THE COMMITTEE OF EUROPEAN SECURITIES REGULATORS

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Market Abuse Directive

Level 3 – preliminary CESR guidance and information on the common operation of the Directive

Paper issued for comment

Comment period closes 31 January 2005

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Annexes

I. Preliminary remarks by Kurt Pribil, Chairman of CESR-Pol

1.1 On 12 October, the Market Abuse Directive is due to be implemented in all the member states of the European Union, with October 23rd being the date in the European Free Trade Area (EFTA). This date marks the coming into force of the framework directive [1] (the level 1 measure in Lamfalussy terms) and its accompanying implementing measures (the level 2 directives[2] and regulation[3]). Over the last five years, CESR has participated actively in advising the Commission on this new legal framework[4].

1.2 Despite the heavy level 1 and 2 workload, CESR has been devoting time to level 3 work through CESR-Pol, the group of senior officials responsible for the surveillance of securities activities, exchange of information and enforcement that I chair. Over the years, this work has involved improving the flow of information between national regulators by putting into practice the agreements set out in CESR's Multilateral Memorandum of Understanding on the Exchange of Information and Surveillance of Securities Activities, setting out the procedures for joint investigations and work on identifying enforcement priorities.

1.3 CESR's work at level 3 is focussed on delivering consistent day-to-day regulation across the EU. Level 3 involves implementation work, enhanced co-operation and identifying emerging regulatory concerns and tackling these in a timely fashion. As regards Market Abuse, CESR-Pol has been tasked with overseeing all level 3 work for CESR. Given this responsibility, I issue an open invitation to all market participants to contact me as and when they become aware of issues in the way that the Market Abuse regime is operating in the EU that causes significant obstacles to the achievement of the single market in financial services.

1.4 In the meantime, the members of CESR-Pol have identified a number of priority areas for level 3 work. This involves two workstreams. The first, relates to this paper which provides preliminary guidance and is open for a comment period until 31 January 2005. It covers three market facing issues that CESR members consider to be priorities. The priority areas cover accepted market practices in relation to market manipulation, guidance on what CESR members consider to constitute market manipulation and guidance and a common reporting format for reporting suspicious transactions.

1.5 The second workstream relates more to the way that CESR members will ensure the co-operation obligations, placed on them by article 16 of the directive, are acted upon. This includes the establishment of a mediation mechanism in the event of a failure to co-operate, and the finalisation of CESR's work on joint investigations. I will have more to say on this stream of work in CESR's annual and half yearly reports to the European institutions in 2005.

1.6 I look forward to receiving your comments on the preliminary guidance set out below. I would urge you, when commenting, to ensure that your comments are made in a manner which is consistent with the objectives of the Financial Services Action Plan adopted in 1999 by the ECOFIN to achieve a single capital market. You should be in no doubt that under the Lamfalussy level 3, CESR is determined to achieve the common day-to-day operation of this new legal framework. It cannot do this on its own. Above all it needs the help of market participants. Furthermore, it also requires close working with the EU institutions particularly at levels 2 and 4. At level 4, the Commission is entrusted by the treaty to act against Member States that fail to implement EU law nationally. And no doubt CESR will be

[1] Directive 2003/6/EC
[2] Directives: 2003/124/EC; 2003/125/EC; 2004/72/EC
[3] Regulation (EC) No 2273/2003
[4] CESR Level 2 advice CESR 03-212d; 02-089d and CESR's paper on "A European Regime against Market Abuse" (ref: 00-096l)

one of the parties the Commission might look towards to provide information when considering level 4 actions.

Executive summary

1.7 Chapter two sets out the key issues facing CESR members when operating the Accepted Market Practices (AMPs) regime established in the directive. Preliminary indications suggest that there will only be a few AMPs in the EU. The ones that are currently under consideration are set out in annex one. In chapter three, CESR has established a common format for the analysis of AMPs which will facilitate the consultation obligations placed upon CESR members.

1.8 Chapter four provides guidance to the market on types of practices that CESR members would consider to constitute Market Manipulation. They are described in non-legal terms and they are not intended to affect the scope of interpretation of the relevant directives and regulation.

1.9 Chapter five concludes the paper with guidance and a common format for reporting suspicious transactions. CESR's aim is to ensure that the directive obligation on reporting such transactions operates in a proportionate and effective manner.

II. Accepted Market Practices

2.1 In undertaking its level 3 work, CESR has been particularly mindful of the need to focus its energy on ensuring the proper operation of the regime for accepted market practices (AMPs) in relation to market manipulation. This is dealt with in this section of the paper.

2.2 It should be noted that the AMP regime also applies to inside information on commodity derivative markets. This aspect of the Directive is not dealt with in this paper. CESR is mindful of the need to ensure the smooth operation of AMPs in this field in due course.

Guidance Provided by the Directive and Level 2 Advice

2.3 Preamble 20 of the Directive 2003/6/EC states that "a person who enters into transactions or issues orders to trade, which are constitutive of market manipulation may be able to establish that the reasons for entering into such transaction or issuing orders to trade were legitimate and that the transactions and orders to trade were in conformity with accepted practice on the regulated market concerned."

2.4 Article 1(5) of the Directive 2003/6/EC defines Accepted Market Practices as practices "that are reasonably expected in one or more financial markets and are accepted by the competent authority in accordance with guidelines adopted by the Commission……"

2.5 These guidelines have now been set out in level 2 implementing measures in Directive 2004/72/EC. In article 2 of that Directive, competent authorities need to assess a particular market practice before accepting it against a non-exhaustive list of factors. Article 3 then sets out the process that the competent authority must follow which includes consultation and disclosure of the decisions.

2.6 It should be emphasised that accepted market practices in no way constitute safe harbours similar to those provided by Articles 7 and 8 of the Directive (which deal with share buy-backs and stabilisation). The intention of the accepted market practice concept is to avoid the penalising of behaviours which would constitute market manipulation under the effect based definition of market manipulation in Article 1(2)(a) of Directive 2003/6/EC, as under certain conditions such behaviours might be justified. However, to benefit from the defence provided, in addition to the transaction/order to trade conforming with an accepted market practice, the person who entered into the transaction or issued the order to trade must establish that their reasons for so doing are legitimate. In the absence of a legitimate purpose the accepted market practice defence would not be available.

Operational issues raised by the legal framework

2.7 The legal framework applicable to accepted market practices raises a number of operational issues that need to be dealt with by CESR and its members.

Consultation and disclosure

2.8 AMP's are the responsibility of individual CESR members. However, each member has a duty to consult, both nationally and with other competent authorities, and to disclose any market practices that they have accepted. There is also an obligation on CESR to publish the AMPs on its website.

2.9 In order to facilitate the implementation of the Directive, CESR members have, during the course of working on this paper, exchanged views on AMPs and, in the annex to this paper, agreed to publish in preliminary form, their initial assessment of AMPs that might ultimately be accepted in one or more jurisdictions. It should be noted however that the full consultation with other parties has not yet taken place.

