Opinion of the Economic and Social Committee on 'Insider dealing and market manipulation (market abuse)'

(2002/C 80/14)

On 2 July 2001 the Council decided to consult the Economic and Social Committee, under Article 262 of the Treaty establishing the European Community, on the above-mentioned proposal.

The Section for Economic and Monetary Union and Economic and Social Cohesion, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 5 December 2001. The rapporteur was Mr Levitt.

At its 387th plenary session (meeting of 17 January 2002), the Economic and Social Committee adopted the following opinion by 51 votes to two with six abstentions.

1. Introduction

1.1. The European Commission has published a proposal for a Directive on Insider Dealing and Market Manipulation (Market Abuse) intended to increase standards for market integrity in the securities field throughout the EU based on the principles of transparency and equal treatment of market participants. It will require closer co-operation and a greater degree of exchange of information between national competent authorities than exists at present. The proposal is intended to reduce potential inconsistencies, confusion and loopholes by establishing a basic framework for the allocation of responsibilities, enforcement and co-operation within the EU. The initiative is an important element of the Financial Services Action Plan and the drive to create an integrated financial services market by 2003. The Commission stresses that it is one of the first two proposals for Directives under the new "Lamfalussy" format distinguishing framework principles from implementing technical details, an approach which was endorsed at the March 2001 Stockholm European Council.

1.2. The Commission says there are two main categories of Market Abuse: insider dealing and market manipulation. The existing Insider Dealing Directive (89/592/EEC) was adopted over a decade ago since when financial markets have developed and it is necessary to update the provisions in the current Directive. The proposal covers both insider dealing and market manipulation to ensure that the same framework will be applied for both categories of market abuse and it is intended to be administratively simpler and reduce the number of different rules and standards across the EU.

1.3. In order for the market abuse regime to remain relevant in future in rapidly changing financial markets the proposal provides for a general definition of what constitutes market abuse which is intended to be flexible enough to ensure that new abusive practices which might emerge are adequately covered while it is sufficiently clear to provide adequate guidance for behaviour to market participants. Scope is related to all financial instruments admitted to trading on at least one regulated market in the EU including primary markets. It applies to all transactions concerning those instruments whether undertaken in regulated markets or elsewhere to avoid abusive practices in unregulated markets, Alternative Trading Systems or elsewhere. However, the Directive recognises that in certain circumstances and for perfectly legitimate reasons exemptions (safe harbours) will be needed where certain prohibitions need not apply.

1.4. The proposal stresses that integrated financial markets in the EU require convergence, rather than divergence, in the methods of implementation and enforcement by Member States whereas at present different sets of responsibilities and powers of national authorities hinder the establishment of a fully integrated market and add to market confusion. Therefore, the proposal envisages that each Member State should designate a single administrative regulatory and supervisory authority with a common minimum set of responsibilities to tackle insider trading and market manipulation. Moreover, given the increasing number of cross-border activities, the legislation needs to ensure that regulatory and supervisory authorities work effectively together and can rely upon assistance and relevant information from each other in good time.

1.5. The Commission stresses that it is unacceptable in an integrated financial market for wrongful conduct to incur a heavy penalty in one country, a light one in another and no penalty at all in a third. But the Commission acknowledges that there is no Treaty basis for harmonising sanctions

although it is both desirable and consistent with Community Law for the proposal to set a general obligation for Member States to impose and determine the administrative and criminal sanctions to be imposed.

1.6. The Commission proposal stresses that at present the existing EU legal framework to protect market integrity is incomplete because there are no common provisions against market manipulation and there is a great variety of rules dealing with market abuse among the Member States. These differences lead to competitive distortions in markets and leave investment firms and other economic actors often uncertain about concepts, definitions and enforcement in each European market. Market abuse can increase the cost of capital for companies, harm the integrity of financial markets and public confidence, and dissuade new investors. The result could be to weaken the EU's economic growth.

1.7. The Proposal follows the recommendation of the Lamfalussy Committee of Wise Men, as endorsed by the Stockholm March European Council, in distinguishing between framework principles incorporated in the Directive while 'non essential' technical implementing measures will be adopted under the comitology procedures. In this instance, the adaptation and clarification of the definitions and exemptions needed to ensure uniform application and compatibility with technical developments in financial markets will be subject to comitology.

1.8. The explanatory memorandum to the Proposal says, 'In view of the urgency of action in the area of market abuse, and in view of the extensive consultations on the issue already carried out with Member State governments, regulators and supervisors, financial industry (...) and other interested parties, the Commission has decided to come forward with a Proposal now rather than to delay it through recourse to a more formal consultative process. In line with the Report of the Wise Men, the Commission will engage in consultations (...) when it prepares the implementing measures in accordance with the relevant provisions of the proposed Directive'.

