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CDWG response to MAD Call for Evidence (15 June 2009)

Introduction

This paper is in response to the Commission's Call for Evidence on the review of directive 2003/6/EC on insider dealing and market manipulation, otherwise referred to as the Market Abuse Directive (MAD), dated April 2009.

ISDA, the FOA and EFET have been cooperating as the Commodity Derivatives Working Group (CDWG), focusing initially on the review of commodities business mandated under MiFID and the CRD, and more recently on the consultations concerning regulation of wholesale electricity and gas markets. The views expressed in this paper are those of commodity firm members of ISDA and the FOA. EFET has elected to prepare a separate response.

ISDA represents participants in the privately negotiated derivatives industry and today has over 800 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on the over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

The FOA is an industry association for more than 160 international firms and institutions which engage in derivatives business, particularly in relation to exchange traded transactions, and whose membership includes banks, brokerage houses and other financial institutions, commodity trade houses, power and energy companies exchanges and clearing houses, as well as a number of firms and organisations supplying services into the futures and options sector.

The CDWG welcomes the opportunity to respond to the call for evidence and is willing to discuss any of the points made below with the Commission.

The CDWG is aware of the joint trade associations' response to the call for evidence prepared by LIBA and, to the extent that the views expressed in this paper do not conflict with those presented in the LIBA paper, we support the views expressed in that response.

The scope of the MAD

Only Regulated Markets? (Articles 1(3) and 9 of Directive 2003/6/EC)

The services of the European Commission recognise that there are divergent arguments as to the extension of the scope of MAD to "non-regulated markets". However, bearing in mind the need to secure integrity of markets and to ensure a level playing field between regulated markets and alternative trading platforms it is worth examining the possibility of extending the MAD scope to MTFs.

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

A: The CDWG agrees with the principle of ensuring market integrity and transparency, but believes that the MAD has been designed for regulated financial markets and may not be suitable for extending beyond those markets without further significant review. We recognise, however, that arguments in favour of the extension of the MAD to MTFs which may offer financial contracts under MiFID, but which are not currently traded on regulated exchanges and therefore not covered by the MAD, should be considered.

MiFID already ensures a degree of market integrity on MTFs. This is achieved through:

- the requirements for MTF operators to monitor transactions and report suspicious transactions to the competent authority;
- the fact that MTF operators are themselves MiFID firms and subject to the organisational and conduct of business rules of MiFID which further ensures investor protection, transparency and market integrity; and
- the fact that those MTFs which compete directly with regulated exchanges in providing a platform for the same instruments are already covered by the MAD, as this covers instruments admitted to trading on regulated markets wherever traded.

However, despite the assurances above, some policy makers and market participants feel that a potential regulatory gap exists for those instruments which are unique to MTFs (i.e. not covered by the MAD as instruments traded on a regulated exchange) but still provide important price information for the industry.

We believe that any extension of the MAD to cover all MTFs would raise concerns over proportionality. While some MTFs are of sufficient size, and their operations of such a nature that the MAD would present no undue regulatory burdens, other MTFs are smaller and/or niche platforms which would likely struggle to comply with the full weight of the MAD. While the larger MTFs have many features in common with regulated exchanges, a more differentiated regime would appear to be the more appropriate solution were the Commission to pursue the notion of extending a specific market abuse regime to MTFs.

Firms would face increased regulatory costs in order to ensure compliance with the MAD on a greatly increased range of instruments. With a wide range of MTFs offering an even wider range of instruments, all of which would be covered by the MAD once admitted for trading on any MTF, firms would need to devote significant resources to ensuring that traders were aware of new instruments admitted to any MTF. MTF operators would also face the increased costs of providing this information to the market at large.

The CDWG is extremely wary of arguments based on a call for a "level playing field" which may fail to consider the full range of differences between, in this case, exchanges and MTFs. At present, MTFs and regulated exchanges operate under regulation which is proportionate to the nature and scale of the platform. To require all MTFs to apply the MAD in full would not produce a level playing field, but one where the regulated financial markets would have a comparative advantage over MTFs, due to the imposition of disproportionate regulation. We believe that the more compelling concern should be for orderly and well regulated markets, which can be achieved through more proportionate means than the blanket application of the MAD to MTFs.

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

In order to clarify the scope of application of the MAD in relation to the various types of financial instruments currently traded on the EU financial markets, the definition of financial instruments in the MAD could be aligned with the definition of financial instruments provided for in MiFID.