Market practices versus activities

2.10 CESR has consistently made a distinction between practices and activities carried out in financial markets. The implementing measures at level 2 were based on advice CESR submitted to the Commission in August 2003 (CESR/03-212c). In paragraph 5 of that advice CESR stated that 'Activities' "would cover different types of operations or strategies that may be undertaken such as arbitrage, hedging and short selling. On the other hand, market 'practices' would cover the way these activities are handled and executed in the market."

2.11 In the view of CESR members, 'activities' are considered to be too broad to qualify for the status of accepted market practices. An 'activity' such as short selling or hedging could be undertaken in many different ways. If the activity is carried out in a way which does not constitute market manipulation, then the question of giving it accepted market practice status does not arise. On the other hand, if the 'activity' is carried out in a way which would constitute market manipulation, it is unlikely that a competent authority would be prepared to accept it as an accepted market practice. Hence to give an activity a blanket accepted market practice status would neither be meaningful nor desirable.

2.12 CESR members also considered the issues of whether certain more specific practices, such as crossing/pre-arranged trades should be given accepted market practice status, subject to the condition that these practices should be undertaken according to the rules of the relevant regulated market applicable to their conduct. However, CESR members came to the conclusion that, in most of the cases considered, conduct of the practice in conformity with the rules of the relevant regulated market would be sufficient in itself to promote market integrity and therefore the question of giving the practice accepted market practice status would not arise.

Common format for assessing AMPs

2.13 CESR members have devised a common format for assessing AMPs. This is set out in accordance with the Directive 2004/72/EC and is designed to facilitate the consultation and disclosure processes. The form is set out below.

Disclaimer
The AMPs published in the annex should not be regarded as definitive unless otherwise stated. However, they are being published now to give market participants a clear indication of the approach CESR members intend to follow for accepting market practices and the type of AMPs that are likely to exist.

Table of indicative AMPs (see annex 1 for details)

Country	Indicative AMP
Austria	Bond valuation trades
Germany	Bond valuation trades
Germany	Formation of first exchange price
UK	Market aberrations on the London Metal Exchange –

III. Format of the table for assessing AMP's

Description of the National AMP:

Rationale for why the practice would constitute manipulation

[refer to article 1(2) (a) of Directive 2003/6/EC]

List of Factors

Commission Directive 2004/72/EC Article 2

Non-exhaustive list of factors to be taken into account by Competent Authorities when assessing particular practices whether they occur on a regulated market or an OTC market:

- The level of transparency of the relevant market practice to the whole market(art 2(1) (a))

Transparency of market practices by market participants is crucial for considering whether a particular market practice can be accepted by competent authorities. The less transparent a practice is, the more likely it is not to be accepted. However, practices on non regulated markets might for structural reasons be less transparent than similar practices on regulated markets. Such practices should not be in themselves considered as unacceptable by competent authorities. (preamble 2)

Conclusion regulator:
[fill in the rationale for this factor]

- the need to safeguard the operation of market forces and the proper interplay of the forces of supply and demand; (art 2(1) (b))

Market practices inhibiting the interaction of supply and demand by limiting the opportunities for other market participants to respond to transactions can create higher risks for market integrity and are, therefore, less likely to be accepted by competent authorities. (preamble 1)

Conclusion regulator:
[fill in the rationale for this factor]

- the degree to which the relevant market practice has an impact on market liquidity and efficiency. (art 2(1) (c))

  Market practices which enhance liquidity and efficiency are more likely to be accepted than those reducing them. (Preamble 1)

Conclusion regulator: [fill in the rationale for this factor]

- the degree to which the relevant practice takes into account the trading mechanism of the relevant market and enables market participants to react properly and in a timely manner to the new market situation created by that practice(art 2(1) (d)).

Conclusion regulator: [fill in the rationale for this factor]

- the risk inherent in the relevant practice for the integrity of, directly or indirectly, related markets, whether regulated or not, in the relevant financial instrument within the whole Community. (art 2(1) (e))

  Particular market practices in a given market should not put at risk market integrity of other, directly or indirectly, related markets throughout the Community, whether those markets be regulated or not. Therefore, the higher the risk for market integrity on such a related market within the Community, the less those practices are likely to be accepted by competent authorities. (Preamble 3)

Conclusion regulator: [fill in the rationale for this factor]

- the outcome of any investigation of the relevant market practice by any competent authority or other authority mentioned in Article 12(1) of Directive 2003/6/EC, in particular whether the relevant market practice breached rules or regulations designed to prevent market abuse, or codes of conduct, be it on the market in question or on directly or indirectly related markets within the Community; (art 2(1) (f))

Conclusion regulator:

[fill in the rationale for this factor]

- the structural characteristics of the relevant market including whether it is regulated or not, the types of financial instrument traded and the type of market participants, including the extent of retail investors participation in the relevant market; (art 2(1) (g))

Conclusion regulator:

[fill in the rationale for this factor]

Overriding Principles

Overriding principles to be observed by Competent Authorities to ensure that accepted market practices do not undermine market integrity, while fostering innovation and the continued dynamic development of financial markets:

- new or emerging accepted market practices should not be assumed to be unacceptable by the Competent Authority simply because they have not been previously accepted by it;
- Practising fairness and efficiency by market participants is required in order not to create prejudice to normal market activity and market integrity.
- Competent Authorities should analyse the impact of the relevant market practice against the main market parameters such as weighted average price of a single session, daily closing price, specific market conditions, before carrying out the relevant market practice.

Conditional elements

In this final section, you should comment on any conditions relating to legitimate reasons and proper execution.

IV. Market Manipulation:

Types of practice that CESR members would consider to constitute Market Manipulation

Introduction

4.1 The work in this area is aimed at providing the competent authorities and market participants with examples of types of market manipulation which have occurred in recent years and which, in the view of CESR members, would breach the prohibitions on market manipulation contained in the Market Abuse Directive. The guidance and accompanying examples are intended to help the development of a common understanding of what constitutes market manipulation.

4.2 The guidance and examples could also facilitate the identification of relevant variables (diagnostic flags or signals of market manipulation) that could be monitored by competent authorities and by market participants within the limits of their sphere of activity in order to detect or avoid engaging in market manipulation. The examples may also be useful in helping the relevant market practitioners to meet the requirement to notify suspicious transactions to competent authorities.

4.3 Market manipulation can often be avoided by implementing adequate market microstructure measures by explicit rules that forbid specific behaviours or by preventative measures set up by market participants. Therefore some unacceptable conduct set out in the following guidance and examples may not actually be feasible in all market environments across Europe and therefore should not necessarily be read as universally applicable.

Disclaimer

4.4 The examples of types of practice set out in this paper are deliberately described in non-legal technical terms and it is emphasised that the descriptions are not intended to affect the scope of interpretation of market abuse directives and regulations.

