



ASSOCIATION FOR
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30 September 2002

Mr. Fabrice Demarigny
The Committee of European Securities
Regulators
17 Place de la Bourse
75082 Paris Cedex 02
France

Re: CESR's Advice on Possible Level 2 Implementing Measures for the Proposed Market Abuse Directive" (Ref. CESR/02.089b)

Dear Mr. Demarigny:

The European Advocacy Committee ("EAC" or the "Committee") of the Association for Investment Management and Research ("AIMR")¹ is pleased to comment on The Committee of European Securities Regulators' ("CESR") consultative paper on *Possible Level 2 Implementing Measures for the Proposed Market Abuse Directive* (the "CP" of the "Proposed Directive"). The EAC is a standing committee of AIMR charged with reviewing and responding to major new regulatory, legislative, and other developments that may affect investors, the investment profession, and the efficiency and integrity of European financial markets. A list of the members of the EAC and their affiliations is enclosed.

General Comments

Members of the EAC fully support CESR's efforts to provide thoughtful and considered advice to the European Commission (the "EC" or the "Commission") and the European Securities Committee regarding a common set of securities laws that would apply to all Member States within the European Union. The Committee further supports the goal of these efforts, which is to produce an integrated, fair, efficient and competitive financial market in Europe.

As directed, the EAC focused its attention not just on the content of the Proposed Directive but also to ensure that the CP maintained the appropriate balance between legislative measures at levels 1 and 2 and regulatory standards at level 3. Furthermore, the Committee's review of the

¹ The Association for Investment Management and Research is a global, non-profit organization of over 59,000 investment professionals from more than 111 countries. Through its headquarters in the U.S. and 117 Member Societies and Member Chapters worldwide, AIMR provides global leadership in investment education, professional standards, and advocacy programs.

Proposed Directive was performed in light of the goals of the four-level process of the Lamfalussy approach. The purpose of this process is to “ensure that the legislative framework can keep pace with and facilitate developments in the EU’s emerging single capital market.” The benefit of this approach is that it gives regulators the ability to make, alter, amend and supplement rules and regulations without having to seek new legislation.

In view of this process and direction from CESR, the EAC has concern that the advice contained in the proposed implementing measures often does not achieve the appropriate balance between level 2 and level 3. The Committee is concerned that many of the proposals have sought to create laws that are too specific to qualify as appropriate legislative measures. The Committee’s views are based on concerns that the tendency toward detail in level 2 measures can produce longer-term problems, both for the regulators administering the law as well as for the integrity of the markets themselves. In some cases the detail provides a roadmap for persons or firms to legally get around the spirit of the laws without direct violation of them. Indeed, if the law narrowly defines what is illegal, then it stands to reason that whatever is not defined is legal.

Regulation must evolve in step with evolution of the markets if market integrity is to be maintained. Making the level 2 legislative measures too specific hampers the ability of regulators to revise their approaches and flexibly develop them in ways appropriate to the effective long-term supervision of markets and market participants. Inflexibility and excess detail could result in requiring regulators to seek even minor changes to the law [as opposed to rules] in order to keep up with changes in the markets.

Finally, providing specific details in level 2 measures that are applicable across all national boundaries within the EU potentially could create additional application problems. Translating long lists of specific items into the legislative languages used by the various Member States increases the possibility for inconsistent application of the laws across different jurisdictions.

To avoid such problems, it is the belief of the Committee that level 2 measures should comprise comprehensive and general principles regarding illegal and abusive market practice, while level 3 measures can and should include detailed descriptions of what *actions* and *behavior* constitute violations of the law. Throughout this response, the EAC has tried to maintain that balance and where appropriate has made suggestions as to how CESR might achieve it.

SPECIFIC COMMENTS

ARTICLE 1

Inside Information

Question 1: Would the level 2 advice relating to the precision required for information to become inside information benefit from further development along the following lines:

“The notion of precision implies the existence of a project sufficiently defined between the parties to have a reasonable chance to come to fruition, even if there remain

uncertainties, inherent to all transactions of that nature, conditioning the actual completion of that project.”

In the original level 2 advice referred to in Question 1, CESR said inside information requires both that an event described by the information be true, or reasonably expected to become true, and that the information is specific enough to permit a conclusion about securities prices.

The Committee’s view is that the original, general definition is sufficient to adequately describe what should constitute inside information. In turn, the Committee does not feel that further development of the advice along the lines described in Question 1 would provide any benefits to the markets. In fact, such development has the possibility of narrowing the definition of inside information to the point that the law may not include many pieces of information that are, in practice, nonpublic, inside information.