Q: ***Do you agree with an alignment of the MAD definition of financial instrument 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?***

A: There is already something of an overlap in the definition of financial instruments in the MAD and MiFID in that they both cover instruments traded on regulated exchanges. The CDWG therefore feels that there is a distinct benefit in terms of consistency across financial regulation in aligning the definition of financial instruments in the MAD with that in MiFID.

However, this consistency should not result in the inadvertent expansion of the MAD to cover MTFs, for example by bringing commodity derivatives traded on MTFs into the scope of the MAD through the adoption of the MiFID definition.

The CDWG agrees that providing a more detailed explanation for a financial instrument "whose value depends on another financial instrument" might provide greater clarity, but does not feel that this is a pressing need as the definition is not problematic as it stands. Likewise, while there is no evident downside to listing asset classes covered by this definition, the CDWG does not believe that this clarification is necessary. It is necessary, however, to ensure that any such list is not taken as comprehensive but rather illustrative only.

The specific case of commodity derivatives markets (Article 1(1) of Directive 2003/6/EC)

A tailor-made market abuse framework for physical markets in a separate piece of legislation (not in financial services regulation) and an interface between regulators concerned could be a possible way forward.

Q: ***Do you see a need for introduction of a market abuse framework for physical markets?***

A: The CDWG strongly believes that an extension of the MAD to cover OTC and spot markets in commodity derivatives and similar products is not advisable. For a more detailed explanation of the issues leading to this conclusion, please refer to the CDWG responses to the CESR-ERGEG advice to the European Commission in the context of the Third Energy Package.[1]

It may be more beneficial to consider a tailor-made regime to cover, in particular, EU energy markets. Such a regime should focus on reasonable and appropriate levels of transparency, and market integrity, but any such regime should be the subject of widespread industry consultation independent of this MAD review.

We are aware that the Commission has been discussing outline proposals for such a tailor-made-regime with some industry participants via EFET. While the CDWG is broadly supportive of the EFET proposals as they apply to a tailor made regime, we would caution that a "one size fits all " approach is not appropriate for all energy and commodity markets. Key fundamental provisions underpinning any such regime will include what defines "inside information" and in particular, what information is expected (or required) to be disclosed and what trading is consequently permitted.

We firmly believe that it is important to protect the interests of all participants including the owners of physical assets and that the latter must be allowed to hedge exposures relating to unforeseen outages before notifying the market. A regime based on the immediate disclosure of any unforeseen outages is clearly attractive on the surface but we believe it would be problematic in practice and that while it may work in one market it would prove to be damaging in another. In some continental power markets for example, where current central systems provide near to real time information on outages and where existing market practices provide confidence that an asset owner will be treated fairly by the market and allowed to hedge the exposures created by an unforeseen outage in an orderly fashion, it may be that an immediate disclosure regime will be appropriate. This will not necessarily be the case in all energy and commodity markets.

Further, we believe that in the gas markets the availability of flexible supply side infrastructure such as storage and line pack will have a damping effect meaning that availability issues with upstream and downstream gas assets may not be felt in the market for many hours. Also, the full impact of an outage in terms of scale (i.e. is the entire facility effected or is it just partially effected) and duration (how long will repairs take to complete) is often difficult to accurately predict. In such cases, pressure to make an immediate disclosure could result in inaccurate and potentially misleading

[1] Available at http://www.isda.org/speeches/pdf/ISDA-FOA-resp-cesrergeg-aug09-bespoke-MAD.pdf

information being provided to market participants which may further exacerbate market volatility as market players react, possibly incorrectly, to such information.

We would counsel that any changes should not be extreme and that a new regime in relation to such disclosure may wish to walk before it tries to run. It may be that an arrangement where the industry could get information as per the UK's National Grid site[2] would be appropriate. The information on NG's site is possibly more important to the traded market than knowing when a field is not going to produce X amount – due to the mitigating effects of line pack and any substitution arrangements that may show that actually X amount subsequently turned up at the beach. This issue demands to be fully considered before any solution is offered.

While the CDWG is broadly supportive of a tailor-made regime we would urge the Commission to maintain an open mind on these issues and encourage discussion with a wider set of market participants, including via the CDWG, when considering any such proposals.

<u>Inside information</u>

Definition of inside information: the general definition (Article 1(1) of Directive 2003/6/EC and article 1 of Directive 2003/124/EC) and the particular definition for commodity derivatives

In this context, there does not seem to be a need to revise the concepts used to define inside information for MAD purposes.

