURS

Share Buy-Backs

Introduction

113. As explained in paragraphs 122 and 123 of its original consultation paper, CESR had intended to pursue a two-stage approach for share buy-backs. This would have consisted of a set of ex-ante conditions for the use of the safe harbour, followed by a set of free standing ex-post measures, which would have been applicable to all those within the safe harbour. Following advice from the European Commission that the scope of Article 8 and the mandate given to CESR by the Commission did not permit such an approach, CESR has restricted its advice to conditions which are necessary in order to benefit from the safe harbour.

114. A number of respondents found the approach proposed by CESR in the first draft of its advice to be too detailed and onerous, particularly in the provisions relating to price and volume of relevant shares. Some respondents also considered that the requirements were too rigid and pointed out that they took little account of the different liquidity conditions in different markets. Some respondents suggested that it would therefore be preferable to undertake more work at Level 3 in this area, rather than Level 2.

115. CESR recognises these criticisms and has attempted to remove some of the detail proposed in the first draft of its advice. Nevertheless, CESR considers it important to retain some requirements on price level and volume at Level 2, but to introduce some flexibility in this area, especially for smaller listed companies whose shares may not be very liquid. The regulatory objective relates to the need for equality of treatment of shareholders and price formation.

116. A significant number of comments received on this section related to scope. The Directive itself states that it is a safe harbour for trading in own shares in "buy-back" programmes**.** CESR has, therefore, limited its advice to shares and to buy-back programmes.

117. A number of respondents requested that the scope of the safe harbour should be extended beyond CESR's proposal. Two particular areas were identified. Firstly, a number of respondents requested that debt buy-backs should be within the scope of the Article 8 safe harbour.

118. CESR considers that it does not have the power to extend the safe harbour in this way, as the Directive states clearly that a safe harbour is provided for trading in own shares**.** Debt buy-backs will, therefore, need to be undertaken in a manner that does not contravene the prohibitions of the Directive.

119. Secondly, CESR received a number of representations seeking the inclusion of sales of own shares within the scope of the safe harbour. CESR's understanding of the scope of the article precludes such a possibility, as the Level 1 wording refers only to buy-back programmes. Moreover, CESR would endorse such a narrow scope as it does not seem appropriate to offer issuers a safe harbour under Article 8 when the issuer itself is both a buyer and a seller of its own shares. While such activity is common practice in many European jurisdictions, the activity generally does not benefit from such a safe harbour and, in the event of market abuse occurring, Competent Authorities have the power to investigate and sanction abusive behaviour.

120. CESR acknowledges that, during the life of a share buy-back programme, an issuer might well need to sell own shares. CESR is of the view that, if such sales are to occur, purchases under the buy-back programme would no longer benefit from the safe harbour. CESR has, however, proposed that the benefits of the safe harbour may be maintained in certain cases. Nevertheless, despite this increased flexibility the principle remains that under a safe-harboured buy-back, the issuer should not be selling shares at the same time.

Level 2 Advice (paragraphs 118-125)

121. CESR has added a new paragraph to state exactly what falls within the safe harbour. This clarifies, as requested by some respondents, that share buy-backs for the purpose of

fulfilling obligations arising from employee share option programmes are within the safe harbour. It also clarifies that share buy-backs for the purpose of reducing the capital of an issuer, as well as to meet obligations arising from debt financial instruments exchangeable into equity instruments are, in CESR's view, equally covered by the safe harbour.

122. To accompany the above provisions, CESR proposes a number of conditions which must be satisfied to benefit from the safe harbour. These cover restrictions on price and volume, as well as disclosure requirements. These are largely as set out in the proposed Level 2 advice in the consultation paper, with some modifications which are explained below.

123. CESR had sought comments in its consultation paper on the maximum duration of the programme. The Second Company Law Directive imposes a limit of 18 months and CESR had suggested that this should be reduced to 12 months. Some respondents were supportive of this reduction. However, a number indicated their preference for the maximum duration to be retained at 18 months, both to ensure consistency with the existing Company Law Directive requirement and to accommodate the cycle of general meetings, which do not necessarily take place within a 12-month period. CESR has, therefore, decided to opt for an 18-month duration.