Question 2: Would there be an advantage in having all or some of the guidance as level 2 implementing measures?

This question refers to a list of factors that would support the level 2 definition of inside information. This list provides five factors that would support the view that a piece of information would have an effect on securities prices in the event it was available to the market.

Given the specificity of the guidance, the Committee sees no advantage in putting any of these factors in level 2. While the EAC members agree, in general, that such factors may better define precision as it relates to inside information, the Committee is concerned that including such specific examples would serve to weaken the law rather than to strengthen it. Including specific examples of what constitutes precision at level 2 creates a roadmap for people to maneuver around the edges of the law while still not violating it. By keeping the law general as described in the original level 2 advice provided in paragraph 32 of the CP and leaving the specifics for the level 3, however, violators of laws against abuse of inside information would have more difficulty escaping prosecution on the basis of minor technicalities.

Question 3: Should the investor mentioned in the level 2 advice be qualified as reasonable/professional/informed?

This question refers to level 2 advice provided in paragraph 40 of the CP. The advice describes factors for regulators to consider when making ex-ante determinations about the possibility of the price-moving effects of a piece of information. In particular, the advice suggests that “a piece of information is likely to have a significant effect on the price of a financial instrument when it is information which an investor could not omit to consider in his investment strategy.” The question asks if the advice would improve if CESR were to require that the definition of investor be refined to ensure the investor is reasonable, professional or informed.

The Committee’s view is that, no, the qualification would not help the advice. On the contrary, members are concerned that such a qualifier has the potential to “add shelter” for someone who

acts on such information and, therefore, undermine market integrity. These individuals could potentially evade prosecution by claiming they were not professional investors and, as a result, neither reasonable nor informed.

Furthermore, including such qualifiers in the level 2 advice would require CESR to advise the Commission on a definition of reasonable, professional and/or informed. As such, the inclusion of the qualifier would complicate the law while simultaneously narrowing the universe of investors who could run afoul of it.

Question 4: Should the guidance be addressed at Level 2?

This question refers to the same level 2 advice covered by Question 3.

In general, the Committee is of the view that the Commission should address issues covered by the proposed advice in level 2. However, there is a concern that the language used by CESR goes too far in defining what information an investor could not omit to consider in his investment strategy. Even though the fourth point in the list points to “all market variables that affect the financial instrument in question,” it is the concern of the Committee that the advice is still too specific. Furthermore, when those factors are translated into the languages of the different Member States it could lead to inconsistent interpretations about what is and is not included.

As such, it is the Committee’s view that CESR could enhance enforceability of the law by leaving the advice general. To that end, the Committee suggests that CESR end its advice prior to saying that the assessment should consider the four factors. This editing would cause the advice to read as follows:

A piece of information is likely to have a significant effect on the price of a financial instrument when it is information which an investor could not omit to take into account or into consideration for his investment strategy. This assessment should be made ex-ante to determine the possibility of a price-moving effect.

While not appropriate for level 2 measures, the factors removed from the above suggestion would provide a strong foundation for future level 3 measures.

Question 5: Are there any other relevant factors that should have been included?

This question refers to the same advice covered in questions 3 and 4. As stated in its response to Question 4, the Committee urges CESR to use the edited version of the level 2 advice it provides and exclude the four detailed factors listed at the end of the proposed advice. It further urges CESR to refrain from adding additional factors to the pared-down advice in level 2. However, these factors should be considered for inclusion in level 3 measures.

Question 6: Are the above diagnostic flags and factors appropriate for level 2 legislation?

Question 7: Is the division between diagnostic flags and factors the right one? Are there any additional diagnostic flags or factors to be taken into account that you may want to suggest?

Question 8: Are the above diagnostic flags and methods appropriate for level 2 legislation?

Question 9: Are there any additional flags or methods to be considered?

These are the first questions covered by the CP's section on market manipulation. In this section, CESR stated its belief that "regulators must have the flexibility to adjust their methods of diagnosing, evaluating and sanctioning manipulative behaviors, in the context of varying market conditions." We strongly support this view. Without that flexibility, regulators would have to seek new legislation every time a new situation developed that did not fit into the narrow confines of existing law.

