Joint FSA/HMT response to the call for evidence, Review of Directive 2003/6/EC on insider dealing and market manipulation (Market Abuse Directive)

2.1 THE SCOPE OF THE MAD:

2.1.1 *do you consider that the scope of the MAD should go beyond regulated markets? In particular, should it be extended to cover MTFs?*

In principle, we believe that the scope of MAD should be extended to cover all instruments admitted to trading on MTFs and instruments whose value depends on an instrument admitted to trading on an MTF (i.e. instruments which are not separately traded on a regulated market). Such a change would recognise the ability of a number of MTFs to admit securities to trading as a primary market, as well as the fact that some member states are already extending the MAD provisions to cover instruments admitted to trading on these markets at a national level

We think that further thought should be given to whether it would be proportionate to extend all of Article 6 to all issuers who have instruments admitted to trading on MTFs, particularly insider lists and managers' transactions. The UK regime already covers securities that are admitted to trading on the "prescribed markets" of Aim and Plus Markets, which are MTFs. For proportionality reasons, the regime did not extend the Article 6 requirements (disclosure obligations, insider lists etc) to these markets, although they are subject to provisions that include requirements for issuers to disclose inside information.

By way of background, currently, 70% of the 1,454 AIM companies have a market capitalisation of under £25 million. In fact around 50% of the companies have a market capitalisation under £10 million with less than 150 employees on average. These companies choose to come to AIM to gain access to equity finance within a principles based regulatory framework and some have limited resources. Given the Call for Evidence exercise forms part of the Action Programme for Reducing Administrative Burdens in the European Union, in proposing any extensions to the scope of the Directive care must be taken to ensure that small firms are not faced with additional and disproportionate burdens.

2.1.2 What kind of financial instruments should be covered by MAD, especially in comparison with the MiFID? (Article 1(3) of Directive 2003/6/EC*):*

- *do you agree with an alignment of the MAD definition of financial instruments to the definition for the same concept provided for in MiFID? Do you think it could be useful to explain in more detail in the MAD what is meant by a financial instrument "whose value depends on another financial instrument" or to list asset classes, such as CFDs and CDS which belong to this category?*

We would welcome an amendment to include CDS as a financial instrument that falls within the scope of MAD.

It is important to ascertain the correct treatment of CDSs under the market abuse regime, as these are an increasingly important financial instrument. Those with access to information relevant to the financial position of the issuer of the reference asset may well find it more profitable to trade in the CDS market on the basis of that information as trading in CDS may be both more liquid and less transparent, thus potentially providing greater concealment for the abusive activities.

Credit-linked products, such as a CDS, are in almost all cases at present not instruments that are admitted to trading on regulated markets. A CDS would therefore only fall within the MAD regime if they were an instrument whose price or value depends on a financial instrument which is admitted to trading. Accordingly, it is not very clear which CDSs fall within the current scope of MAD regime, and we see value in amending the scope of the regime to ensure that such products are clearly covered.

We would welcome a review of an alignment of the definition of financial instrument in MAD with that of MiFID. However, we have some concerns about importing the definition of financial instrument wholesale from MiFID lest the instruments are not described in a way that is consistent with the purposes and scope of MAD.

2.1.3 The specific case of commodity derivatives:

- d*o you see a need for introduction of a market abuse framework for physical markets?*

We would not support the extension of the scope of the MAD regime to encompass physical commodity markets. However, we recognise there may be merit in exploring the potential for creating a separate anti-abuse regime covering physical markets – outside the scope of financial services regulation.