124. In response to comments from some respondents, CESR has deleted the requirement that a buy-back programme must be announced outside the closed periods at the time of quarterly, half yearly and annual reports, in view of the fact that the programme has to be approved by a general meeting of shareholders.

125. CESR proposed in the first draft of its advice that the issuer must have in place the necessary mechanisms to ensure that it is able to fulfil its trade reporting obligations to the competent authority and/or market. This requirement has been supplemented with the requirement that the system in question must be capable of providing at least the information set out in Article 20(1) of the Investment Services Directive (93/22/EEC).

126. On the requirements relating to price, volume and volatility restrictions, CESR has made some modifications to the proposals in its original consultation paper. Firstly, on price, an issuer will not be permitted to purchase shares at a price which is higher than the price of the last independent trade or the current independent bid. This restriction will also apply to the price of the share underlying a derivative contract when entering into that contract.

127. On volume, CESR is advising that the issuer will not be permitted to purchase more than 25% of the average daily volume of the shares in any one day. Special provisions have, however, been made for particular circumstances (e.g. low liquidity) to permit a higher daily volume figure, providing certain additional conditions are met.

128. The volatility restriction set out in the original consultation has been deleted in order to avoid excessive restrictions.

129. CESR had sought views on whether special consideration should be given to developing conditions for short-term programmes. Some respondents indicated that they saw no reason for modification or lifting of the restrictions with regard to short-term programmes. Some respondents suggested that these programmes could increase volatility. CESR has therefore not proposed any special conditions for short-term programmes.

130. The scope of the safe harbour is strict. Sales of own shares and insider dealing restrictions have been put in place. CESR was keen, however, to introduce greater flexibility if appropriate suggestions were forthcoming. This has been done with recognition of Chinese walls for issuers that are banks and investment firms and "formulaic" programmes for other issuers, e.g.. where an issuer commits to buying 1000 shares every third Friday in the month, for a defined period. Buy-back programmes which are lead managed independently on behalf of the issuer by an investment firm are also relieved of the restrictions envisaged by CESR in connection with sale of shares during the buy-back programme.

ARTICLE 8 SAFE HARBOURS

Stabilisation

Introduction

131. In its consultation paper, CESR proposed a two-stage approach to accessing the safe harbour for stabilisation. At the first level, CESR proposed two sets of conditions relating to time and price limits. It was proposed that these conditions would be applicable to everyone seeking access to the safe harbour. CESR also proposed, however, that a further set of requirements should be established by each national jurisdiction within the safe harbour to ensure the regulatory effectiveness of the safe harbour.

132. A general trend emerging from the consultation in this area was the wish of respondents to see a more harmonised approach in this area. Respondents considered that this would offer market participants increased certainty and avoid the risk that national measures at Level 3 could lead to differing or conflicting requirements, which could impede or even increase the cost of cross-border offerings. Whilst CESR is of the view that the Lamfalussy process should be sufficiently robust to avoid such variations arising, CESR has nevertheless taken the point that legal certainty in this area is desirable. Other respondents considered that the proposed Level 2/Level 3 mix was acceptable, but pointed out that the Level 3 measures should not be seen as a condition for the safe harbour.

133. Having considered these comments, CESR has moved a number of provisions, which had been proposed as Level 3 measures in the original consultation paper, into the Level 2 advice, whilst retaining the two original conditions on stabilisation period and stabilisation price. The revised text therefore covers pre- and post-stabilisation disclosure requirements, the stabilisation manager and record keeping. Where relevant, further discussion of these areas is continued below.

134. Secondly, respondents recognised that CESR has attempted to base its proposals to a large extent on its April 2002 paper on Stabilisation and Allotment (*Stabilisation and*

Allotment – a European Supervisory Approach, Ref: CESR 02-020b). Most were generally satisfied with this approach, although some pointed out that there were a number of issues which nevertheless required further modification or clarification. In particular in this respect, some respondents pointed out that CESR's Level 2 proposals made no reference to some aspects of stabilisation activity, in particular Over-allotment and exercise of a Greenshoe Option. These respondents argued that these issues were considered to be part of the normal range of activities undertaken by managers in furtherance of the overall objective of price support and had, moreover, been dealt with in the earlier CESR paper.