The EAC is concerned, however, that the approach proposed by CESR in the CP may not achieve that goal of regulatory flexibility. This concern is based in large part on the detailed list of diagnostic flags designed to help regulators identify the kinds of activities, behavior and evidence that constitute possible market manipulation. Among the suggested flags were sudden and significant price or volume changes; transactions concentrated among a small number of brokers or clients and in a small time span; and frequent introduction and withdrawal of orders prior to execution.

While the Committee members agree with the intent and coverage of the list of diagnostic flags, we are of the view that providing such specific detail at level 2 would limit the ability of regulators to adapt to a changing environment. As such, we are of the view that the diagnostic flags are more appropriate for level 3 measures.

This view toward moving the diagnostic flags to level 3 covers questions 7 through 9, as well. In each case, our views are based on our understanding of the Lamfalussy approach and the need for regulators to adapt to changing market conditions without having to go to Parliament for approval.

With this in mind, the Committee proposes a different approach to this section, one that states more generally that it is illegal to take actions that mislead or provide false signals to the market. A general statement of this type would cover a broader spectrum of activities while permitting regulators on the ground to create an evolving set of regulations necessary to prevent abusive activities and behavior.

Regarding the list of diagnostic flags, the Committee sees the need to add two more diagnostic flags as part of future level 3 measures:

- Media reports should fall under the proposed rules, as well; and
- CESR should note that the flags listed do not represent an exhaustive list of all the factors that might signal false or misleading actions or activities, and that regulators should have latitude in determining what flags beyond the list might indicate inappropriate and illegal activities.

ARTICLE 1

Market Manipulation

Question 10: Are there any additional factors to consider at level 2?

The purpose of this section is to determine whether a transaction or order employed fictitious devices or some other form of deception or contrivance. In its level 2 advice under this heading, CESR lists a number of factors that would provide possible evidence of the use of fictitious devices, deception or contrivances.

Again, the Committee sees the list of factors as a guideline for regulators, and therefore both too specific for level 2 and more appropriate for level 3 measures. A more general approach at level 2 that states that use of fictitious devices or other forms of deception or contrivance to provide misleading disclosure, misrepresentation and possible bias is illegal will achieve the goal of making deceptive behavior illegal.

While the Committee feels the factors listed are appropriate for level 3 measures, members of the Committee are concerned about use of the term “material interest” as it relates to erroneous or biased analyst reports. Specifically, some members say that, without an appropriate definition, it could “take years” for their national legal system to determine what is material.

At the same time, the qualification that the bias is the result of a material interest may exclude actions that are, nonetheless, taken on the basis of bias. For example, a wealthy analyst may write a biased or erroneous report that would either provide relatively immaterial benefits to his or her portfolio, but may help a friend or relative. In its current form, the advice would exclude such abusive behavior.

With this in mind, the Committee suggests that in its future level 3 proposals, CESR should consider rewriting the factor to say something to this effect:

Analyst reports which are erroneous or biased and demonstrably influenced by personal or self interest...

This would eliminate the immediate need for a definition of material interest.

ARTICLE 1

Definition of Financial Instrument

Question 11: Do you agree with the above advice?

The level 2 advice to which Question 11 refers states that “all financial instruments traded on a regulated market should be included within the list of financial instruments.”

In this case, the Committee thinks that CESR did not go far enough in its advice. In particular, members believe that the advice should cover all securities and derivative instruments, whether traded on a regulated market or negotiated in private, where misrepresentation, false or misleading disclosures or other forms of market manipulation may affect market prices. While

this definition would include private securities, private placements, private-equity transactions, debt securities not traded on regulated exchanges, as well as all over-the-counter instruments such as swaps and derivatives, it is the view of the Committee that CESR should provide such a list in level 3 measures.

In fact, Committee members see the use of swaps and derivatives as a more effective means for determined market participants to manipulate market prices. This is due to the combination of two factors. First, the leverage associated with these instruments can have a more profound impact on prices than a similar investment in the underlying shares, bonds or commodities. And second, many of these instruments, while affecting prices on regulated markets, often are negotiated privately away from the transparency of regulated exchanges and therefore out of the view of market participants. By combining the stealth of a privately negotiated transaction with the leverage associated with these derivative instruments, persons intent on market abuse can have a significant impact on securities prices.

ARTICLE 6(1)

Appropriate Disclosure Of Inside Information By Issuers

Question 12: CESR would be interested in receiving views on the disclosure obligations when a financial instrument is traded in more than one EU jurisdiction. The objective is to ensure equal treatment of all investors. For instance, should an issuer be able to rely on disclosure through an officially appointed mechanism in one jurisdiction even when the instrument is traded in other jurisdictions, as well?