2.1 INSIDE INFORMATION

2.1.1 Definition of inside information: the general definition

- *Do you share this view as far as insider dealing prohibition is concerned? (see also next point for disclosure of inside information). If not, which concepts would you advise to modify and how?*

The UK considers that the Directive should be amended to introduce the concept of a 'dual definition' of inside information that distinguishes between information that is disclosable by issuers and that whose abuse by market participants should be covered by the prohibition. . Further comment on this with regard to the disclosure considerations, is set out in our answer to question 2.2.2.1

The UK considers that the current definition of 'inside information' is too narrow for the prohibition on insider dealing and does not cover information, which, while not meeting the tests for inside information, is capable of being used illegitimately for trading purposes. For the insider trading prohibition, we think that the Level 1 definition should be expanded to include the concept of relevant information not generally available ("RINGA") – information which, although not required to be

disclosed, is of a type and nature that should not be used for trading on. This provision was introduced in the UK in 2001 and was maintained as a superequivalent provision after the implementation of MAD. We think it is very important to recognise that information can be abused for trading purposes before it is precise or certain enough for the issuer to be under an obligation to disclose it (for example, information about the state of negotiations over a major contract, detail that an M&A deal is progressing, the fact that an issuer is on track for its financial performance etc). Judging the precise point at which a piece of information becomes specific and precise and therefore 'disclosable' is often difficult but information can be abused by traders at a point before it meets this test.

- *Do you support an alignment of the inside information definition for commodity derivatives with the general definition of the directive?*

We recommend including a requirement within the definition of inside information in relation to commodity derivatives that the information be price sensitive; as there is negligible scope to use non-price sensitive information abusively. However, we do not think that a case has been made for removing the requirement set out in Article 1(1) of Directive 2003/6/EC that to qualify as inside information there must also be an expectation that the information be received by users of the market. For disclosure purposes, we consider that the existing definition continues to be suitable and does allow for the development of more stringent transparency requirements in commodity markets. If disclosures are mandated then clearly the users of the markets would expect to receive that information.

2.2.2 Dissemination of inside information and deferred disclosure mechanism (Article 6 of Directive 2003/6/EC and Article 3 of Directive 2003/124/EC)

2.2.2.1 General obligation of disclosure of inside information

- *Do you consider that any changes to the definition of inside information for disclosure purposes is necessary*

Our view is that the Level 1 definition of inside information as a disclosure standard is for the most part satisfactory but that the Level 2 elaboration causes complications and could be improved. The Level 1 Directive currently specifies that that one of the tests for inside information is that it should be information which would be likely to have a significant effect on price of the financial instrument. Level 2 then introduces a new and separate concept of information which a reasonable investor would be likely to use as part of the basis for his investment decisions. It is not clear how these two definitions interact and, on one interpretation, could result in a very broad requirement on issuers to disclose information.

We note that ESME has also identified some concerns with the Directive provisions relating to disclosure of inside information and have proposed to remedy the situation in a number of ways, including: (i) introducing a distinct definition of inside information for disclosure purposes (ii) narrowing the concept of precise nature employed in the definition of inside information, when used for disclosure purposes; or (iii) enlarging the scope of exceptions to immediate dissemination by deleting the

"not likely to mislead the public" condition. We do not consider proposals ii) and iii) to be desirable but we do consider there to be some merit in proposal i) which we understand, as set out in our answer to question 2.1.1. above, to be the concept of a 'dual definition' that distinguishes between "inside" information that is disclosable and "relevant information not generally available" which is abusable but not disclosable (we do not think that the latter category should be disclosable because it is not precise or certain enough for the issuer to be under an obligation to disclose it).

Question: Do you agree that the described deficiencies of the deferred disclosure mechanism need to be addressed, possibly by way of amendments to the MAD framework? Do you consider that Level 3 guidance could be sufficient?

Our understanding of the Call for Evidence text is that the 'deficiencies' that the Commission has identified and to which the question refers are: first, that even where an issuer has a legitimate interest to delay disclosure, it cannot do so unless delay would not be likely to mislead the public and the confidentiality of the inside information can be ensured; and second that there is some uncertainty around the concept of 'not be likely to mislead the public'.

