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ISDA comments on the proposal for a Directive on Insider Dealing and Market Manipulation (Market Abuse) (COM (2001) (281 Final))

The International Swaps and Derivatives Association (ISDA) is the global trade association representing leading participants in the privately negotiated derivatives industry. ISDA was chartered in 1985, and today has more than 530 members institutions from 41 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 over-the-counter derivatives to managed efficiently the financial market risks inherent in their core economic activities.

The European Commission presented the proposal for a Directive on Market Abuse in May 2001 ostensibly under the new Lamfalussy Procedures. These require, inter alia, that all proposed legislation should be the subject of a full consultation process prior to its issuance. In this case, the Commission issued the proposal without a formal consultation exercise, citing in the explanatory memorandum to the proposal the urgency with which action was required and the extensive consultations on the issue already carried out with Member State governments, regulators and supervisors, financial industry (Forum Group meetings) and other interested parties. ISDA wishes to express its grave concern that no formal consultation exercise was undertaken in this case. The result has been that those within the financial services industry who are most familiar with the issues raised by the Directive have had no opportunity to give input on the technical detail of the Directive. Discussion within the Forum Group meetings was not informed by knowledge of the detailed proposals to be put forward by the Commission. Had a full consultation process been undertaken on the detail of the proposals, ISDA believes that the proposal would not have suffered from a number of serious defects which, in ISDA's opinion, are present in the current proposal.

ISDA stresses that it is supportive of measures which provide appropriate prohibitions on insider dealing and market manipulation and effective means of enforcement, so that the integrity of the EU's financial markets can be safeguarded. It believes, however, that any such measures should not hamper the legitimate activities of participants in the financial markets by imposing unreasonable costs or inhibiting financial innovation, thereby potentially rendering European markets uncompetitive in the international arena. As an example, it is vital that insider dealing and market abuse provisions are not extended so far that the important principle that market participants should be entitled to profit from the possession of

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information not generally available is completely eroded. For overriding public policy reasons, existing insider dealing laws, which in the EU already extend further than those in the US, provide an exception to this principle for publicly offered securities, but to extend this exception any further would risk destroying European markets as locations for the transformation of differential levels of information into price signals. ISDA urges the EU institutions to work together on amendments to the current proposal which will achieve the objectives outlined above.

We set out in below our principal concerns with the Directive as it stands, followed by some further drafting comments.

Our Principal Concerns

- (1) ***Insider dealing concepts should not be extended beyond the securities markets.*** As currently drafted, the bulk of the Directive applies both insider dealing and market manipulation provisions equally to securities instruments as well as to commodity, interest rate, foreign exchange and other non-securities related derivatives. While we appreciate that appropriate market manipulation provisions may need to apply beyond securities instruments, we strongly believe that it is inappropriate to apply insider dealing concepts to commodity, interest rate, foreign exchange and other non-securities related derivatives.

It is generally accepted that the purpose of insider dealing provisions is to prevent a person taking advantage of possession of material, non-public information relating to an issuer of securities for the purposes of making a profit or avoiding a loss. As a matter of public policy, information of this kind should generally be brought to the attention of the markets as soon as possible to allow all market participants access to it on an equal basis. This is achieved by imposing an obligation on the issuer of the securities to disclose the information. A provision of this kind can be found in Article 6 of the proposed Directive. This is the method by which information of this kind should reach the market. It is the approach which is also adopted by FESCO in its August 1, 2001 paper "Measures to promote Market Integrity".

By contrast, there is no issuer of a commodity such as oil or of foreign exchange or of other non-securities financial instruments. There is no one upon whom an obligation to disclose price sensitive information can be imposed. It is well recognised that, in these cases, the market is the medium by which differential levels of information are transformed into price signals. Applying insider dealing concepts to these markets would generally inhibit this price formation process without providing any appropriate means whereby information could reach the public domain. This is implicitly recognised in the FESCO paper referred to above, which envisages the disclosure obligations being applied to issuers of securities only.