This question relates to proposed level 2 advice that sets requirements for issuers regarding the public disclosure of inside information. In its proposal, CESR suggests that issuers would have to disclose inside information through “an officially appointed mechanism,” with such mechanisms allowing “fast access by issuers and by the public.” The requirements also would prohibit distribution through other channels prior to dissemination through the officially appointed mechanism, and would require companies to make such official dissemination in the jurisdictions of all regulated markets where their financial instruments are traded or under consideration for trading.

The requirements raise two questions that are not entirely clear from the text of the advice. First, it is unclear whether the “officially appointed mechanism” is intended to be one appointed by the regulators or one appointed by the issuers. The confusion derives not only from the CP but also from the Commission’s update on the Investment Securities Directive, *Transparency Obligations for Issuers Whose Securities Are Admitted to Trading on a Regulated Market*. In that update, the Commission proposed simultaneously allowing issuers to choose which media to use as a “basic means of disseminating information” while also proposing creation of central repositories in each Member State. These central repositories would disseminate information in “a language customary in the sphere of finance.” As it relates to this Proposed Directive, it was unclear whether CESR was referring to something like the central repositories proposed in the Commission’s ISD update, or some other form of dissemination.

For the purposes of this question, the Committee took the view that CESR was referring to regulatory or governmental repositories. In part, this view is based on the issues raised in Question 13 concerning a fully harmonized officially appointed mechanism. Nonetheless, if this is what CESR is suggesting then it should clarify this position in its advice to the Commission.

The Committee also is unclear about what CESR meant when it asks about the advisability of whether an issuer should rely on disclosure in one jurisdiction even when the instrument is traded in other jurisdictions. For the purpose of this question, we concluded that CESR was asking about whether an issuer should consider having fulfilled its duty to disseminate inside information in all jurisdictions when the information is available in the jurisdiction in which its securities are traded, or under consideration for trading.

Regarding the advisability and feasibility of central repositories, the EAC has covered this topic in the context of the Commission's *Transparency Obligations* proposals. In that revision, the EC proposed establishing central repositories in each Member State that would provide ease of use and access to investors as well as determine the type of information issuers would need to provide. This proposal raises concerns among the Committee members. In its 14 July 2002 letter to the Commission on these proposals, the Committee stated that "without guidance to Member State repositories as to how to make such information easy to use and accessible to investors across borders, the quality of the repository activities among individual Member States may vary greatly."² The Committee went on to suggest that the Commission establish standards for minimum information requirements for the type of information required to be disclosed.

In this Proposed Directive, however, we are not asked to consider what information is provided, but rather the manner in which issuers must disseminate inside information. Under the assumption that the officially appointed mechanism is intended to be a governmental repository, the issue is where the repository should reside.

In that regard, the Committee is concerned that CESR's proposed advice will not achieve full and complete access to investors across national borders. Sending disclosures only to the jurisdictions where the financial securities are traded or under consideration for trading would not necessarily provide clear and open access to all investors. For example, an investor in Italy may not have open access to documents for a company whose shares are traded in Frankfurt.

It is the Committee's belief that the level 2 measures should ensure access to the general public by requiring disclosure in different languages and through different media. The question is how to best achieve that goal.

While the use of central repositories in each Member State as envisioned by the EC in its *Transparency Obligations* directive could achieve the goal of clear and open access to all investors, it also may create unintended problems. If each Member State is able to set its own

² AIMR European Advocacy Committee letter to the European Commission, Internal Market Directorate General, dated 14 July 2002, regarding *Revision of Investment Services Directive: Transparency Obligations for Issuers Whose Securities Are Admitted to Trading on a Regulated Market*, " page 4.

requirements on what information an issuer should provide, it might create disparities between jurisdictions in the quality and quantity of the information available on specific issuers, as we stated in our 14 July letter to the Commission.

However, if CESR were to propose a central repository that could disseminate the same information, including the inside information considered here, through the appropriate regulator in each Member State, it might create an efficient mechanism for harmonized, simultaneous and broad dissemination of all information, including inside information, across all national boundaries within the European Union and beyond. Such a system would also benefit from disseminating information in languages relevant not just to the sphere of finance, as described by the Commission in its proposals for an updated ISD, but also in languages relevant to the markets of the Member States.

