

# ZENTRALER KREDITAUSSCHUSS

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN • BUNDESVERBAND DEUTSCHER BANKEN E. V. BERLIN • BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E. V. BERLIN • DEUTSCHER SPARKASSEN- UND GIROVERBANDE E. V. BERLIN-BONN • VERBAND DEUTSCHER HYPOTHEKENBANKEN E. V. BERLIN

**Comments of the  
Zentraler Kreditausschuss<sup>1</sup>  
on “Market Abuse Directive - Level 3 - preliminary CESR  
guidance and information on the common operation of the Directive”  
(Ref.: CESR/04-505)**

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The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR)*, for the cooperative banks, the *Bundesverband deutscher Banken (BdB)*, for the private commercial banks, the *Bundesverband Öffentlicher Banken Deutschlands (VÖB)*, for the public-sector banks, the *Deutscher Sparkassen- und Giroverband (DSGV)*, for the savings banks financial group, and the *Verband deutscher Hypothekenbanken (VdH)*, for the mortgage banks. Collectively, they represent almost 2,500 banks.

## A. General

The proposals put forward in CESR's paper are of key importance for the practical application of the provisions of the Market Abuse Directive and its implementing measures.

This is because, first, many aspects of the Level 1 and 2 rules on market manipulation and the requirement to report suspicious transactions remain very vague despite the high degree of detail in the rules in general. These therefore need to be spelt out more precisely if they are to be implemented in practice and the setting out of certain categories of behaviour constituting market abuse would certainly prove helpful in this regard. Second, there is a need to examine the compatibility of certain national market practices with European law on the basis of the criteria laid down at Levels 1 and 2 in order to achieve the directive's objective of upholding generally accepted market practices while ensuring that the development of innovative market practices is not hampered. Against this background, we warmly welcome the opportunity to comment.

Before going in more detail into some of the specific issues addressed by the paper, we would like to stress the following points:

The requirement introduced under Article 6(9) of the Market Abuse Directive to **report transactions suspected of constituting insider dealing or market manipulation** will be onerous for the banking industry to implement. This is especially problematic in light of the fact that compliance with the rules will take place not in the interests of preventing violations against the ban on insider dealing and market manipulation by the banks themselves, but so that violations by other market participants can be notified to the competent authorities in order to provide them with leads for investigation and prosecution. This shifts responsibility for a primary task of the supervisory authorities onto private service providers. It is therefore essential for CESR, when fleshing out this requirement, to keep strictly to the narrow framework established at Levels 1 and 2. We have serious reservations in this context about the following points, in particular:

- In paragraph 5.1 of the paper, CESR expresses the view that persons subject to the requirement to report suspicious transactions must have "the necessary systems and controls" to identify such transactions. We strongly reject this view. The Market Abuse Directive and Directive 2004/72/EC impose **no investigative duties on those required to report suspicious transactions** which would oblige them systematically to analyse the information available to them for suspicious elements. Nor are these persons required to adopt structural provisions to prevent or detect market manipulation.
- In paragraph 5.6, CESR infers from recital 9 of the Market Abuse Directive that transactions appearing innocuous at the time of their execution need to be reported if they become suspicious in the light of subsequent events or information. This conclusion is

unfounded, violates the framework established by the European legislators and should therefore be corrected. **Persons required to report suspicious transactions have no obligation to notify the authorities if the circumstances giving rise to the suspicion only become known after the event (i.e. after the transaction has been executed).**

## **B. Specific comments**

### **I. Comments on “II. Accepted Market Practices” and “III. Format of the table for assessing AMPs”**

#### **2.6**

In paragraph 2.6 CESR states quite rightly that the recognition of “accepted market practices” at Level 1 in no way constitutes classification as a safe harbour within the meaning of Articles 7 and 8 of the Market Abuse Directive. The market participant concerned must, in addition, have acted for legitimate purposes. Levels 1 and 2 refrain from defining what might constitute legitimate purposes, however. We believe it is correct for CESR therefore not to establish criteria at Level 3 which would unnecessarily restrict the scope of “accepted market practices”. In the interests of increasing legal certainty regarding the term “legitimate purposes”, however, CESR should clarify that the existence of such purposes may generally be assumed if the market participant applies a practice conforming with accepted practice on the market concerned unless he acts with intent to defraud or manipulate. Otherwise, market participants planning to carry out an accepted market practice would have to explain their purpose in doing so to the competent authority and have the legitimacy of this purpose confirmed in order to avoid regulatory or criminal sanctions at a later date.