Directive Definition of Market Manipulation

4.5 The Market Abuse Directive defines market manipulation as meaning:-

a. Transactions or orders to trade:-

- which give, or are likely to give, false and misleading signals as to the supply of, demand for or price of financial instruments [for ease of reference this might be termed "false or misleading transactions"]; or

- which secure by a person or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level ["price positioning"]

unless the transaction/order to trade had a legitimate reason and conforms to accepted market practices on the regulated market concerned.

b. Transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance ["fictitious devices"].

c. Dissemination of information through the media… which gives or is likely to give false and misleading signals as to financial instruments … where the person who made the dissemination knew, or ought to have known, that the information was false or misleading… ["false or misleading information"]

4.6 It is noted that the acceptable market practice defence can only be available in respect of the first two categories ("false and misleading transactions" and "price positioning"). No such defence is available in respect of the other categories

4.7 The Directive itself gives three particular instances of market manipulation:-

i. Conduct by a person, or persons acting in collaboration, to secure a dominant position over the supply of or demand for a financial instrument which has the effect of fixing, directly or indirectly, purchase or sale process or creating other unfair trading conditions;

ii. The buying or selling of financial instruments at the close of the market with the effect of misleading investors acting on the basis of closing prices;

iii. Taking advantage of occasional or regular access to the traditional or electronic media by voicing an opinion about a financial instrument (or indirectly about its issue) while having previously taken positions on that financial instrument and profiting subsequently from the impact of the opinions voiced on the price of that instrument, without having simultaneously disclosed that conflict of interest to the public in a proper and effective way.

Possible Signals of Market Manipulation

4.8 Article 4 of implementing Directive 2003/124/EC sets out the following non-exhaustive signals of false or misleading transactions or price positioning transactions.

a. The extent to which orders to trade given or transactions undertaken represent a significant proportion of the daily volume or transactions in the relevant financial instrument on the regulated market concerned, in particular when these activities lead to a significant change in the price of the financial instruments;

b. The extent to which orders to trade given or transactions undertaken by persons with a significant buying or selling position in a financial instrument lead to significant changes in the price of the financial instrument or related derivative or underlying asset admitted to trading on a regulated market;

c. Whether transactions undertaken lead to no change in beneficial ownership of a financial instrument admitted to trading on a regulated market;

d. The extent to which orders to trade given or transactions undertaken include position reversals in a short period and represent a significant proportion of the daily volume or transactions in the relevant financial instrument on the regulated market concerned, and might be associated with significant changes in the price of a financial instrument admitted to trading on a regulated market;

e. The extent to which orders to trade given or transactions undertaken are concentrated within a short time span in the trading session and lead to a price change which is subsequently reversed;

f. The extent to which orders to trade given change the representation of the best bid or offer prices in a financial instrument admitted to trading on a regulated market, or more generally the representation of the order book available to market participants, and are removed before they are executed;

g. The extent to which orders to trade are given or transactions are undertaken at or around a specific time when reference prices, settlement prices and valuations are calculated and lead to price changes which have an effect on such prices and valuations.

4.9 Article 5 of the same Directive sets out the following non-exhaustive signals of transactions employing fictitious devices:

a. Whether orders to trade given or transactions undertaken by persons are preceded or followed by dissemination of false or misleading information by the same persons or persons linked with them;

b. Whether orders to trade are given or transactions are undertaken by persons before or after the same persons or persons linked to them produce or disseminate research or investment recommendations which are erroneous or biased or demonstrably influenced by material interest.

Examples of the various types of practice which would constitute market manipulation

4.10 The following guidance gives examples of types of practice which, in the view of CESR members, would contravene the prohibition on market manipulation as defined by the Directive, although it is acknowledged that in some cases a practice may, in particular circumstances, have a legitimate purpose. The examples are categorised according to which element of market manipulation as defined by the Directive they relate to. However, it should be noted that there can be some overlap: a practice may involve a number of types of market manipulation according to how it is used.

4.11 False/Misleading Transactions

a) Wash trades. This the practice of entering into arrangements for the sale or purchase of an financial instrument where there is no change in beneficial interests or market risk or where the transfer of beneficial interest or market risk is only between parties who are acting in concert or collusion. (Repo transactions and stock lending/borrowing do not constitute wash trades.)

b) Painting the tape. This practice involves engaging in a series of transactions which are shown on a public display facility to give the impression of activity or price movement in a financial instrument.

c) Improper matched orders. These are transactions where both buy and sell orders are entered at or nearly at the same time, with the same price and quantity by different but colluding parties, unless the transactions are legitimate crossing trades in accordance with rules of the relevant trading platform.

d) Placing orders with no intention of executing them. This involves the entering of orders, especially into electronic trading systems, which are higher/lower than the previous bid/offer. The intention is not to execute the order but to give a misleading impression that there is demand for or supply of the financial instrument at that price. The orders are then withdrawn from the market before they are executed. (A variant on this type of market manipulation is to place a small order to move the bid/offer price of the financial instrument and being prepared for that order to be executed if it cannot be withdrawn in time.)

4.12 Price Positioning

a) Marking the close. This practice involves deliberately buying or selling securities or derivatives contracts at the close of the market in an effort to alter the closing price of the security or derivatives contract. This practice may take place on any individual trading day but is particularly associated with dates such as future/option expiry dates or quarterly/annual portfolio or index reference/valuation points.

b) Colluding in the after market of an Initial Public Offer. This practice is particularly associated with Initial Public Offers of securities immediately after trading in the security begins. Parties which have been allocated stock in the primary offering collude to purchase further tranches of stock when trading begins in order to force the price of the security to an artificial level and generate interest from other investors – at which point they sell their holdings.

c) Abusive squeeze. This involves a party or parties with a significant influence over the supply of, or demand for, or delivery mechanisms for a financial instrument and/or the underlying product of a derivative contract exploiting a dominant position in order materially to distort the price at which others have to deliver, take delivery or defer delivery of the instrument/product in order to satisfy their obligations. (It should be noted that the proper interaction of supply and demand can and often lead to market tightness but that this is not of itself market manipulation. Nor does having a significant influence over the supply of, demand for, or delivery mechanisms for an investment/product by itself constitute market manipulation.)

d) Creation of a floor in the price pattern. This practice is usually carried out by issuers or other entities which control them, and involves transactions or orders to trade employed in such a way that obstacles are created to the share prices falling below a certain level, mainly in order to avoid negative consequences for their share or credit ratings. This needs to be distinguished from legitimate trading in shares as part of "buy-back" programmes or the stabilisation of financial instruments.

e) Excessive bid-ask spreads. This conduct is carried out by intermediaries which have market power – such as specialists or market makers acting in cooperation – in such a way intentionally to move the bid-ask spread to and/or to maintain it at artificial levels and far from fair values, by abusing of their market power, i.e. the absence of other competitors.

f) Trading on one market to improperly position the price of a financial instrument on a related market.This practice involves undertaking trading in one market with a view to improperly influencing the price of the same or a related financial instrument in another market. Examples might be conducting trades in an equity to position the price of its derivative traded on another market at a distorted level or trading in the underlying product of a commodity derivative to distort the price of the derivative contract. (Transactions to take legitimate advantage of differences in the prices of financial instruments or underlying products as traded in different locations would not constitute manipulation.)