There are a number of benefits of such a system. First, a centralized repository would ensure standardization not only of filing requirements of issuers, but also ensure a harmonized product for investors. Second, investors would have a single location in their own jurisdictions where they could go to collect the information in whatever form they wish. Finally, such a system would have the added benefit of giving issuers a single location to which they would submit their disclosures, which would provide immediate disclosures to investors in all Member States and beyond. While it may cost issuers more to translate filings into different languages, they will benefit from filing in one location and through lower costs of capital resulting from a wider pool of investors.

Supplementing such an EU-wide central repository, CESR should suggest permitting issuers to simultaneously disseminate information broadly via whatever public mechanisms they wish to use, be it on the company's Web site, a broadcast press release or an advertisement in a newspaper. The combination of these mechanisms likely would achieve the best and most immediate distribution of the information.

Question 13: CESR would welcome views on whether the EU needs a fully harmonized officially appointed mechanism. In putting forward any position respondents are asked to articulate the costs and benefits of any proposal.

Please see our comments for Question 12.

Question 14: Should there be technical implementing measures at Level 2 further defining the qualitative requirements for complete, prompt and not misleading disclosure?

This questions deals with the technical factors that determine whether disclosure is complete, immediate or prompt, and not misleading. This includes ensuring that financial reports are comparable from period to period. In this case, CESR thought that regulatory guidance rather than legal rules was the appropriate manner in which to achieve this.

In general, the EAC supports the approach of CESR in this matter. However, there was concern that without some legal guidance at level 2 that regulators in different regions might adopt different minimum standards for disclosure. With that in mind, CESR might consider providing level 2 advice stating that as a supplement to required periodic financial disclosures, companies must make complete, prompt and not misleading disclosures of all events, transactions and other items that have the potential to affect the market prices of an issuer's securities, as well as its finances and operations.

Question 15: Would a definition of legitimate interests be useful as a Level 2 implementing measure? If yes, what definition would you propose?

In this question, CESR was looking at possible considerations for delaying publication of inside information. Its level 2 advice provided two possible scenarios for delay: matters in negotiation and matters concerning an issuer's ability to operate as a going concern.

The EAC did not find any reason for providing a definition of legitimate interests.

Furthermore, the Committee thinks that CESR should change a provision in the level 2 advice given on page 29 of the CP. In its proposal, CESR suggests that "disclosure should take place as soon as the event occurs." This provision, in the Committee's view, provides too much wiggle room for issuers to delay publication.

It is the recommendation of the Committee, therefore, that CESR should not include a definition of legitimate interests in level 2.

Question 16: Are there any other examples of situations that should be included in the list?

This question deals with the same issues raised in Question 15. Please see the explanation of our views for Question 15.

ARTICLE 6(4)

Research

General Comments

The purpose of the section of Article 6(4) is to ensure fair presentation of research and other relevant information. CESR states that the implementing measures related to this Article should consider both how research should be presented and what would require disclosure of interests and conflicts of interests.

The Committee is concerned that in many cases in Article 6(4) the proposals are too specific to allow adequate regulatory flexibility. Indeed, in some cases the issues relate to circumstances, events or topics that may change over time. To impose a narrow test for these issues would not only give analysts broad latitude to avoid violating the law, it would also impede the goal of

ensuring fair presentation of research. In part, this is because the only remedy for faults in the prescriptive approach would be to obtain Parliamentary approval for proposed changes. While this approval is being sought, however, investors may continue to endure research reports tainted by kinds of self interest and conflicts of interest that are not imaginable at this point in time.

It is the EAC's view that a more general approach to prohibitions and requirements in level 2 will serve the purpose of preventing market manipulation and trading on inside information better than a detailed list that will only serve as a roadmap for people looking to abide by the tenor of the law but not its spirit. To that end, the Committee urges CESR to use restraint in its approach to developing advice regarding matters of research objectivity.

Throughout the answers given to questions in this Article 6(4), the Committee has presented its views on how to alter the language of the proposals to provide a legal foundation for a flexible system of securities laws. In some places the suggestions amount to nothing more than eliminating a phrase or word, while in other places the suggestions involve a complete rethinking of what issues should be covered and how to do so without going into too much detail.

The Committee points out that while many of the proposals are inappropriate for level 2 measures, they are certainly appropriate for level 3. Indeed, in many cases, the Committee urges CESR to retain the lists of prohibited and required actions for use when it is time to consider such level 3 measures.

Question 17: How should the proposed implementing measures, in particular regarding the disclosure of conflicts of interest, be adapted to relevant information that is distributed in another form, for example a public appearance?