On the first issue we consider the condition that disclosure of inside information cannot be delayed unless omission would not be likely to mislead the public to be an important and necessary condition in most circumstances. In the case of financial institutions however, we accept that there may be circumstances in which a delay in disclosure of inside information could be justified even when it may mislead the public (please see answer to next question for further detail).

With regard to the condition that a delay in disclosure of inside information ceases to be legitimate once the confidentiality of the information can no longer be ensured we consider this to be an essential condition in all circumstances. Once inside information has leaked, it is necessary for the issuer to make a prompt announcement to the market to mitigate the resultant uncertainty and so that the smooth operation of the market is not undermined.

With regard to the issue of what is likely to mislead the public, we recognise that there may be some uncertainty amongst market participants as to what actually constitutes misleading the public and we in the UK have received requests from market participants to clarify the concept. Whilst we have not given a view on specific scenarios where we consider delay may or may not be misleading, we have publicly articulated the following principle that may be considered. This is that a delay in disclosure of inside information may mislead the public in cases where non-disclosure would amount to an implicit endorsement of some specific misapprehension among market participants because, for example, publication of the information would contradict an earlier statement by the company or a specific misapprehension which is known to be generally held in the market.

We would be willing to consider additional guidance in the Directive in relation to the concept of not misleading the public. However, we believe any guidance should stop short of providing specific examples, as any judgement as to whether delay would mislead the public must be made on a case-by-case basis in light of the specific circumstances of the issuer. We consider any amendments should be implemented via changes to the Directive rather than via L3 guidance.

- *Do you agree that the issuer may be exempted from disclosing inside information in situations when that information concerns emergency measures being prepared in case the issuer's financial stability is endangered?*

We agree that an issuer may be exempted from disclosing insider information in such situations but only subject to the following conditions:

a. We propose that only information concerning financial institutions should be eligible for any extended ability to delay disclosure. This could be tied to the type of event or transaction where delay of disclosure is justifiable and so it would not be necessary to try and limit it to systemically important firms.

We do not believe all issuers should have an unconditional or less constrained ability to delay disclosure of severe financial difficulty. This would risk creating a general charter for non-disclosure on the pretext that an issuer is hoping to find their way out of financial difficulty. This would also undermine the intention that the market should have timely and accurate information.

A delay in disclosure of information concerning a financial institution may be justified where, for example, the information to be disclosed concerns circumstances giving rise to, discussions leading to, or actual, emergency government assistance or intervention. We consider that non-disclosure is important in cases where firms might be in receipt of (for example) such support, the public knowledge of which could have impacts on the viability of the firm, and also (but not exclusively in addition to) broader implications for financial stability.

b. However, the power to authorise such delayed disclosure should rest with the competent authority nominated by a Member State. The competent authority must be able to determine the period for which the institution is to be permitted to delay disclosure, and that authority should have general powers to sanction non-disclosure of emergency assistance where this is necessary on public interest grounds, though we do not think it would be appropriate for any institution to be permitted to delay disclosure indefinitely.

The competent authority will be aware of the issuer's severe financial difficulty and the associated remedial measures. It would thus be open to the authority to make the issuer disclose inside information if the authority considered the point had been reached where a disclosure should be made.

2. If the ability to delay disclosing severe financial difficulty and associated remedial measures is to be made unconditional or less constrained, Article 6 of the Directive could be amended to lift the disclosure requirement on the issuer in the specified circumstances. It is the issuer on whom the disclosure obligation falls under the Directive and it is more obvious to tackle.

3. We acknowledge that any such delay is likely to be temporary and, practically, it is doubtful whether the confidentiality of such situations could be maintained for very

long. In any event, as noted above, we do not think it would be appropriate for any institution to be permitted to delay disclosure indefinitely.

2.2.2.2 Disclosure in commodity derivatives markets

Do you agree with this approach? Can you identify cases where a modification or deletion of the obligations may be undesirable for market integrity?