2. **Main features of the Proposal**

2.1. Insider information is defined as follows:

2.1.1. Article 1(1) defines insider information as 'information which has not been made public of a precise nature relating to one or more issuers of financial instruments or to one or more financial instruments, which, if it were made public, would be likely to have a significant effect on the price of those financial instruments or on the price of related derivative financial instruments'.

2.2. Market manipulation is defined in two ways:

2.2.1. Article 1(2)(a): 'Transactions or orders to trade, which give, or are likely to give, false or misleading signals as to the supply, demand or price of financial instruments, or which secure, by one or more persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level, or which employ fictitious devices or any other form of deception or contrivance.'

2.2.2. Article 1(2)(b): 'Dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to the supply, demand or price of financial instruments, including the dissemination of rumours and false or misleading news.'

2.2.3. Article 1(5) says that clarification of these definitions will be handled by a comitology process described in article 17 (2).

2.3. Articles 2, 3 and 4 are those which specify the prohibition of the misuse of inside information and it should be noted that Article 2.1 specifies that these prohibitions shall apply to 'any natural or legal person who possesses inside information from taking advantage of that information'.

2.4. Article 5 stipulates that:

> 'Member States shall prohibit any natural or legal person from engaging in market manipulation. A non-exhaustive list of typical methods used for market manipulation is laid down in Section B of the Annex. (...) Member States may decide to introduce specific provisions to cover persons acting for journalistic purposes in the normal course of the exercise of their profession.'

2.5. Article 6 sets out the requirements for the disclosure of information, for example Article 6.1 states 'Member States shall ensure that issuers of financial instruments inform the public as soon as possible of inside information'. However Article 6.3 says, 'An issuer may at its own risk delay the public disclosure of particular information such as not to prejudice his legitimate interest provided that such omission would not be likely to mislead the public (...)'.

2.6. Articles 7 and 8 specifies certain exemptions from the general rules otherwise set out in the Directive; for example they do not apply to certain operations by Member States, central banks or share 'buy backs'.

2.7. Article 9 says the provisions of the Directive '(...) shall apply to any financial instrument (...) trading on a regulated market and at least one Member State, irrespective of whether the transaction itself actually takes place on that market or not.' Article 10 says, 'Every Member State shall apply the prohibitions and requirements provided for in this Directive at least to actions undertaken within its territory whenever the financial instruments concerned are admitted, or are going to be admitted to trading in a Member State.'

2.8. Article 11 specifies that 'Every Member State shall designate a single administrative authority competent to ensure that the provisions of this Directive are applied.'

2.9. Article 12 says, 'The competent authority shall be given all supervisory and investigatory powers that are necessary for the exercise of its functions.'

2.10. Article 14 specifies that Member States are required to impose, '(...) administrative and criminal sanctions in conformity with their national law' where the provisions of the Directive have not been complied with, and Member States competent authorities are required to cooperate with one another under Article 16.

3. **General comments**

3.1. The intentions of the Directive — furtherance of the objective of securing an integrated financial market through reducing the myriad of national approaches to market manipulation — is in itself entirely admirable. However, the approach taken in the instance of this particular proposed Directive is subject to a number of concerns.

3.2. Although the Press Release, the Explanatory Memorandum and the Directive itself make frequent reference to the recommendations of the Lamfalussy Committee of Wise Men and the endorsement of that Report by the Stockholm European Council, the Directive itself fails to meet one of the most important elements of the Lamfalussy Recommendations. This is that consultation with market practitioners and other interested parties should be open and continuous throughout the legislative process. This was not done in the case of this Directive, one of the first two to be issued ostensibly according to Lamfalussy Recommendations, on the grounds of the need to make rapid progress. However, it might be the case that had consultation with market practitioners been properly conducted prior to the Commission adoption of the Directive the whole process might have been faster than that which could ensue now. While it is true that market practitioners provided comments and expressed concerns — including questions about the precise meaning and interpretation of certain provisions which were contained in the proposals of the Federation of European Securities Commissioners (FESCO) — those comments did not receive any reasoned response. So the Proposal does not in fact conform to the Lamfalussy Recommendations. It is essential that the Lamfalussy principles are adhered to henceforth.

3.3. A principal objective of the Proposal is to reduce the complexity and variety of different national approaches to market manipulation but in a number of respects the text needs to be clarified with regard to:

— the precise definition of insider dealing;

— the application of the proposed regime to market manipulation;

— the precise requirements concerning disclosure;

— the potential for confusion as to which national authority has responsibility;

— how common standards crucial to the aims of the Directive will be achieved, this should be a major task for the article 17 (2) regulatory process.

These remarks are explained in more detail in the following section.