It is sometimes suggested that it is necessary to extend insider dealing concepts beyond the securities markets in order to prohibit misuse of inside information relating, for

example, to official government statistics or central bank interest rate setting decisions. We do not believe that use of insider dealing laws generally applied to non-securities financial instruments is the appropriate method of dealing with this issue. Instead, we believe that, to the extent that there is specific information relating to particular instruments whose use should be controlled, limited targeted prohibitions should be introduced in appropriate laws or rules to the extent that they do not already exist. It is not appropriate in this area to be introducing further generalised exemptions to the important principle that persons should be entitled to trade freely on the basis of information they possess or are able to accumulate.

ISDA therefore strongly urges that the proposal be amended to disapply insider dealing concepts to non-securities instruments. This would require an amendment to the definition of "Inside Information" in Article 1(1). At the same time, Article 6 should be amended so that it applies only to issuers of securities. As it stands, Article 6 cannot sensibly be applied to non-securities instruments. As the authoritative voice on information relating to itself, an issuer can be obliged to disclose that information. It cannot be appropriate to oblige a person to disclose information relating either to third parties or to commodities or foreign exchange where that person is not the authoritative source of the information. As a matter of detail, it would also be unworkable in these circumstances to require a person dealing in non-securities instruments to maintain a list of the persons who might have access to this sort of information.

- (2) ***The legislation must provide a defence where the person did not know that the information was inside information.*** Article 2 of the existing Insider Dealing Directive of 1989 prohibits a primary insider from taking advantage of information "with full knowledge of the facts". Article 2 of the current proposal deletes these words on the grounds that "by nature these insiders may have access to inside information on a daily basis and are aware of the confidential information they receive." We strongly disagree that it is appropriate to delete the requirement that a primary insider has knowledge that the information is inside information. It cannot be assumed that, just because a person obtains information in a professional capacity, for example, that he knows that the information is non-public or price sensitive.

Example: a French broker tells a French fund manager that a bid has just been announced for a Greek company. The fund manager places an order for the company's securities. It transpires that the bid had not been announced (the broker's corporate finance colleagues had mistakenly released the information to him prematurely). The fund manager should have a defence to a charge of insider dealing as it was legitimate for him to rely on the broker in this respect.

ISDA strongly urges the reinstatement of the wording from the existing directive.

- (3) ***The Directive should explicitly recognise that information may not be accessible to individuals within a corporation by reason of the operation of Chinese Walls.*** It is common and recognised practice for financial institutions to operate Chinese Walls which prevent price sensitive information from flowing between different departments or individuals within the organisation. The most obvious example would be a Chinese Wall between the Corporate Finance department and the Equities Trading department. This would be created by ensuring physical separation between the two departments (often on different floors or in different buildings with security barriers to prevent access by unauthorised personnel) and a strict prohibition on exchange of information between them. The operation of the Wall would be monitored by the Compliance function and records would be maintained of any occasion when, with the permission of Compliance and/or appropriate senior management, a member of the Equities Trading department was brought across the Wall for some legitimate exceptional reason. That person would then be subject to a prohibition on further disclosure and restricted from taking advantage of the information.

The purpose of the Chinese Wall is to enable a firm to continue to deal for clients or for itself in financial instruments even where some other part of the firm has price sensitive information which would otherwise prevent the dealing. These arrangements are commonly recognised as effective by regulators. The current proposal does not recognise the use of Chinese Walls as a method of controlling the flow of information. Given that the Directive imposes insider dealing liability on corporations, the absence of a carve out for effective Chinese Walls means that, as it stands, the Directive would impose liability on the corporate even where the Chinese Wall had operated effectively.

ISDA therefore urges the inclusion of a specific exception to the insider dealing prohibition for corporations where the individual responsible for taking the dealing decision or advising or recommending others to deal is not himself in possession of the price sensitive information because of the operation of a Chinese Wall. This could be included in Article 8.

- (4) ***Information concerning trading intentions or positions should not be treated as inside information.*** A serious defect in the existing Insider Dealing Directive is the fact that it does not contain a sufficiently broad recognition that trading or market information is of a different character than insider information emanating from issuers. Information of this kind would include knowledge of a firm's own trading intentions or of the trading intentions of a third party or knowledge of the size of a firm's own existing positions or the positions of a third party. Misuse of this knowledge should be dealt with under Conduct of Business Rules relating, for example, to trading ahead of a customer's order ("front running") where the information is in relation to a customer's order. To bring such information within the ambit of insider dealing prohibitions would make much legitimate trading activity entirely impossible. ISDA therefore urges that the definition of inside information be explicitly amended to exclude information concerning trading intentions

or positions or other similar market information. Of course, any exception for market related information should not cover information concerning proposals to launch take-over bids.