We recognise that these issues might warrant further consideration. However, we caution against modifying the obligation before conducting a comprehensive review and analysis. For example, it is worth closely examining the circumstances in which the issuers of commodity derivatives (e.g. exchanges) might in practice hold inside information. Additionally, there may be problems in introducing alternative obligations over and above the disclosures required by MAD and/or the 3rd Energy Package. For example, there may be geographical jurisdictional difficulties where the stakeholder (e.g. commodity producer) is located outside the EU. Additionally, there is another jurisdictional issue in relation to firms who are neither financial services firms nor firms covered by the 3rd Energy Package; there may be problems in identifying a regulatory agency responsible for enforcing any disclosure obligations.

We therefore cannot at this stage agree that the issuers of commodity derivatives should have an obligation that inside information relating to products traded on their exchanges is disclosed. This is in part due to the fact that the issuer of those derivatives might not have the power to require all parties to disclose the information.

2.2.3 Prohibition of insider dealing (Articles 2, 3, and 4 of Directive 2003/6/EC)

Would you support this approach?

We agree that it is best to wait for the ECJ decision. However, in addition, our view is that the user test i.e. the requirement that the trading is informed by the inside information is an important concept. There may be circumstances where there is legitimate cause to trade whilst in possession of inside information where the trading is not in fact informed by the inside information.

2.2.3 Three new tools to help detect suspicious transactions

2.2.4.1 Insider lists

Do you consider that the obligations to draw up lists of insiders are proportionate?

We consider that the obligations to draw up insider lists to be proportionate. However, for smaller firms e.g. those with securities admitted to trading on an MTF, an alternative option might be to include a requirement to provide the regulator with an insider list only if requested by the regulator on a case by case basis.

FSA has identified a number of shortfalls when requesting insider lists to help progress preliminary market abuse case enquiries,

(i) The list compiled by issuers requires the inclusion of only those "persons acting on their behalf or for their account". However, when conducting a preliminary market abuse enquiry, a competent authority needs to review a wider list showing all those individuals who could have had access to the inside information. Whilst we do not think that it would be proportionate to extend the obligation to maintain this additional detail as a matter of course, we think it is important that the competent authority is able to obtain this detail on individual cases as required. The current framework does not provide the necessary powers. FSA's experience is that advisers not subject to financial regulation such as law firms or public relations firms engaged by the issuer have sometimes refused to provide this additional information unless a formal enforcement investigation has been launched by the FSA (in which case we can compel the firm to provide the information). At an early stage of an enquiry it may not be proportionate or an effective use of resources to launch such an investigation.

(ii) Advisors to the issuer may in turn employ firms to undertake specific tasks that might not be directly charged to the issuer. Our interpretation of the Directive text: "Member States shall require that issuers, or persons acting on their behalf or for their account, draw up a list of those persons working for them, under a contract of employment or otherwise, who have access to inside information" is that there is no requirement for these firms to be included on the insider lists maintained by the issuer. FSA's experience in requesting insider lists from regulated advisors frequently shows them as unwilling to coordinate the inclusion of firms employed by them.

To address these weaknesses, we think it would be helpful for the Directive to state that a wider list of those individuals who could have accessed the inside information should be provided to the regulator if requested and that this applies to all firms that are "insiders" even if they are not directly engaged by the issuer.

2.2.4.2 Transaction reporting by managers and closely associated persons and subsequent disclosure

Do you see a need for a regulatory action in the above areas? Would you suggest further improvements?

We believe some improvements could be made to the Directive by clarifying the scope of transactions in Article 6(4). As 'transaction' is not a defined term in the Directive, there is some ambiguity as to which transactions by persons discharging managerial responsibilities (PDMRs) require disclosure, which may undermine the level of harmonisation across the EU. For example, in the UK, we have recently become aware of uncertainty as to whether a pledge of shares as collateral constitutes a transaction under the Directive and we note divergent views on this matter across different member states. We therefore believe there may be some merit in providing additional guidance around the definition of a transaction.

We do not consider that it would be a priority for the Directive review to consider the mechanics of disclosure.