#### **2.10 - 2.12**

We agree with CESR’s distinction between activities and practices. When dealing with the recognition of accepted market practices, however, the practice concerned should be described in broad, general terms which will ideally cover all its permissible permutations in order to keep the number of recognition procedures to a minimum and enable the conclusions to be used by as many market participants as possible.

## II. Comments on “V. Possible Signals of Suspected Insider Dealing or Market Manipulation Transactions”

### 5.1

The view expressed by CESR members that persons subject to the requirement to report suspicious transactions must have the “necessary systems and controls” to identify such transactions has no basis in the Market Abuse Directive or Directive 2004/72/EC. We strongly urge CESR to delete this statement. **No investigative duties for persons required to report suspicious transactions** may be inferred from the Level 1 and 2 provisions. These impose no obligation on such persons either to analyse systematically the information available to them for suspicious elements or to adopt specific structural provisions to prevent or detect market manipulation.

There is no evidence in the above mentioned directives to support CESR’s view. Article 6(9) of the Market Abuse Directive explicitly confines the requirement imposed on persons professionally arranging transactions in financial instruments to “[notifying] the competent authority without delay” if they have reasonable grounds for suspicion. A requirement to adopt structural provisions aimed at preventing or detecting market manipulation practices exists only for “market operators” under Article 6(6). In discussions with market participants, the European Commission repeatedly stressed that the notification requirement was intended to be confined to cases of possible insider dealing or market manipulation which – bearing in mind the speed and anonymity of trading and the number of transactions processed – could easily be recognised as such by the financial services provider involved. There was no intention to impose investigative duties on financial services providers or to oblige them to assume a “police-type” role. This is not least why the European Commission refrained from adopting in Directive 2004/72/EC those proposals put forward by CESR which went a step further and aimed at requiring investment firms and banks to analyse transactions in more detail. Furthermore, this was the only way of respecting the will of the European legislators with regard to the Market Abuse Directive. The European Parliament replaced the originally envisaged ban on executing suspicious transactions with the notification requirement expressly in order to take account of the fact that financial intermediaries do not have time to undertake a detailed analysis of each and every incoming order (cf. report by the Committee on Economic and Monetary Affairs of 27 February 2002, PE 307.438, page 21/37.).

### 5.6

In paragraph 5.6, CESR infers from recital 9 of the Market Abuse Directive that transactions appearing innocuous at the time of their execution need to be reported if they become suspicious in the light of subsequent events or information. This conclusion is unfounded and violates the framework established by the European legislators.

It is true that a person working for an investment firm or bank must report any transaction which may seem innocuous in itself if he is already aware of further transactions, certain behaviour or other information that, viewed together with the transaction being executed, give rise to an obvious suspicion of insider dealing or market manipulation. It is also true that it may be necessary to consider details of earlier transactions to substantiate a suspicion regarding a transaction being carried out.

It must be emphasised, however, that this applies only if the person arranging the transaction knows of these circumstances or details himself. We would strictly reject any requirement to take account of information on the other side of a Chinese wall.