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

A: In respect of financial markets, the CDWG shares the view that there is no need to revise the concepts used to define inside information.

The current MAD provisions on this issue may not offer sufficient certainty. Alignment of the definition of inside information for commodity firms with the general definition given by the MAD could be considered. However, if new obligations on public disclosure in the physical commodities markets were tailored in the short to medium term as a consequence of the Third Energy Package, we may need to reassess whether maintenance of the status quo is more appropriate.

Q: ***Do you support an alignment of the inside information definition for commodity derivatives with the general definition of the Directive?***

A: The CDWG strongly believes that the definition of inside information for commodity derivatives should not be aligned with the general definition of inside information in the Directive. The CDWG further identifies problems with the specific definition for commodity derivatives as it currently stands.

[2] http://www.nationalgrid.com/uk/Gas/Data/dsr/

The general nature of the definition in the MAD is at odds with the need for a bespoke approach to commodity derivatives markets noted above. The result is that the existing definitions lead to uncertainty as to the scope of the directive. For example, the term "derivatives on commodities" is not defined under MAD and appears not to cover exotic/hybrid derivatives such as carbon based contracts, other than those which are currently traded on regulated markets.

Any definition must be considered in the context of both the knowledge deemed to be inside information and the practical impact that this will have on the legitimate activities of firms involved in physical markets. The combination of definition and permitted trading activities must not prevent physical market participants from undertaking necessary risk management activities in relation to their physical position.

Further, the general concept of the disclosure requirement does not fit commodity markets, as the issuer of commodity derivatives in regulated markets is the market operator and not the individual market participant, and the issuer is not in possession of inside information. Hence there is no single issuer with responsibility to ensure equality of information for all market participants.

In consequence of the above, while the CDWG supports the concept of greater congruence between the directives concerned, this requires significant further work to identify the implications and necessary exceptions in practice.

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

At this stage, no changes in the definition of inside information for disclosure purposes would seem to be justified.

Q: ***Do you consider that any change to the definition of inside information for disclosure purposes is necessary?***

A: Subject to points made above, the CDWG agrees that no changes are necessary at this time.

It may be necessary to revisit the mechanism for deferred disclosure of inside information in order to ensure (i) that the conditions for the use of this possibility are sufficiently precise and (ii) that when the viability of an issuer is at stake, they are not unduly stringent. It may be worth examining whether exemptions to the obligation of disclosure of inside information should be broadened and should exclude financial stability measures from such an obligation. Effecting changes or providing clarifications in this area may imply changes to Level 1 and/or Level 2 measures.

Q: ***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?***

A: No comment.

Q: ***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?***

A: No comment.

Q: ***What are other deficiencies in this area that raise major interpretation/application difficulties? What is the best way to address them?***

A: No comment.

Consideration should be given to reviewing the obligation to disseminate inside information for commodity derivatives issuers (e.g. electricity and gas derivatives).

Q: ***Do you agree with this approach? Can you identify cases where a modification of deletion of the obligation may be undesirable for market integrity?***

A: The CDWG agrees with this approach.

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

This matter has been recently brought to the attention of the European Court of Justice (ECJ), in the context of a preliminary ruling requested by a court in Belgium. At this stage, there is merit in considering the ECJ preliminary ruling before the services of the European Commission envisage measures that would seek to clarify this apparent divergence.

Q: ***Would you support this approach?***

A: The CDWG agrees that it is reasonable to wait for the ECJ verdict in this matter. However, this point should be subject to review once the ECJ verdict is known. However, the CDWG feels that the correct approach would be for the offence to be limited to persons trading on the basis of inside information and not merely trading while in possession of such. Restrictions on trading while in possession of information could apply equally to firms as legal entities, as well as to individuals, and could result in situations where one individual in a firm trades with no personal knowledge of the information due to internal controls but the firm is nevertheless deemed to have committed an offence.

Three new tools to help detect suspicious transactions:

i) Insider lists (Article 6(3) of Directive 2003/6/EC and Article 5 of Directive 2004/72/EC)

The rules on insider lists may need to be re-examined in order to address concerns regarding the balance between their efficiency and the burden they entail for the entities obliged to produce them. Due consideration needs to be given to problems with legal certainty, consistency at EU level

or workability of the insider lists' requirement in specific circumstances.