135. CESR has decided, therefore, to include reference in the text to the fact that a stabilisation manager may, during the stabilisation period, purchase and sell relevant securities, as well as Overallot and exercise a Greenshoe Option. Definitions of G*reenshoe Option* and O*verallotment Facility* have been added to the definitions section of the paper.

Explanatory text

136. In the course of the consultation on CESR's revised advice, some respondents queried the position of Relevant Securities or Associated Securities, where these are traded on a third country exchange. The question was put to CESR whether any stabilisation undertaken in the third country could benefit from the safe harbour provided by the Directive, as the Directive's prohibitions extend to trading on non-EU markets in instruments which have an impact on EU-traded instruments.

137. Given the impact on EU competitiveness, CESR considers that the safe harbour should also apply, providing the same conditions are being observed. CESR has therefore included explanatory text, which clarifies that CESR considers that stabilisation undertaken in third country jurisdictions should be permitted, providing it is undertaken in conformity with the relevant Level 2 implementing measures. To facilitate this process, CESR has suggested that the Commission might further examine the issue of third country equivalence.

Level 2 advice

Stabilisation Disclosure

138. Pending finalisation of CESR's advice on the Level 2 implementing measures under the Prospectus Directive, CESR has developed interim advice on the disclosure requirements relating to stabilisation which must be carried within the prospectus.

Record Keeping

139. There has been significant discussion of the record keeping requirements, both within CESR and with respondents to the consultation. CESR has defined stabilisation as "any purchase or offer to purchase Relevant Securities…" In view of this, CESR considers, in its final advice, that it is necessary to include a requirement that systems must be in place to record both stabilisation orders and transactions. CESR is therefore reverting to the position as set out in its original consultation paper, which was closely based on its April 2002 paper on Stabilisation and Allotment.

The Overallotment Facility

140. In response to consultation and, in line with its earlier paper on Stabilisation and Allotment, CESR has made provision in its final advice for the exercise of an Overallotment Facility. Within this facility, CESR provides for firms to have an uncovered short position, over and above any agreed Greenshoe Option, providing this does not amount to more than 5% of the original offer. CESR considers that the ability to have an uncovered short position will provide useful flexibility in volatile markets where trading conditions may be difficult. CESR's advice also clarifies that Overallotment may only be undertaken during the subscription period and at the offer price.

The Greenshoe Option

141. CESR has also made provision for investment firms to exercise a Greenshoe Option, as CESR considers that this can be a useful tool in the stabilisation process. Nevertheless, CESR considers that there should be a limit to this practice and its advice sets this limit at

not more than 15% of the original offer. The exercise of the Greenshoe Option should be within the stabilisation period and a number of public disclosure rules regarding the details of the Greenshoe Option should also apply.

Definitions

Associated Securities

142. The definition originally proposed by CESR in this section stated that other financial instruments would only be "associated securities" if they themselves were admitted to trading on a regulated market. One European trade association respondent pointed out that this would have the effect of limiting the safe harbour, as there would be occasions when trading in securities which are not themselves admitted to trading on a regulated market, could fall within the scope of the proposed Directive. This would be the case, for example, when the value of the instruments in question was dependent on the value of other financial instruments which are admitted to trading on a regulated market. CESR agrees with this analysis and has therefore removed the requirement that associated securities must be admitted to trading on a regulated market. However, regulators must be satisfied that adequate standards of transparency are in place for non-regulated market transactions.

143. The definition of associated securities has also been extended to include securities which are issued or guaranteed by the issuer or guarantor of Relevant Securities and, because of the similarity of their terms, is likely materially to influence the market price of the Relevant Security.

Relevant Securities

144. The definition here has been amended to make it clear that new securities being issued which are not, at the outset, fully fungible with a class of existing issued series of securities, but which will (after the initial period) become fully fungible with the existing class, will be regarded as identical at the outset, when stabilisation is likely to take place.