2.2.4.3 Reporting of suspicious transactions (Article 9(9) of Directive 2003/6/EC and Article 7(11) of Directive 2004/72/EC)

Do you agree that rules on suspicious transactions reporting do not require modifications?

Yes, we support an amendment of the STR rules to ensure that OTC derivatives are covered by the regime. In general, we have found the regime to be extremely valuable in identifying possible cases of market abuse with over 1000 reports submitted to the FSA.

2.2.5 The competent authorities' right of access to telephone and existing data traffic records

Do you consider that an amendment of the MAD is necessary?

We agree that telephone and data traffic records can be particularly useful for providing proof of possession and use of inside information. Such records can also be useful in the context of other types of market abuse, which don't necessarily involve the use of inside information. We note that the Commission states that some regulators have interpreted the provisions of the e-privacy Directive as implying that they would not always be able to require access to such records, notably in the case of administrative proceedings. We consider that we do have the power to require these records, and consider the recent decision of the ECJ in the Promusicae case as helpful in this regard. However, to the extent that further clarification is needed, we would welcome an amendment to MAD and/or the e-privacy Directive to make it clear that the power to acquire these records in market abuse cases is not constrained by anything in the e-privacy Directive.

2.3 Market Manipulation

2.3.1 Definition of market manipulation by transactions/orders to trade

Do you think that the definition of market manipulation should be amended? If this is the case, what elements of the definition should be reconsidered?

The current law does not give us a clear power to take action against attempted manipulation where there has been no impact on price or the impact has not been significant. For commodity derivatives, it can be difficult to prove that manipulation has had, or is likely to have a direct effect on market movement. Parties involved in manipulation may not succeed as it is difficult to influence the price of a derivative contract and it is difficult for regulators to prove perfected manipulation.

We therefore would support a change to the Level I definition of market manipulation which clarifies that the scope of market manipulation can include attempted manipulation even where there has been no resultant movement in price.

Case example

We have undertaken an investigation concerning the repeated conduct of a number of individuals attempting to manipulate a commodity derivative. However, on only one out of nine occasions was the contract price actually influenced by the trading and this

was not considered to be a material price move. We had strong evidence of attempted manipulation, including recordings of telephone conversations, but were unable to pursue to the case due to the fact that the price had not moved sufficiently for us to be able to show that the manipulation had actually succeeded.

There is also a second area in which the Directive could be strengthened in this area. Currently, the scope of the Directive prohibitions is limited to transactions or orders to trade. However we believe that it is possible to distort the market without actually undertaking specific transactions. The UK regime includes the following offence which is superequivalent to the Directive (section 118(8) of the Financial Services & Markets Act):

"Behaviour
(a) likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for or price or value of, qualifying investments, or
(b) that would be, or would be likely to be, regarded by a regular user of the market as behaviour that would distort, or would be likely to distort, the market in such an investment"
and the behaviour is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market."

Examples of behaviours falling into this category are:

(1) the movement of physical commodity stocks, which might create a misleading impression as to the supply of, or demand for, or price or value of, a commodity or the deliverable into a commodity futures contract; and
(2) the movement of an empty cargo ship, which might create a false or misleading impression as to the supply of, or demand for, or the price or value of a commodity or or the deliverable into a commodity futures contract

We would welcome the inclusion of this offence within the Directive.

2.3.2 Accepted Market Practices (AMPs)

2.3.2 Do you consider that the rules on accepted market practices should be amended in the MAD? Do you think there is room for greater convergence among competent authorities in this area?

We do not consider that the rules on AMPs should be amended. The Directive framework should allow the possibility for practices to be accepted on one market without their having to be accepted in other markets

2.3.3. Exemption for buy-back programmes and stabilisation activities
Do you consider that the safe harbour for buy-back programmes and stabilisation activities should be revisited? Do you think that greater convergence is desirable in the application of the Regulation 2273/2003? What would be the most appropriate way forward in this respect?