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

A: The requirement for firms to establish and maintain "real time" insider lists does not produce a benefit proportionate to the cost involved. Particularly in the commodity markets, the requirement is not realistically practical due to the nature of the physical market information concerned and the range of individuals who may have access to it.

In practice, the CDWG does not believe that any benefit is gained from this requirement that would not be gained from a more relaxed requirement for firms to ensure that appropriate lists are compiled on a timely basis and made available for regulators on request.

ii) Transaction reporting by managers and closely associated persons and subsequent disclosure (Article 6(4) of Directive 2003/6/EC and Article 6 of Directive 2004/72/EC)

It may be necessary to reassess this measure and consider whether it provides for sufficient legal certainty.

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

A: No comment.

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

The advantages of this measure seem to largely outweigh any regulatory burden. However, Level 1 or 2 changes could still be envisaged in order to enhance the efficiency of the reporting mechanism.

Q: ***Do you agree that rules on suspicious transaction reporting do not require modifications?***

A: The CDWG agrees that the current rules do not require modification, but feels that further steps might be taken to encourage firms to report suspicions outside of the existing rules, most significantly when they are not a party to the transaction concerned. Such encouragement should not take the form of an obligation, given the additional degree of uncertainty involved, but protection against liability for breach of confidence would render the regime more robust and increase the likelihood of at least one market participant notifying the regulator in the even of suspicious activity. Additionally, firms might be encouraged to report suspicious transactions retrospectively once the market has reacted to a series of individually innocuous transactions that may not have been reported at the time.

The competent authorities' right of access to telephone and existing data traffic records (Article 12 of Directive 2003/6/EC)

It may be necessary to amend the MAD and/or the e-privacy Directive, in order to remove any uncertainties on the rights of the competent authorities to require this data. Article 12(2)(d) of Directive 2003/6/EC could clearly state that the power of competent authorities to require existing telephone and data traffic records in the course of their proceedings against market abuse are not limited by confidentiality restraints or other limitations on entities possessing such records that may stem from the e-privacy Directive.

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

A: No comment.

<u>Market manipulation</u>

Definition of market manipulation by transactions/orders to trade (Article 1(2) of Directive 2003/6/EC)

As a consequence, no legislative change is envisaged.

Q: ***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?***

A: No comment.

Accepted market practices (AMP) (Articles 1(2)(a) and 1(5) of Directive 2003/6/EC)

At this stage, consideration should be given to whether further Level 3 work on this topic could help.

Q: ***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?***

A: No comment.

Exemption for buy-back programmes and stabilisation activities (Article 8 or Directive 2003/6/EC and Commission Regulation 2273/2003)

Not all buy-back programmes and stabilisation activities should benefit from an outright exemption (safe harbour) under the MAD rules. Even if some of them are currently not included within the scope of Regulation 2273/2003, they are not to be automatically considered as manipulative behaviour. There may be merit in considering the specific areas where greater convergence would be desirable in the application of these rules.

Q: ***Do you consider that the safe harbours 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?***

A: No comment.

Short selling

Q: ***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?***

A: The CDWG agrees with the recent IOSCO report, that short selling enhances prices discovery, increases liquidity and facilitates risk management activity such as hedging. In this context, a comprehensive European framework on short selling would be beneficial to the market and restore the confidence of market participants following the varied responses to short selling from different local authorities during the recent financial crisis, and prevent the reoccurrence of any similar period of uncertainty.

The MAD already provides a framework to punish the use of short selling to abuse the market, and the CDWG does not believe that any specific amendments to the Directive are necessary.

Q: ***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 on naked short selling) within prescribed limits when they need to address specific market risks and disruptions?***

A: There is no immediately apparent need for firms to specifically report short positions to competent authorities, beyond the accepted levels of transaction reporting and transparency applied to other market behaviour, but the CDWG feels that disclosure requirements should ultimately be the subject of separate and more detailed consideration. Some reporting requirements may indeed be required in conjunction with the triggers for any short term bans allowed under a hypothetical regime.

Naked short selling presents a greater potential for manipulation and could be reasonably constrained through measures to ensure timely settlement, but prohibition of naked short selling, or restrictive policies requiring firms to own or borrow shares prior to the transaction would likely impede the efficiency and liquidity gains that short selling provides.

The CDWG accepts that emergency measures to impose short term bans are advisable to curb short selling in situations where markets are behaving in a disorderly manner. Any such ban should, however, be limited in the term of application and contingent on clear evidence of disorderly trading.

Q: ***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?***

A: No comment.