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4.13 Transactions involving fictitious devices/deception

a) Concealing ownership. This is a transaction or series of transactions which are designed to conceal the ownership of a financial instrument via the breach of disclosure requirements through the holding of the instrument in the name of a colluding party (or parties). The disclosures are misleading in respect of the true underlying holding of the instrument. (This practice does not cover cases where there are legitimate reasons for financial instruments to be held in the name of a party other than the beneficial owner – e.g. nominee holdings. Nor do all failures to make a required disclosure necessarily constitute market manipulation.)

b) Dissemination of false or misleading market information through media, including the internet, or by any other means (in some jurisdictions this is known as 'scalping'). This is done with the intention of moving the price of a security, a derivative contract or the underlying asset in a direction that is favourable to the position held or a transaction planned by the person disseminating the information.

c) Pump and dump. This practice involves taking a long position in a security and then undertaking buying activity and/or disseminating misleading positive information about the security with a view to increasing the price of the security. Other market participants are misled by the resulting effect on price and are attracted into purchasing the security. The manipulator then sells out at the inflated price

d) 'Trash and cash'. This is the opposite of pump and dump. A party will take a short position in a security; undertake further selling activity and/or spread misleading negative information about the security with the purpose of driving down its price. The manipulator then closes their position after the price has fallen.

e) Opening a position and closing it immediately after its public disclosure. This practice is typically carried out by portfolio managers and other large investors whose investment decisions are usually valued by market participants as relevant signals of future price dynamics. The canonical unfair conduct consists in closing the position previously acquired immediately after having publicly disclosed it putting emphasis on the long holding period of the investment. However, making a report or disclosure will not, in itself, give rise to a false or misleading impression if it was made in the way specified by any applicable legal or regulatory requirement and was expressly required or permitted by such a requirement.

4.14 Dissemination of false and misleading information

This type of market manipulation involves dissemination of false and misleading information without necessarily undertaking any accompanying transaction. This could include creating a misleading impression by failure properly to disclose a price sensitive piece of information which should be disclosed.

(a) Spreading false/misleading information through the media. This involves behaviour such as posting information on an internet bulletin board or issuing a press release which contains false or misleading statements about a company whose shares are admitted to trading on a regulated market. The person spreading the information knows that it is false or misleading and is disseminating the information in order to create a false or misleading impression. Spreading false/misleading information through an officially recognised channel for disseminating information to users of a regulated market is particularly serious as it is important that market participants are able to rely on information dissemination via such official channels.

(b) Other behaviour designed to spread false/misleading information. This type of market manipulation would cover a course of conduct designed to give false and misleading impression through means other than the media.

V. Possible Signals of Suspected Insider Dealing or Market Manipulation Transactions

Introduction

5.1 Article 6.9 of the Directive 2003/6/EC requires "any person professionally arranging transactions in financial instruments who reasonably suspects that a transaction might constitute insider dealing or market manipulation shall notify the competent authority without delay". The Directive and its implementing measures do not deal with the steps which those persons subject to this requirement need to take to identify such transactions. However, CESR members consider that those persons should have the necessary systems and controls.

5.2 This note is intended to provide those persons subject to the notification requirement with guidance as to indications of transactions which may involve insider dealing or market manipulation. At present no Member State operates a mandatory suspicious transactions reporting regime for market abuse. However, in a number of jurisdictions, market participants already do alert the authorities on a voluntary basis to situations they regard as suspicious or abnormal in this context. The following guidance draws on these cases as well as the views of CESR members as to what might constitute a signal of a suspicious transaction. Annexed to this guidance is a standard reporting format which should be used by institutions to report suspicious transactions to the relevant competent authority.

The Duty to Notify Suspicious Transactions

5.3 It should be emphasised that the notification regime laid down by the Directive requires that persons subject to it decide on a case-by-case basis where there are reasonable grounds for suspicion concerning the relevant transaction. The indications given below are therefore neither exhaustive (a particular transaction may be suspicious even if it matches none of the indications) nor determinative (a transaction may not necessarily be suspicious simply because it matches one or more of the indications. The indications are therefore merely a starting point and firms need to exercise their judgement and consider the particular circumstances of the case before deciding whether or not to report.

5.4 CESR members are clear that blanket pro forma notifications to the authorities of all transactions conducted through an institution would not be in conformity with the provisions of the notification regime. Such notifications would not benefit from the protection provided by Article 11.3 of Directive 2004/72/EC against breach of restriction on disclosure obligations or other liabilities arising from the notification. This is because in the view of CESR members blanket notifications would not be in good faith. Nor would such practice conform with the requirement to consider on a case by case basis whether there were reasonable grounds for suspicion. CESR members are interested in quality not quantity of reporting and will pursue vigorously cases where firms are notifying transactions without seriously considering whether they meet the test of reasonable suspicion.

Guidance Provided by the Directive

5.5 Directive 2003/6/EC and accompanying implementing Directives outline what constitutes insider dealing and market manipulation. This is supplemented by the proposed CESR guidance on practice that constitutes market manipulation (see Chapter 4 of this paper).

5.6 It is worth noting Recital 9 of Directive (reference) which states

> "Notification of suspicious transactions by persons professionally arranging transactions in financial instruments to the competent authority requires sufficient indications that the transactions might constitute market abuse.... Certain transactions by themselves

may seem completely void of anything suspicious, but might deliver such indications of possible market abuse, when seen in perspective with other transactions, certain behaviour or other information."

Investment firms and credit institutions should therefore not only notify transactions which they consider are suspicious at the time the transaction is carried out but also any transactions of which, in the light of subsequent events/information (for example publication of financial results, profits warnings or announcement of a takeover bids in relation to the security in question), they might retrospectively become suspicious.

<u>Indications of Possible Suspicious Transactions</u>

5.7 It is again emphasised that these examples of indications are only a starting point for consideration of whether a transaction is suspicious and are neither conclusive nor comprehensive. Moreover, they are to be applied using judgement rather than necessarily being interpreted literally.

5.8 *Possible Signals of Insider Dealing or Market Manipulation*

a) An unusual concentration of transactions in a particular security (for example, with one or more institutional investors known to be affiliated with the issuer or a party with a particular interest in the issuer such as a bidder/potential bidder);

b) An unusual repetition of a transaction among a small number of clients over a certain period of time

c) Unusual concentration of transactions and/or orders with only one client; or with the different securities accounts of one client; or with a limited number of clients (especially if the clients are related to one another).

