

Market Abuse

Speech by Sharon Bowles MEP, Chair Economic and Monetary Affairs Committee, at the Commission Consultation on Market Abuse, 2 July 2010

Thank you for inviting me to speak here today. I am as ever happy to share my thoughts and those of the Economic and Monetary Affairs Committee with you.

Issues of market abuse and market manipulation are frequently commented upon and have also arisen in the context of the role of the European Securities Market Authority.

Not unexpectedly, I can say that the Committee certainly sees a role for more transparency and I will take that as my starting point for elaboration. My first elaboration is to say that there are three interlinked issues of Transparency, Clarity and Harmonisation. I tried to split my ideas along those lines, it didn't really work because they are so interconnected, but at least I will start out that way.

I also discovered that trying to define changes, or possibly more accurately updates, in the Market Abuse Directive led me to look at other legislation, because Market Abuse is not stand alone: it relates to behaviour, rather than to instruments or products, which can be merely the tools of abuse.

Very broadly, under Transparency, I include issues such as more reporting, greater understanding and providing the public with confidence. And to take the topical issue of derivatives, it is clear that legislation on derivatives provides potential to define, for example, more reporting.

Under Clarity, I earmarked issues such as better definitions in line with developments and to ensure greater capture of activity, widening the scope to equivalent structures such as MTFs, and making it certain that instruments such as CDS are covered – so as you can see I am already back at derivatives.

Under Harmonisation, I generally meant coordination, having the same scope, powers and sanctions, and also information sharing.

So, already I have told you that there should be greater consistency between MiFID and the Market Abuse Directive – such as extension of definitions both in the context of activities and venues that are covered – and also greater harmonisation so that rules are clear and understood across the Member States. This latter point will need some handling with care to make sure the balance is right between clarity, proportionality and understanding of market practices. Also, the requirements of smaller businesses will become more relevant to take into consideration in the widening of the scope of the market abuse directive, for example to MTFs.

On the matter of public confidence, prior to the crisis there were many matters where the public were the last to know. There may be reasons for this, for example one that came up recently during trialogue discussions on the supervisory authorities was transmission and publication of offences and offenders, for example on to a register available over the whole of the EU.

You can see immediately the driver for such a request - to increase awareness at supervisory and public levels, to aid in preventing and uncovering abuses and also as a deterrent. Immediately ranged against that came arguments such as that ‘naming and shaming’ was a punishment tool that was not always used and that some Member States considered naming and sharing of names was a breach of e-privacy or data protection. For the main part I reckon that is a poor excuse and should be fixed. It may not be easy – and I guess the new Director General has seen the other side – so now we can harness his expertise to have a good, honest look at this.

I postulate that it is no good promising the public lots of new regulation to prevent future crises and not being prepared to share with them truths about where and how abuses and other problems have happened. Indeed the issue is wider than just market abuse, it

goes to the core of morality or ethics within the markets and financial institutions, an important part of which is peer and public pressure.

Greater transparency can also prevent excessive excursions, adventures and populism with regard to suspected but unproven activities. There has been rather too much uninformed speculation about speculation in recent times, and my conclusion rather than seeking bans for what is not understood is to shine some light around, and then get stuck in when we can see our way.

This again leads us back to derivatives as an example.

We are already in the process of ensuring better clearing and reporting of OTC derivatives, which also raises questions about improvements in other reporting, such as positions, and possibly position limits or temporary bans in certain circumstances. All these things are good for consideration and inclusion in appropriate, specific legislation, but I do not believe the basic definitions belong in the Market Abuse Directive. Of course I would not exclude from the scope of the Market Abuse Directive abuses that misuse these instruments, and certainly suspicious reporting should be extended to OTC derivatives. But again this brings me to the fundamental point that for the main part it is behaviour not products that are at the root of abuse.

A similar analysis applies to short selling, it would be wrong to regulate this via the Market Abuse Directive and imply that all short selling is a market abuse. Within specific legislation it would be reasonable to include more disclosure requirements for short positions. Naked short selling without any settlement plan (or purpose) would already seem to be covered in the market abuse directive, but this could be clearly reiterated since it is a matter of popular and political concern.

Moving on to Clarity and definitions, one issue is the definition of financial instrument, especially in the context of derivatives. I am not sure that the definition as something ‘whose value depends on another financial instrument’ is always reckoned wide enough to include

Credit Default Swaps, and as I mentioned earlier it seems clear that these should be covered by MAD. Somebody with access to information relevant to the financial position of an issuer may find it easier and less transparent to trade in CDS, making it a potential vehicle for abusive practices.

Having got into the issue of CDS, I must comment on whether the much maligned activity of holding naked CDS is legitimate or not. There can be fully justified reasons for holding such an instrument including, in the case of sovereign CDS, as a risk management hedge to overall country exposure; under Basle 2 capital rules using models there can be a capital benefit; internal risk management may indicate their use as a way to reduce counterparty exposure; they can be used to manage price volatility where mark-to-market accounting is required; and sovereign CDS can be used to manage macroeconomic fundamentals and currency e.g. trading US CDS in Euros.