- (5) ***The market manipulation prohibition must recognise that a core element of the offence is the person's knowledge or purpose.*** As it stands, the definition of "market manipulation" in Article 1(2) of the proposed Directive does not include as an element of the offence the need for the person in question to have the requisite illegitimate purpose (in the case of transactions) or knowledge that the information is inaccurate or misleading (in the case of dissemination of information). This appears to be intentional in view of the comment on the definition contained in the explanatory memorandum. On the other hand, the methods of market manipulation contained in the non-exhaustive list in Section B of the Annex all contain recognition of some illegitimate intention or purpose. Given the definition of market manipulation, however, and the comments in the explanatory memorandum, it is clearly intended that the offence can be committed where the effect is in fact manipulative even where this was not intended. The consequence is that activities with an entirely legitimate purpose may nevertheless fall within the prohibition.

Example: Repo transactions or asset swaps may, as a result of reporting requirements, give a false or misleading impression of the transfer of ownership of a security even though the economic risk of the security remains with the transferor. However, these may be perfectly legitimate transactions.

Example: A broker's research report, published to clients on its internet site, contains information about an issuer extracted from its published prospectus. The information is in fact inaccurate but the broker has no means of knowing this. It would be quite wrong to impose liability on the broker merely because its research report contained false or misleading information and had an adverse effect on the market.

While ISDA supports measures to ensure the integrity of the EU's financial markets, it strongly believes that an appropriate balance should be drawn between the need to ensure market integrity on the one hand and permitting transactions for legitimate purposes or dissemination of information believed to be accurate on the other. It is therefore critical that the Directive be amended so that the offence of market manipulation can only be established where it can be proven that the person in question had the requisite illegitimate purpose or the requisite knowledge that the information was in fact false or misleading (and that the information was disseminated with the purpose of misleading the market). This is all the more important in order to ensure that the Directive is drafted to be consistent in this area with the requirements of the European Convention on Human Rights, and in particular Article 7 which, in the light of relevant decisions made under it, requires that offences be clearly defined so that the person is able to know, at the time of the act, that the doing of the act will constitute an offence.

- (6) *The Directive should impose sensible limits on the extraterritorial application of a Member State's laws.* Article 10 of the proposed Directive requires every Member State to apply the Directive "at least to actions undertaken within its territory whenever the financial instruments concerned are admitted, or going to be admitted, to trading in a Member State". It does not prohibit Member States from applying a much wider jurisdictional test. Indeed, we understand that many Member States intend to apply their insider dealing rules to dealings in financial instruments taking place abroad solely because the instruments are traded on a regulated market in their state. This would mean, for example, that the UK could take steps to impose its interpretation of the Directive's requirements on a Portuguese individual or corporate trading in shares on a Portuguese listed company on the Lisbon Stock Exchange with a Portuguese counterparty, solely because a UK regulated market has chosen to admit those securities to trading. That admission to trading may even have been done without the initiative or agreement of the Portuguese company.

If a wide territorial scope of this kind were adopted, it would have the effect of subjecting a person to the insider dealing regime of a Member State which has only a very limited nexus with the transaction in question. Indeed, the nexus may be difficult for the person in question to discover. Is that person to have to investigate which markets in which Member States might have admitted a security for trading so as to be able to consider whether there are any implications for his transactions under the insider dealing laws of that Member State? The position would be even more difficult if the transaction in question were a derivative on an index or basket of stock where one of the stocks happens to have a secondary admission to trading in another Member State. The imposition of jurisdiction where the nexus is so remote would offend against generally accepted jurisdictional principles of international law.

The problem would, of course, in practice be considerably improved if the substantive insider dealing regimes and policies in each Member State were identical and identically operated. This would, however, still leave the risk of enforcement action being taken in an unlikely quarter. It is, however, unthinkable that this state of harmonisation will be achieved across the EU in the foreseeable future.