5.9 *Possible Signals of Insider Dealing*

a) The client opens an account and immediately gives an order to conduct a significant transaction in a particular security – especially if the client is insistent that the order is carried out very urgently or must be conducted before a particular time specified by the client;

b) The client's requested transaction or investment behaviour is significantly out of character with the client's previous investment behaviour. (e.g. type of security; amount invested; size of order; duration of holding). [5]

c) The client specifically requests immediate execution of an order regardless of the price at which the order would be executed (this indicator pre-supposes more than the simple placing of a 'market order' by the client);

d) Significant trading by major shareholders or other insiders before the announcement of important corporate events.

[5] One case reported by a CESR member involved a client wanting to sell his whole portfolio and immediately invest the proceeds in the securities of a specific company. Others have involved a client who had previously invested only in mutual funds suddenly requesting the purchase of the securities of a single company or a client who had previously only invested in 'blue chip' stocks who made a sudden switch into illiquid securities. In a further case a 'buy and hold' client suddenly conducted a purchase and then sale of a particular security just before the announcement of inside information and the sale directly after the announcement;

e) Unusual trading in the shares of a company before the announcement of price sensitive information relating to the company; transactions resulting in sudden and unusual changes in the volume of orders and shares prices before public announcements regarding the security in question;

f) Employees' own account transactions and related orders timed just before clients' transactions and related orders in the same financial instrument.

5.10 Possible signals of Market Manipulation

(a) Transactions with no other apparent justification than to increase/decrease the price of or to increase the volume of trading in a financial instrument. Particular attention might be given to orders of this kind which result in the execution of transactions near to a reference point during the trading day – e.g. near the close;

(b) The client submits orders which, because of their size in relation to the market in that security, will clearly have a significant impact on the supply of or demand for or the price or value of the security. Again, particular attention might be given to orders of this kind which result in the execution of transactions near to a reference point during the trading day – e.g. near the close;

(c) Transactions which appear to have the purpose of increasing the price of a financial instrument during the days preceding the issue of a related derivative/convertible;

(d) Transactions which appear to have the purpose of maintaining the price of a financial instrument during the days preceding the issue of a related derivative/convertible when the market trend is downward;

(e) Transactions which appear to be seeking to modify the valuation of a position while not decreasing/increasing the size of that position;

(f) Transactions which appear to be seeking to increase/decrease the weighted average price of the day or of a period during the session;

(g) Transactions which appear to be seeking to set a market price when the liquidity of the financial instrument is not sufficient to fix a price within the session (unless the rules or regulation of the regulated market explicitly allow such operations);

(h) Transactions which appear to be seeking to bypass the trading safeguards of the market (e.g. as regards volume limits; bid/offer spread parameters; etc);

(i) When a transaction is to be concluded/executed, narrowing the bid-ask prices (as computed by the trading system) when this spread is a factor in the determination of the price of that transaction;

(j) Entering significant orders in the central order book of the trading system a few minutes before the price determination phase of the auction and cancelling these orders a few seconds before the order book is frozen for computing the auction price so that the theoretical opening price might look higher or lower than it otherwise would do;

(k) Transactions which appear to be seeking to maintain the price of the underlying financial instrument below the strike price of a related derivative at expiration date;

(l) Transactions which appear to be aimed at modifying the price of the underlying financial instrument so that it crosses over the strike price of a related derivative at expiration date;

(m) Transactions which appear to be seeking to modify the settlement price of a financial instrument when this price is used as a reference/determinant in the calculation of margins requirements.

Suspicious transaction reporting form

Description of the transaction(s) *Please include details of the financial instrument(s), including the ISIN code of the instrument; the market(s) concerned; the original order's entry date/time, price and size; the times and sizes of the transaction(s); the type and characteristics of the order, etc*
Reasons for suspecting that the transaction(s) might constitute insider dealing/market manipulation
Identities of persons carrying out transaction(s) *Names, address, telephone number, date of birth, account number, client identification code used by the firm, etc*
Identities of any other persons known to be involved in the transaction(s) *Names, address, telephone number, location, date of birth, relation to person carrying out transaction; position held , role played, etc*
Capacity in which the person performing the transaction(s) acts *e.g. broker, underwriter, agent*
Further information which may be of significance (please list any accompanying material you are supplying)
Details of the person making notification. *Name of person, name of firm, position held within firm, contact details etc*

Signed………. (*person making notification*)

Dated…………(*Date of notification)*

ANNEXES

THE ANNEXES HAVE YET TO BE SET OUT IN THE FINAL FORMAT AS SET OUT IN CHAPTER THREE

Disclaimer

The AMPs published in the annex should not be regarded as definitive unless otherwise stated. However, they are being published now to give market participants a clear indication of the approach CESR members intend to follow for accepting market practices and the type of AMPs that are likely to exist.

Annex	Country	Indicative AMP
1A	Austria	Bond valuation trades
1B	Germany	Bond valuation trades
1C	Germany	Formation of first exchange price
1D	UK	Market aberrations on the London Metal Exchange

ANNEX 1 (A)

Bond valuation trades – Austria

Description of the National AMP: Valuation transaction on the bond market Members of the Vienna Stock Exchange are allowed to carry out a "Valuation transaction", in order to provide the market with a reference price.

Rationale for why the practice would constitute manipulation According to Art. 1 (2) a of Directive 2003/6/EC the above mentioned practice might show supply or demand in bonds which does not reflect the real supply or demand, as the transaction is only done to get a reference price for valuation reasons.

<u>List of Factors</u>

Article 2 of level 2 directive

Non-exhaustive list of factors to be taken into account by Competent Authorities when assessing particular practices whether they occur on a regulated market or an OTC market:

- the level of transparency of the relevant market practice to the whole market(art 2(1) (a))

Transparency of market practices by market participants is crucial for considering whether a particular market practice can be accepted by competent authorities. The less transparent a practice is, the more likely it is not to be accepted. However, practices on non regulated markets might for structural reasons be less transparent than similar practices on regulated markets. Such practices should not be in themselves considered as unacceptable by competent authorities. (preamble 2)

<u>Conclusion regulator:</u> The above mentioned practice and the conditions under which such transactions can be done have to be made available to all investors. An alternative might be to mark the price as a "valuation" price.

- the need to safeguard the operation of market forces and the proper interplay of the forces of supply and demand; (art 2(1) (b))

Market practices inhibiting the interaction of supply and demand by limiting the opportunities for other market participants to respond to transactions can create higher risks for market integrity and are, therefore, less likely to be accepted by competent authorities. (preamble 1)

Conclusion regulator:

There are no higher risks for the market integrity as due to the size / volume of the transactions the bond market is a typical market for professional market participants.

- the degree to which the relevant market practice has an impact on market liquidity and efficiency. (art 2(1) (c))

  Market practices which enhance liquidity and efficiency are more likely to be accepted than those reducing them. (Preamble 1)

Conclusion regulator:

95% of the liquidity in the bond market is not traded via the stock exchange.

- the degree to which the relevant practice takes into account the trading mechanism of the relevant market and enables market participants to react properly and in a timely manner to the new market situation created by that practice(art 2(1) (d)).