4. **Specific comments**

4.1. Articles 1(1), 2, and 4 aim to define the offence of misuse of inside information (see paragraphs 2.1, 2.2 and 2.3 above) but it is not absolutely clear from the text as drafted (in particular Article 2) whether a person can be accused of inside information if they are not in full possession of all the relevant facts, i.e. do they know it is inside information? Do they know it is market sensitive? And did they intend to take advantage of inside information? The relationship between Articles 2 and 4 on the issue of the test of 'full knowledge of the facts' needs to be clarified. Article 2 fails to refer to the test of 'full knowledge of the facts'. It is surprising that there is no test of culpability on the basis of intent — nor, therefore, no possibility of defence by anyone accused of inside information on the grounds that they had no intention to abuse that information. As drafted, it leaves any employee of any firm liable to accusation, although that is not the intention of the Directive.

4.1.1. Proposed amendment: Article 1 (2)(a)

4.1.1.1. 'Market manipulation' shall mean: 'Knowingly carrying out transactions which give, or are likely to give, ...'.

4.1.1.2. Reasons:

1) It is important to specify that the manipulation operations in question have to be carried out with a full knowledge of the facts, i.e. knowingly. This condition is generally admitted in criminal law and forms part of the safeguards to protect people.

2) The words 'or orders to trade' should be deleted because the act of placing an order is simply the implementation of the wishes of a third party. The person who actually places an order does not know what the intentions of the customer are, or what the effects of the transaction will be.

4.1.1.3. For similar reasons, articles 2 and 3 should be amended in a comparable manner:

— Article 2: Member States shall prohibit any natural or legal person who possesses and knows he/she possesses inside information from taking advantage of that information with full knowledge of the facts ...;

— Article 3: Member States shall prohibit any person subject to the prohibition laid down in Article 2 who knowingly possesses inside information ...

4.1.2. Proposed amendment: Article 4

4.1.2.1. '... any person other than those persons referred to in those Articles who knowingly uses or causes use to be made of inside information.'

4.1.2.2. Reasons: This article is of special importance because it is particularly aimed at company employees. The expression 'with full knowledge of the facts' is less clear than 'knowingly', which implies an intention to act. Replacing 'possesses' by 'uses or causes use to be made of' is also clearer.

4.2. Because Article 2 refers to both legal and natural persons, the affect could mean that European investment banks one department of which provides corporate finance advice (e.g. on new issues, mergers and acquisitions) and a separate department of which takes market positions or provides advice to investors on the very companies about which their colleagues in the former department is advising, could stand accused of insider dealing. Again, this is not the intention of the Directive but the draft as it stands does not make this crystal clear. In particular, it could mean that the traders taking market positions or senior management of the bank which is aware of the activities of both departments but does not prohibit their trading arm from taking market positions could stand accused of insider dealing although 'Chinese walls' within the institution prevent inside information possessed by the corporate finance department being used by the traders.

4.2.1. Proposed amendments: Article 6(4) and (6)

4.2.1.1. Delete the following text:

— in §4 'and disclose their interests or indicate conflicts of interest in the financial instruments to which that information relates.'

— in §6, last indent — 'and the disclosure of particular interests or conflicts of interest as referred to in paragraph 4.'

4.2.1.2. Reasons: These provisions are against the practice and the internal ethics of service providers. The rule that is rigorously applied is to establish a 'Chinese wall' between the persons responsible for managing orders and those responsible for managing customers' accounts. Any breach of this confidentiality rule would be prejudicial to the very foundations of the directive.

4.3. The provisions concerning insider dealing (Articles 2 and 6) have a clear rationale when applied to securities, where inside information about the issuing company is material to the question of market manipulation. But the proposed regime extends to such things as interest rate, exchange rate and commodity derivatives where no issuer is involved, e.g. an oil company may be concerned about production prospects over the coming year and seeks to hedge its position against the risk of an adverse price movement by the use of an appropriate derivative instrument. Under the proposed regime as drafted, it could be required to disclose all its information to counterparties and competitors and this cannot be right. Clarification is needed. Although Article 9 seems to exclude over-the-counter derivatives traded by restricting the application of the Directive to regulated markets, the definition of 'regulated market' is currently under discussion in the review of the Investment Services Directive and the matter remains of concern to market operators.

4.4. Article 1(2)(b) defines the dissemination of rumours as market manipulation without any test as to whether or not the principal objective or a significant objective of spreading the rumours is to manipulate the market nor is there any test of whether or not the rumour is correct. Again, some clarification of the intention of the Directive is required.

4.5. The disclosure requirements in Article 6 are ambiguous. Whereas 6.1 requires disclosure as soon as possible, Article 6.3 permits delay by an issuer 'at its own risk'. This could give rise to differences in interpretation among the competent authorities of the different Member States. Also, Article 6.4 requires those responsible for the production/dissemination of information to the public to take 'reasonable care' but the standard as to what represents reasonable care is not stated; likewise Article 6.5 prohibits anyone from entering into a transaction if it 'reasonably suspects' that the transaction would be based on inside information, without defining what 'reasonably suspects' means. In both cases the standard of reasonableness needs to be specified (e.g. reasonableness as understood in criminal courts? Civil courts?)