So it may turn out to be very difficult to separate out the legitimate - like a strip tease its not quite certain when you will get down to the nitty gritty - and if naked trades are banned it may also be difficult to predict the consequences on risk management. Again I would say that other legislation to address lack of transparency and give a better understanding of volume and who holds what, is on its way.

Returning to definitions, although CDS and other known instruments can easily and specifically be written in as falling under the ambit of the MAD, why can't we aim wider to make sure that instruments that do other things, that may not even be transacted but give rise to some other kind of right or obligation are captured too. So there we have another definition to look at – that of transactions or maybe transaction equivalents. Once more I have come back to needing to capture behaviour and intent, I would say, rather than the instrument per se.

Questions also arise about physical markets. These are often treated separately and different conditions do prevail, however I believe that it is important to have a complete picture and not always leave these

out as separate from financial markets. Indeed when I spoke at the Conference on Financing Europe's Energy needs in March I dealt with issues of securitisation and derivatives and said "We have a report in the Parliament in response to the Commission consultation on derivatives. The main thrust is central clearing and extra capital requirements. So far the subject is notable in Europe for not dealing with commodities or emissions trading, but as I said that is because we have a split of responsibilities on this subject area."

That is not to say everything has to be solved all at once, but it is all part of a bigger picture of markets and trading, and the way in which different data flows will link up in the future is important.

So it was a little worrying that when the Parliament was considering its report on derivatives, I slightly confused everyone by what I thought was quite a simple observation in the context of emissions permits – that opportunities – or risk – from cornering may need to be treated differently in a system where the number of available permits was designed to reduce over time.

So it is time to join up our thinking and our legislation on financial, commodity and energy markets.

Turning to my final topic of Harmonisation, one area where suspicion is always rife and where standards differ over Member States is what is covered and captured by insider trading. It seems to me that this should be upgraded so more is captured everywhere. Surely any activity that makes use of information that is not available to the public for trading purposes should be captured. It is not necessary for this information to be fully fledged for it to yield an unfair benefit. So limiting insider dealing to using knowledge defined as that which ultimately needs to be disclosed is too narrow, using precursors to that disclosure information should be caught too.

Intent is then also relevant because knowledge may not always be the motive for a trade. For example with algorithmic trading that is fixed, technically as soon as information is known trades can become

notionally an abuse even if the information had no bearing on the activity. This can be solved by the ability to rebut, which in some instances such as the one I just described, could be quite a simple process or even automatically eliminated. Again we do need to make sure that small financial businesses are not overburdened.

Whilst on the matter of insider trading, insider lists are a useful tool for detecting abuse, coupled with reporting. Some adjustment to the scope here might also be useful. So much is subcontracted now, or tied up with other parties, lawyers, accountants and so on, that it does need to be possible to get all necessary information about insiders in all such subcontracted firms. Further, should there be an investigation it must be possible to get access and responses from these other firms. At present this not possible under the directive.

It may be this issue is best solved by enabling powers which are activated when needed, rather than adding to routine reporting. Small businesses could be exempted from routine maintenance of an insider list but be asked to provide information to supervisors on demand. There is also cross-border and third country access to consider here, as well as more widely in the legislation.

One of the things that the crisis has highlighted is when can there be a delay in the disclosure of information. I think the UK had a quite famous misunderstanding about this, which serves well to illustrate that this is something which should be available for financial institutions when there is a matter of grave public concern. It seems hard to justify a wider exemption and even for financial institutions it needs to be controlled and subject to supervisory permission. It will be important for there to be guidelines that are consistently applied.

I can not be fully comprehensive, but the final issue I raise under what I would regard as traditional market abuse is that of market manipulation. I believe this should cover planned or attempted as well as actual manipulation. So there should be punishment not just when a market price has changed, but when attempts to change it have been

made. And it follows that penalties, here and elsewhere, should not be limited by links to gains.

This is a big issue for culture change and could be further widened to behavioural manipulations beyond just transactions, for example to decoy movement of physical commodities or ships, aimed at tricking a price change.

Some may be reluctant to widen to areas where there is no material change in the market - which is relevant not just to attempted manipulation but maybe also to the precursors to disclosable information which I mentioned earlier.

A new topic that has caught my attention is bank stress tests where market confidence could be greatly influenced, so transparency of assumptions and end results is important and the subject will need to be covered by MAD.

Going further into areas that have been exposed in the crisis, and to end on a controversial note, maybe we should consider broadening the whole concept of market abuse into issues like taking advantage of extreme asymmetry of information, such as disguised tail risks, or 'bought negotiation' where success fee payments go to 100% of negotiators of a deal.

What I am aiming for here is a continuum between corporate governance and market abuse. So there will be Before Abuse and Market Abuse. 'MAD Bad and Dangerous to know' is the warning I want to give abuse and sharp practice.

Thank You.