Conclusion regulator:

For the bond trading the trading system XETRA foresees a daily auction during the trading hours. The auction time depends on the type of bond, like government bonds, corporate bonds etc. as describes in the market model for XETRA.
The auction starts with a pre trading phase (approx. 3 hours) switches to the main trading phase with a random end for the price fixing (approx. 9 min.) switches then over to a post trading phase.

- the risk inherent in the relevant practice for the integrity of, directly or indirectly, related markets, whether regulated or not, in the relevant financial instrument within the whole Community. (art 2(1) (e))

  Particular market practices in a given market should not put at risk market integrity of other, directly or indirectly, related markets throughout the Community, whether those markets be regulated or not. Therefore, the higher the risk for market integrity on such a related market within the Community, the less those practices are likely to be accepted by competent authorities. (Preamble 3)

Conclusion regulator:

From our point of view there are no specific risks especially to related markets available

- the outcome of any investigation of the relevant market practice by any competent authority or other authority mentioned in Article 12(1) of Directive 2003/6/EC, in particular whether the relevant market practice breached rules or regulations designed to prevent market abuse, or codes of conduct, be it on the market in question or on directly or indirectly related markets within the Community; (art 2(1) (f))

Conclusion regulator: There have not been any investigations or convictions.

- the structural characteristics of the relevant market including whether it is regulated or not, the types of financial instrument traded and the type of market participants, including the extent of retail investors participation in the relevant market; (art 2(1) (g))

Conclusion regulator: There is no obligation to trade always via the Vienna Stock Exchange, banks and brokers also trade OTC, which means that the transaction is concluded between e.g. two market participants. 95% of the bond market is traded OTC. Normally retail investors do not participate in the bond market, and if they participate, they only trade in very small sizes. The bond market is characteristic for institutional (professional) investors. During discussions with retail investors they mentioned that this would be no big deal for them.

Overriding Principles

Overriding principles to be observed by Competent Authorities to ensure that accepted market practices do not undermine market integrity, while fostering innovation and the continued dynamic development of financial markets:

- new or emerging market practices should not be assumed to be unacceptable simply because they have not been previously described as acceptable by the Competent Authority;

- the need to safeguard the operation of market forces and the interplay of proper supply and demand;

- the need for market participants to operate fairly and efficiently without interfering in normal market activity. In this sense, it would be useful to analyse the impact of a market practice against the main market parameters considered by the market participants (eg. weighted average price of a single session, daily closing price, market conditions before carrying out this accepted market practice).

Conditional elements

The AMP fulfills this factor. We are of the opinion that for the bond market there are similar tools or references available, in order to evaluate if the price of a bond is fair. These factors might be similar bonds with the same maturity, same rating, and same interest rate etc.

ANNEX 1 (B)

Bond valuation trades – Germany

Description of the National AMP:

This practice is used to produce an exchange price in a bond for valuation purposes.

The bond market in Germany is by and large an OTC market. Often, there is no liquid market on the exchange with the consequence that the OTC prices reflects the "true" value of a bond. In order to get the exchange price (the last price could be days old) in line with the OTC price a market participant does a wash sale or organizes a pre-arranged trade. Usually, the transaction has only a small size (in terms of turnover).

Quite often this market participant has been involved in the issuing of the bond and acts as an (voluntary) market maker.

Reference to local rules:

Wash sales and pre-arranged trades are forbidden, given that there is the intention to move the price.

Exception: If there is pre-trade transparency (as with cross-requests) wash sales are not considered to be market manipulation.

Reference to local rules: Paragraph 20a WpHG and Paragraph 3 Section 2 Number 1 and 2 KuMaKV.

Rationale for why the practice would constitute manipulation

Reference to article 1(2) (a) of Directive 2003/6/EC:

On first sight, the transactions might be considered to create an artificial or abnormal price.

Having a closer look, the purpose of the transaction is not to create an artificial price but to bring an outdated (historic) price in line with the prices actually determined in a liquid market. Therefore, the result is neither an artificial price nor an abnormal price.

<u>List of Factors</u>

Article 2 of level 2 directive

Non-exhaustive list of factors to be taken into account by Competent Authorities when assessing particular practices whether they occur on a regulated market or an OTC market:

- the level of transparency of the relevant market practice to the whole market(art 2(1) (a))

Transparency of market practices by market participants is crucial for considering whether a particular market practice can be accepted by competent authorities. The less transparent a practice is, the more likely it is not to be accepted. However, practices on non regulated markets might for structural reasons be less transparent than similar practices on regulated markets. Such practices should not be in themselves considered as unacceptable by competent authorities. (preamble 2)

Conclusion regulator:

There is no pre-trade transparency. But market participants know that these "valuation" trades occur regularly.

(Professional) market participants will notice ex post that the price on the exchange and off-the-exchange do not significantly differ any longer.

Additionally, market participants have a benchmark in order to make a judgment whether the results of such transactions reflects an appropriate price. The benchmark is the SWAP curve adjusted by rating spreads. SWAP rates are derived from the interest rate curve of benchmark bonds (e.g. government bonds). The SWAP rates are well known by the market participants, they are published by information vendors like Reuters or Bloomberg.

- the need to safeguard the operation of market forces and the proper interplay of the forces of supply and demand; (art 2(1) (b))

  Market practices inhibiting the interaction of supply and demand by limiting the opportunities for other market participants to respond to transactions can create higher risks for market integrity and are, therefore, less likely to be accepted by competent authorities. (preamble 1)

Conclusion regulator:

This practice is only used in a non liquid market. The purpose is to bring the exchange price in line with the OTC price which is in the interest of market participants. The market practice is not inhibiting the interaction of supply and demand.

- the degree to which the relevant market practice has an impact on market liquidity and efficiency. (art 2(1) (c))

  Market practices which enhance liquidity and efficiency are more likely to be accepted than those reducing them. (Preamble 1)

Conclusion regulator:

Liquidity: Neither positive nor negative effects.

Efficiency: Improves efficiency since it improves the quality of the exchange prices.

- the degree to which the relevant practice takes into account the trading mechanism of the relevant market and enables market participants to react properly and in a timely manner to the new market situation created by that practice(art 2(1) (d)).

Conclusion regulator:

The bond market is mainly an OTC market. Consequently, OTC prices reflect the "real" value of a bond in a better way than exchange prices do. In extreme cases, exchange prices are far away from the the prices on the more liquid OTC market.

Market participants are well aware of this fact and do accept the practice.

- the risk inherent in the relevant practice for the integrity of, directly or indirectly, related markets, whether regulated or not, in the relevant financial instrument within the whole Community. (art 2(1) (e))

  Particular market practices in a given market should not put at risk market integrity of other, directly or indirectly, related markets throughout the Community, whether those markets be regulated or not. Therefore, the higher the risk for market integrity on such a related market within the Community, the less those practices are likely to be accepted by competent authorities. (Preamble 3)

Conclusion regulator:

There is no risk for the integrity of the markets.