We do not believe that the safe harbour for buy-back programmes needs to be revisited.

In terms of greater convergence where the interpretation of permitted stabilisation may differ across member states, the FSA is of the view that while this may have beneficial aspects, we do not see the appointment of, for example, a single supervisor when stabilisation affects more than one member state as a necessary provision. This is because it should already be possible to identify the lead regulator as the national regulator where the issuer has its primary listing rather than concern all regulators in whose jurisdiction the transaction is taking place; this would in fact appear to be the intention of the Directive on all levels.

With regard to buy-backs, we do not believe that the number of exemptions covered by the safe harbour should be increased to include for example, buy-backs undertaken for M&A activities. MAD is clear that operating outside of the safe harbour does not necessarily constitute market abuse and therefore, rather than extend any safe harbour, such situations should be judged on a case by case basis and on their own merits. Furthermore, we do not believe that, where an issue trades on a regulated market, there should be any provision for the issuer to buy back up to 50% of their own shares on the premise of extreme low liquidity, as such liquidity issues should not in fact exist on regulated markets.

2.3.3 Short Selling

Do you see a need for a comprehensive framework for short selling? If so, should it be addressed in the Market Abuse Directive? What issues should such a regime cover?

We find that there is a case for enhanced transparency requirements regarding short selling. We are of the view that it would be inappropriate to incorporate such measures into the Market Abuse Directive (MAD) and instead recommend a new directive. This is because short selling can normally be expected to enhance market efficiency and were one to include short selling measures within MAD that might result in the perception that short selling per se is abusive. Other than enhanced transparency requirements and an emergency power to ban (see below), we think that no additional regulation of short selling is warranted. In particular, we think that direct constraints on short selling would be disproportionate. For further information please see the FSA's recent short selling Discussion Paper http://www.fsa.gov.uk/Pages/Library/Policy/DP/2009/09_01.shtml

Should short sellers be required to report positions to competent authorities? Under which conditions should naked short selling be allowed? Should competent authorities be able to take emergency measures (e.g. temporary bans on short selling or naked short selling) within prescribed limits when they need to address specific market risks and disruptions?

We are of the view that significant short positions should be disclosed to the market as a whole rather than just to competent authorities because public disclosure would tend to deter more aggressive short selling (thereby mitigating the risks that short

selling might pose to orderly markets) and also such disclosures contain information that is of value to the market. However, we support a two tier disclosure regime - in which disclosures are made first at a lower threshold privately to the regulator and then, at a higher threshold, publicly to the market - as we believe there is value in regulators being made aware of building short positions that have not yet been disclosed publicly. This can give them advance notice of potential market abuse or looming issues that might create disorder in the market. There ought to be no direct constraints on naked short selling as we are of the view that the costs of such measures far outweigh the benefits. For example, a naked short selling prohibition would stop intraday naked short selling (e.g. by day traders), an activity generally accepted to be legitimate trading that provides valuable liquidity to the system and does not pose a significant risk of settlement disruption. Also such a prohibition would significantly impair the ability of market makers to function properly, as it is often a necessary part of their role to short sell to meet client demand for a stock (where their own inventories are exhausted). However, our view is that naked short selling without any reasonable plan to settle constitutes market abuse. We consider that regulators ought to have an emergency power to temporarily ban short selling where necessary e.g. to maintain orderly markets. Apart from these measures we do not consider that the imposition of any additional direct constraints (e.g. price restriction rules) on short selling would be proportionate.

Is there a need to enhance risk management by financial intermediaries and banks? Should investment firms and banks be required to have necessary arrangements in place to ensure timely delivery of financial instruments traded on own account or in the context of execution of clients' orders?

In relation to short selling, we do not think that additional regulation would be a proportionate response to either of these issues. In particular, we reiterate our view that although naked short selling without any reasonable plan to settle the short position would constitute market abuse, such potential mischief is adequately addressed by the current market abuse regime.

Other Comments

None.