4.5.1. Proposed amendments: Article 6(5)

4.5.1.1. Replace 'if it reasonably suspects' by 'if it has in its possession objective elements allowing it to suspect'.

4.5.1.2. Reasons: The expression 'reasonably suspects' is far too vague. It is not clear how an intermediary could refuse orders simply on the basis of an impression. It imposes on service providers (agents instructed by customers), a responsibility which exceeds what may reasonably be expected from them. In addition, the text is not clear about where the burden of proof lies. It would be very difficult to prove that the service provider could 'reasonably suspect' that an offence was being committed.

4.6. The principle of the Directive is to promote a simpler and more coherent regime but differences in interpretation of the precise wording of the Proposal by the competent authority in each of the 15 EU Member States will not secure this desirable objective. As a general principle, the broader the range of interpretations of any of the Articles of the Directive, the greater that risk whereas the narrower the specification of what is required in the Directive then the lower is that risk. Consequently it is important that the draft should be tightened up and more narrowly focused in several places, as outlined above.

4.7. An important aspect of market integration is that market participants should know what regime they face, with which rules they must comply and which competent authority has responsibility for enforcing the rules and any possible sanctions. However, Articles 10-15 appear to enable the authority of any Member State where a given security or financial instrument is traded to impose its own rules on the market participant wherever that participant may be based. An alternative would be to specify that the principal competent authority should be that where the market participant is based (country of origin basis) and that authority could be required/empowered to require that all market participants abide by its rules. It might be, however, that the intention is to protect the integrity of markets where securities are first issued to prevent market manipulation by traders based in another Member State — but that is far from clear from the text of Article 10 (see paragraph 2.7 above) which appears to enable the authority of any Member State to take action against any market participant trading in any financial instruments admitted in any Member States.

4.8. Article 12, supplemented by Article 14, set the framework for effective enforcement by the Member States and the requirement that a single competent authority should be established in each Member State is desirable. Article 12, last paragraph should be deleted, since it will entail an unequal treatment of the companies and natural persons in the Member States depending on whether or not there are any national legal provisions on professional secrecy. Indeed, chances are that in those countries where there are no exceptions to the rule of professional secrecy, it will be far more difficult to investigate cases of market abuse and hence the enforcement of the regulations will be far more restricted. However, it is also likely to be the case that the relative dearth of successful prosecutions of insider dealing/market manipulation in the EU reveals deficiencies in the resources devoted to enforcement — in terms of both the quantity of such resources and quality (e.g. in terms of skills and supporting information/intelligence gathering/monitoring systems). More proactive enforcement without enhancement of skills and systems could damage the operation of legitimate market participants while doing nothing to impede the activities of the truly guilty. In any event, all Member States should ensure that have and enforce effective proportionate administrative sanctions.

4.8.1. The Committee proposes that the following sentence be added to Article 14(1):

4.8.1.1. 'Criminal sanctions should only be invoked on the basis of solid evidence of market manipulation'.

4.8.1.2. Reasons: The proposed accumulation of administrative and criminal sanctions is an extremely serious matter. Concerns which the Committee expresses in paragraphs 4.1, 4.2, 4.3, 4.5 and 4.9 above need to be taken into account.

4.8.2. Article 16(2), 3rd sub-paragraph

4.8.2.1. Delete the last sentence of this sub-paragraph 'However, where the competent authority communicating information consents thereto, the authority receiving the information may use it for other purposes or forward it to other States' competent authorities.'

4.8.2.2. Reasons: Since the aim of the directive is to stamp out market abuse, it is inappropriate to provide for the possibility of such information being used for other purposes. EU competition law lays down the principle that communicated information should only be used for the purposes of applying competition law.

4.9. Article 5 says that Member States may 'introduce specific provisions to cover persons acting for journalistic purposes in the normal course of their profession' It is unclear, however, whether a journalist in Country A, where the State introduces provisions to protect journalists, may be at risk from the authorities in Country B where such protection is not available, if he/she comments on a company based in Country B.

5. **Conclusion**

5.1. The objectives of the Directive in terms of furthering the integration of European financial markets and reducing the complexity and confusion surrounding the rules concerning market manipulation are entirely worthwhile. But in a number of respects it would be helpful for the draft to be refined so as to reduce ambiguity about interpretation and the consequent risk of differences in implementation and enforcement across the EU. Moreover, more serious consideration needs to be given to the question of how a test of 'intent' — and a defence of lack of intent to manipulate the market — can be introduced into the Directive.

Brussels, 17 January 2002.

The President

of the Economic and Social Committee

Göke FRERICHS