If a market participant would try to use this kind of transactions in order to create an artificial price, the rest of the market would notice that as the price would not be in line with the OTC price (see arguments above related to the SWAP rates).

- the outcome of any investigation of the relevant market practice by any competent authority or other authority mentioned in Article 12(1) of Directive 2003/6/EC, in particular whether the relevant market practice breached rules or regulations designed to prevent market abuse, or codes of conduct, be it on the market in question or on directly or indirectly related markets within the Community; (art 2(1) (f))

Conclusion regulator:

There have not been any investigations or convictions.

- the structural characteristics of the relevant market including whether it is regulated or not, the types of financial instrument traded and the type of market participants, including the extent of retail investors participation in the relevant market; (art 2(1) (g))

Conclusion regulator:

Market structure: See above arguments.

Financial instruments: All kind of bonds (Government and related issuers, mortgage-bank bond (Pfandbriefe), corporate bonds).

Overriding Principles

Overriding principles to be observed by Competent Authorities to ensure that accepted market practices do not undermine market integrity, while fostering innovation and the continued dynamic development of financial markets:

- new or emerging market practices should not be assumed to be unacceptable simply because they have not been previously described as acceptable by the Competent Authority;

- the need to safeguard the operation of market forces and the interplay of proper supply and demand;

- the need for market participants to operate fairly and efficiently without interfering in normal market activity. In this sense, it would be useful to analyse the impact of a market practice against the main market parameters considered by the market participants (eg. weighted average price of a single session, daily closing price, market conditions before carrying out this accepted market practice).

Conditional elements

This proposed AMP only applies to such bonds for which a benchmark (SWAP rates) is available/applicable. Therefore, complex bond structures are not covered by this AMP.

ANNEX 1 (C)

The formation of the first exchange price – Germany

Description of the National AMP:

Participation of the institution, acting also as stabilization manager or underwriting syndicate, in the formation of the first price on the exchange after the announcement of the offering price of the shares of an IPO. The same applies for the formation of the first price with regard to trading in subscription rights (Bezugsrechtshandel) when subscription rights start being traded on the exchange.

Art. 10 No. 1 of EU Regulation 2273/2003 states that stabilisation measures shall not in any circumstances be executed above the offering price. Measures that lead to an exchange price above this level are not covered by the safe harbour concept. Therefore they can constitute market manipulation because they may be executed in order to influence the price.

According to German exchange rules the participating institutes usually participate in the formation of the first listed price on the exchange by giving orders. Thus they help to find the best possible order book balancing and to prevent partial execution of orders. This is the main goal of this activity. But in order to reach this goal their orders participate in a price formation process which may lead to a price higher than the offering price. The intention is not directed towards influencing the price, but towards reaching a balanced order book. Furthermore there is an interest that investors get the same price on every exchange where the shares start to be traded simultaneously after the IPO, which makes it necessary that the underwriting syndicate is active in the formation of the first price.

[reference to local rules: § 20a Abs. 1 Nr. 2 WpHG, § 8 Nr. 1 KuMaKV; §§ 44, 45 Exchange Rules Xetra, FWB 08, Ziff. 2.1.2.]

Rationale for why the practice would constitute manipulation

[reference to article 1(2) (a) of Directive 2003/6/EC]

The safe harbour concept of the EU Regulation 2273/2003 foresees that actions that do not meet the prerequisites of the safe harbour rules may constitute market manipulation. An action (independently from its categorization as stabilisation or proprietary trading) that produces a first price above the level of the offering price and which therefore does not meet the safe harbour is suspicious because this action may produce an artificial price level and may therefore constitute market manipulation.

<u>List of Factors</u>

Article 2 of level 2 directive

Non-exhaustive list of factors to be taken into account by Competent Authorities when assessing particular practices, whether they occur on a regulated market or an OTC market:

- the level of transparency of the relevant market practice to the whole market(art 2(1) (a))

  Transparency of market practices by market participants is crucial for considering whether a particular market practice can be accepted by competent authorities. The less transparent a practice is, the more likely it is not to be accepted. However, practices on non regulated markets might for structural reasons be less transparent than similar practices on regulated markets. Such practices should not be in themselves considered as unacceptable by competent authorities. (preamble 2)

Conclusion regulator: The practise should be considered as AMP under the condition that it is made transparent to the market, e.g. the acting bank/market participant should be obliged to publish in advance that he will give orders for the first price in order to reach a full order book balancing. A possible way to have transparency could be to mention this fact in the prospectus and to make this practice a part of the exchange rules for the formation of the first price.

- the need to safeguard the operation of market forces and the proper interplay of the forces of supply and demand; (art 2(1) (b))

  Market practices inhibiting the interaction of supply and demand by limiting the opportunities for other market participants to respond to transactions can create higher risks for market integrity and are, therefore, less likely to be accepted by competent authorities. (preamble 1)

Conclusion regulator: The interaction of supply and demand is not inhibited by this market practice.

- the degree to which the relevant market practice has an impact on market liquidity and efficiency. (art 2(1) (c))

  Market practices which enhance liquidity and efficiency are more likely to be accepted than those reducing them. (Preamble 1)

Conclusion regulator: The practice has a positive influence on market liquidity, because it is intended to reach a fully balanced order book.

- the degree to which the relevant practice takes into account the trading mechanism of the relevant market and enables market participants to react properly and in a timely manner to the new market situation created by that practice(art 2(1) (d)).

Conclusion regulator:

The participation of the underwriting syndicate (or stabilisation manager) in the formation of the first price on the exchange should only be accepted with the restriction that it may not produce overlaps either on the buy or on the sell side and the respective order may not constitute the prevailing or overwhelming order with regard to the produced turnover. The order may not turn upside down the existing amount of supply of demand

- the risk inherent in the relevant practice for the integrity of, directly or indirectly, related markets, whether regulated or not, in the relevant financial instrument within the whole Community. (art 2(1) (e))

  Particular market practices in a given market should not put at risk market integrity of other, directly or indirectly, related markets throughout the Community, whether those markets be regulated or not. Therefore, the higher the risk for market integrity on such a related market within the Community, the less those practices are likely to be accepted by competent authorities. (Preamble 3)

Conclusion regulator:

If an IPO is introduced on more than one market simultaneously,,the underwriting syndicate is usually active on all of these exchanges, because there is an interest that investors who placed orders to be executed at the first price on the exchange get a full execution and get the same price; with the AMP this goal can be reached

- the outcome of any investigation of the relevant market practice by any competent authority or other authority mentioned in Article 12(1) of Directive 2003/6/EC, in particular whether the relevant market practice breached rules or regulations designed to prevent market abuse, or codes of conduct, be it on the market in question or on directly or indirectly related markets within the Community; (art 2(1) (f))

Conclusion regulator:

It is common practice that the underwriting syndicate takes part with orders in the formation of the first price; as this is not allowed in the framework of the safe harbour concept it would only be possible if the practice is regarded as AMP; if it is not considered as AMP, banks will do it anyway in the form of own account trading, which is not documented according to the rules in EU Regulation 2273/2003, but is reported to the competent authority in the usual transaction reporting system. The competent authority does not get a similar documentation as in stabilization cases. As these own account trading activities are not within the safe harbour they are subject to investigation, but on the other hand they are necessary and should not be prosecuted. If there was no AMP for the formation of the first price, the competent authority would regularly have to open an investigation, which would finally lead to the conlusion that the acticity was justified.