There is, in contrast, **no obligation to report a transaction as suspicious if the circumstances giving rise to the suspicion become known to the person handling the transaction only after the event (i.e. after the transaction in question has been executed)**. The suspicion and thus knowledge of the circumstances giving rise to the suspicion must exist at the time of execution at the very latest. This may be concluded from the function of the notification requirement, which is to report to the competent authority circumstances which appear suspect in the course of concrete transactions being carried out and thus support the ongoing monitoring of trading by stock exchange regulators and supervisors so that they can avert immediately existing risks to the integrity of the capital market. Detecting and prosecuting previous occurrences which no longer have any influence on current market activities is not, on the other hand, the purpose of the notification requirement. The requirement is therefore not retroactive, i.e. banks, for example, are under no obligation to notify suspicions based on evidence which becomes apparent only after an initially innocuous looking transaction has been executed. Such a retroactive requirement would, moreover, be unworkable given the speed of securities dealing and normal working procedures. What is more, the routine reporting of transactions means that information on past trades is available to the competent authorities anyway.

#### **5.7 - 5.10**

Paragraphs 5.7 to 5.10 list examples of possible signals of violations against the ban on insider dealing and market abuse. These are intended to be neither conclusive nor exhaustive, but merely a starting point for consideration of whether a transaction might be suspicious.

We endorse the decision not to regard the examples in question as conclusive or exhaustive. The listed cases will often constitute behaviour which conforms to legitimate market practices, is economically justified and complies with the provisions of the Market Abuse Directive. We also welcome the fact that the possible signals of market manipulation (5.10), in particular, largely

focus on whether the transactions concerned give the impression that they are trying to influence the price of a financial instrument in the way described.

In contrast, we do not agree with the approach of regarding the examples as merely a “starting point for consideration” by the investment firm. This implies an obligation to analyse every transaction in depth for signs of possible market manipulation, which is expressly not intended by the Level 1 and 2 rules (cf. above comments on paragraph 5.1).

We consider most of the examples of possible **signals of insider dealing** in paragraph 5.9 to be highly problematic.

- Examples a), b) and c) describe entirely normal routine occurrences which, in the absence of additional, noteworthy circumstances (e.g. the client is an employee of the issuer of the securities to be acquired), lack any discernible connection to insider dealing. Yet such a connection is essential if the examples are to be regarded as effective signals. We would therefore advocate either deleting these examples or at least stating that there must, in addition, be some indication that the client is in possession of insider information.
- Although examples d) and e) can, in principle, be considered adequate evidence of possible insider dealing, they are unsuitable in their present form given the scope of the notification requirement. The service provider will become aware of the suspicious circumstances (announcement of important corporate events or other price-sensitive information) only after the transaction has been carried out. In this case, however, he is not required to notify the competent authority (cf. above comments on paragraph 5.6). The situation would be different if it were known that the company was planning to make an announcement likely to affect the price of its shares and the service provider was aware of this when the transaction was carried out. These examples can only be retained if they are amended to this effect.

### **III. Comments on Annexes 1(A) - 1(D)**

#### **1(B) – Bond valuation trades**

In our view, bond valuation trades are sensible and economically justifiable market practices which, by creating liquidity on the market concerned, ensure its smooth functioning and thus benefit all market participants. The Level 2 criteria for recognition as an accepted market practice are met. There is a need, at most, to examine whether the described practice is really intended to create an artificial or abnormal price and there may be some merit in considering whether it is really a market practice at all. In CESR’s own terminology, bond valuation trades are not, in fact, a market practice but an accepted market activity. Its purpose is merely to bring the exchange price

of a security for which the exchange market is largely illiquid into line with the price on the OTC market. In view of the fact that large volumes in the fixed income area are mainly traded over the counter, this activity is in the interests of investor protection since it enables private investors, who rely on placing their orders on a stock exchange, to see the actual price of a security instead of a price which might be several days old and possibly based on an interest rate which no longer applies. We therefore believe it would be preferable to classify bond valuation trades as an accepted market activity. If CESR is unable to accept this view, however, it is essential to at least recognise them as an accepted market practice as outlined in the paper. Further consideration needs to be given to whether complex bond structures really ought to be excluded from the AMP, however (page 26). There is a risk that with structured bonds and certificates, which are becoming increasingly widespread, at least on the German market, market making might be considered price manipulation. Yet retail investors are dependent on the bank ensuring that there is a secondary market for these bonds and certificates.

### **1(C) – The formation of the first exchange price**

We support recognition of the described market practice.