ISDA therefore urges an amendment to Article 10 to allow Member States to apply their insider dealing laws to conduct abroad only where that conduct has some more extensive and foreseeable nexus with the territory of the Member State concerned, for example because the trading takes place with a counterparty within its territory or using its markets, the inside information is disclosed to a person in its territory or the person encouraged is within its territory. Similarly market manipulation laws should only be applied to extraterritorial conduct where the conduct has a foreseeable material adverse effect on a domestic market which is a significant trading market for the financial instrument concerned.

However, in itself this limitation would not be enough to limit the problem of overlapping and conflicting rules.

- (7) ***Regulated financial services firms, at least, should only be subject to the regime of their country of origin.*** ISDA, along with many other industry participants, has consistently argued that financial services firms should not be subject to the costly burden of compliance with different sets of rules in each country into which they do business on a cross-border services basis. The most obvious examples are conduct of business and solicitation and marketing rules. To impose host state rules is to impose a costly burden which may, in the extreme, limit products and services provided within the EU or, at the very least, increase the cost of provision of those services, to the detriment of consumers and users of the markets generally. This argument has been accepted by the Commission which is proposing in its consultation document on updating the Investment Services Directive to move to a country of origin regime for conduct of business and marketing rules. That same document contains a proposed new Article 16 which appears to suggest that it may be intended that the country of initial authorisation (i.e. home country) should be the country whose market abuse rules shall apply. If that is the intention, ISDA would support this proposal, although the responsibility for the application and enforcement of rules in this area should perhaps be the responsibility of the state from which the firm conducts the relevant business (that is, its home country or, in the case of business done by a branch, the country of location of the branch). If not to be achieved by an amendment of the ISD, then it could equally be achieved by amending Article 10 to provide for the application of country of origin rules only. If left to the ISD, then it will be important that the two directives are implemented simultaneously.

A similar point arises in relation to the obligations in Article 6 on an issuer or producer of research. Issuers should only be required to comply with the rules of a country where they have initiated trading on a market in that country. Producers of research should only be obliged to comply with rules of the country in which the research is produced.

Further comments

- (1) **Powers conferred on the Securities Committee**

It has been suggested to ISDA that the powers conferred on the Securities Committee by the Directive would be sufficiently wide to allow it to create new exceptions, exemptions or safeharbours. An example suggested is that a safeharbour for information which is chinese walled could be created under Article 8(2). ISDA reads these powers as being limited to technical amplification of the existing provisions of the Directive and not as effectively allowing substantive changes. If this is correct, the amendments suggested by ISDA in this paper must be introduced in the Directive itself and not left to the Securities Committee.

- (2) **Article 2**

It is not entirely clear from the wording of paragraph 1 that this Article applies only to primary insiders. Language similar to the beginning of Article 2 of the existing Insider Dealing Directive should be used so that the second sub-paragraph of paragraph 1 should begin "The first sub-paragraph shall apply to any person who has obtained that information: "

(3) **Article 6**

Paragraph 4 of Article 6 should be deleted. This is a matter which should be dealt with by appropriate Conduct of Business Rules. Consequential amendments should be made to paragraph 6.

(4) **Article 14**

Article 14 requires Member States to introduce sanctions for market abuse, but harmonisation of sanctions is said to be outside the scope of the directive. ISDA would be very concerned if the lack of harmonisation resulted in significant differences between Member States in the use of criminal or administrative sanctions or in the level of penalty. We therefore urge the Commission and Member States to work together to ensure comparable treatment.

Conclusion

The Market Abuse Directive is an important part of the measures proposed by the Commission for the completion of the Financial Services Action Plan. Maintaining the integrity of the EU financial markets is clearly both a desirable and an essential objective if those markets are to function effectively as places for the raising of capital and the transfer of risk. It is vital that the public and users of the markets have confidence in them. On the other hand, it is also vital that measures taken to reinforce market integrity do not have the undesirable effect of creating uncertain obligations and liabilities on users of the markets or of inhibiting innovation and legitimate trading. ISDA believes that the balance is not appropriately drawn in the Commission's current proposal. Amendments to deal with the significant concerns raised in this paper are essential if the EU is to have a workable set of controls over market abuse.