- the structural characteristics of the relevant market including whether it is regulated or not, the types of financial instrument traded and the type of market participants, including the extent of retail investors participation in the relevant market; (art 2(1) (g))

Conclusion regulator: For retail investors it is an advantage if the issuing bank helps to get a fully balanced order book at the first price. Thus, investors do not get partial executions.

Overriding Principles

Overriding principles to be observed by Competent Authorities to ensure that accepted market practices do not undermine market integrity, while fostering innovation and the continued dynamic development of financial markets:

- new or emerging market practices should not be assumed to be unacceptable simply because they have not been previously described as acceptable by the Competent Authority;

- the need to safeguard the operation of market forces and the interplay of proper supply and demand;

- the need for market participants to operate fairly and efficiently without interfering in normal market activity. In this sense, it would be useful to analyse the impact of a market practice against the main market parameters considered by the market participants (eg. weighted average price of a single session, daily closing price, market conditions before carrying out this accepted market practice).

Conditional elements

ANNEX 1 (D)

Market aberrations on the London Metal Exchange – UK

Description of the National AMP:

Behaviour conforming with the London Metal Exchange's Policy Guidance which governs the behaviour expected of long position holders in this market (the 'Policy Guidance'). Long position holders who trigger the thresholds specified in the Policy Guidance are expected to be prepared to lend stock at no more than a premium of specified level of percentage of the cash price for a day.

Rationale for why the practice would constitute manipulation

Creation of long positions giving rise to the application of the London Metal Exchange (LME) Policy Guidance may involve transaction or orders to trade which

(i) give or are likely to give, false or misleading signals as to the supply of or demand for or price of financial instruments

(ii) secure, by a persons or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level.

List of Factors

Article 2 of level 2 directive

Non-exhaustive list of factors to be taken into account by Competent Authorities when assessing particular practices whether they occur on a regulated market or an OTC market:

- the level of transparency of the relevant market practice to the whole market(art 2(1) (a))

Transparency of market practices by market participants is crucial for considering whether a particular market practice can be accepted by competent authorities. The less transparent a practice is, the more likely it is not to be accepted. However, practices on non regulated markets might for structural reasons be less transparent than similar practices on regulated markets. Such practices should not be in themselves considered as unacceptable by competent authorities. (preamble 2)

Conclusion regulator:

The Policy Guidance has been published to the market by the exchange on which it applies. The transparency criterion is therefore met. Those who have long positions at or above the thresholds specified in the Policy Guidance are required to advertise to the market that they will be prepared to lend stock at the appropriate level.

- the need to safeguard the operation of market forces and the proper interplay of the forces of supply and demand; (art 2(1) (b))

  Market practices inhibiting the interaction of supply and demand by limiting the opportunities for other market participants to respond to transactions can create higher risks for market integrity and are, therefore, less likely to be accepted by competent authorities. (preamble 1)

Conclusion regulator: The Policy Guidance is designed to facilitate the operation of supply and demand on the market by avoiding abusive squeezes or other circumstances which could result in or involve distortion of the market for the investment in question.

- the degree to which the relevant market practice has an impact on market liquidity and efficiency. (art 2(1) (c))

  Market practices which enhance liquidity and efficiency are more likely to be accepted than those reducing them. (Preamble 1)

Conclusion regulator: The practice has a positive effect on market liquidity and efficiency as it facilitates the orderly operation of a market in which a participant has a dominant long position. The degree to which the practice takes into account the trading mechanism of the relevant market and enables market participants to react properly and in a timely manner to the new market situation created by the practices.

- the degree to which the relevant practice takes into account the trading mechanism of the relevant market and enables market participants to react properly and in a timely manner to the new market situation created by that practice(art 2(1) (d)).

Conclusion regulator: The practices in the LME Policy Guidance were developed taking into account the trading mechanism of the LME. The behaviour required of long position holders under the Policy Guidance is monitored by the LME compliance department on a daily basis using public and confidential regulatory information available to it. The LME compliance department takes into account the trading mechanism of the LME when performing this task. Procedures exist for escalating any concerns about market circumstances to a Special Committee that is able to intervene in order to enable market participants to react properly and in a timely manner to any new market situations created by the practices.

- the risk inherent in the relevant practice for the integrity of, directly or indirectly, related markets, whether regulated or not, in the relevant financial instrument within the whole Community. (art 2(1) (e))

  Particular market practices in a given market should not put at risk market integrity of other, directly or indirectly, related markets throughout the Community, whether those markets be regulated or not. Therefore, the higher the risk for market integrity on such a related market within the Community, the less those practices are likely to be accepted by competent authorities. (Preamble 3)

Conclusion regulator: The practices in the Policy Guidance were developed to maintain the integrity of the markets in financial instruments traded on the LME. The practices have been shown to be an aid in maintaining the integrity of those markets.

- the outcome of any investigation of the relevant market practice by any competent authority or other authority mentioned in Article 12(1) of Directive 2003/6/EC, in particular whether the relevant market practice breached rules or regulations designed to prevent market abuse, or codes of conduct, be it on the market in question or on directly or indirectly related markets within the Community; (art 2(1) (f))

Conclusion regulator: The FSA supports the regime outlined in the Policy Guidance and, under the previous Code of Market Conduct applying to trading on the LME, provided a safe harbour for behaviour in conformity with the practices outlined in the Policy Guidance.

- the structural characteristics of the relevant market including whether it is regulated or not, the types of financial instrument traded and the type of market participants, including the extent of retail investors participation in the relevant market; (art 2(1) (g))

Conclusion regulator: The London Metal Exchange is a commodity derivatives market which has Recognised Investment Exchange status in the UK. It is a professional market with minimal retail involvement.

Overriding Principles

The FSA had regard to the following overriding principles to ensure that the practices outlined in the Policy Guidance do not undermine market integrity, while fostering innovation and the continued dynamic development of financial markets:
:

- new or emerging market practices were not be assumed to be unacceptable simply because they had not been previously described as acceptable by the FSA;
- the need to safeguard the operation of market forces and the interplay of proper supply and demand;
- the need for market participants to operate fairly and efficiently without interfering in normal market activity.

Conditional elements

The Policy Guidance specifies the behaviour required in the circumstances where it is triggered and conduct in conformity with the Policy Guidance is for legitimate reasons.