Question 18: How should measures relating to disclosure of conflicts of interest be adapted to research reports, articles in the press and other relevant information recommending bonds and other types of financial instruments such as warrants?

In the level 2 advice related to these questions, CESR proposes, among other things, that “any recommendation must have an adequate basis in fact, and the interests and conflicts of interest that may impair the objectivity of the information must be appropriately disclosed.”

First, the EAC supports the disclosure of any interests or conflicts of interest that the author of the research or the author's firm may have. As reported in recent months, such interests and conflicts can have a significant influence on the recommendation associated with the research. With disclosure, investors should have the ability to adequately judge the relative objectivity of the report.

As for adapting such disclosures to any form of distribution, we are of the opinion such issues are not appropriate for level 2 measures. Nonetheless, it is appropriate that CESR propose level 2 measures to create a legal foundation for monitoring such research reports. To achieve that goal as well as to achieve the combined goals of disclosing conflicts of interest in all forms of distribution, the Committee suggests editing the proposal to read something like this:

...Any recommendation or rating, regardless of the subject of the research or the manner in which the recommendation or rating are distributed, must have an adequate basis in fact, and the interests and conflicts of interest that may impair the objectivity of the information must be appropriately disclosed.

Question 19: Do you think that investors would benefit from disclosure of the qualification of the person producing the information?

In general, the Committee members feel strongly that regardless of its benefits, including such a requirement at level 2 is inappropriate. However, it may be appropriate at level 3.

On the advisability of including such information, the Committee is split. Some think that such disclosures would provide assistance to the reader of the report in determining whether the author is competent. Other members see such a requirement as not beneficial and think such disclosures should be handled by the firms issuing the reports rather than covered by legislation or regulation.

Either way, however, the Committee believes CESR should not include a requirement for disclosure of such information at level 2.

Question 20: Where there is doubt about the reliability of a source, should this be indicated or should a relevant person refrain from publishing unreliable information?

The EAC members agree that relevant persons should refrain from publishing unreliable information and that this issue is appropriate for level 2 measures.

Question 21: Where should these disclosures go and in what form should they be made?

This question relates to issues under the heading, “Disclosure of interests and conflicts of interests,” and relate to the types of such disclosures analysts should make. Indeed, the text relating directly to the question is not part of any level 2 advice but part of CESR’s explanatory text under this heading. In particular, the question relates to a suggestion that analysts and their firms could direct readers of research reports to the firms’ Web sites to find information about the analysts’ personal investments, dealings, compensation considerations and supporting statistical information, and about the firm’s policies regarding release of research.

It is the Committee’s view that discussions about the type of disclosures required in a research report are inappropriate for level 2. A better form of the level 2 advice would say more generally that any information related to potential conflicts of interest must be disclosed promptly or immediately. To get too specific at this level of legal and regulatory development would lock local regulators into a set of laws that may become outdated even before they are enacted.

Question 22: The threshold in EU law tends to be at 10% (e.g. directive 88/627). CESR considers that a 5% threshold may, in many situations, be “reasonably expected to impair the objectivity” of the research. CESR seeks comments on this proposed disclosure obligation, as well as comments regarding the “timing” of the disclosure, exemptions from the disclosure obligation and the desirability and feasibility of extending this disclosure to instruments other than shares (other equity instruments, and derivatives on the relevant instruments)?

In our understanding of the CP, Question 22 refers to the entirety of the level 2 advice beginning with the “Basic rule” described on page 37 and concluding with the discussion of thresholds for disclosure on page 38. The Committee has some concerns about a number of items in the advice.

First, in the first item under the basic rule, CESR suggests:

Where producers of relevant information – the individual, his/her employer – has a material interest in the subject financial instruments covered by the report, or a material conflict of interest with respect to issuers of these instruments, the nature of such interest or conflict should be indicated clearly and prominently.

While the Committee approves of the approach of this advice as part of level 2 measures, it is concerned about the inclusion and use of the term “material” in the advice. For one thing, material is not defined and therefore is subject to interpretation by those looking to circumvent the law. Second, by qualifying the statement so that only material interests or material conflicts of interests are covered, the proposals limit the scope of the advice and allow firms to avoid disclosing significant positions that, while not material relative to their size, could, nonetheless, be significant to the market and impair the objectivity of the author. Indeed, just because an interest is not material does not preclude firms or individuals from acting illegally in their own self interests, as some recent high-profile insider trading and fraud cases in the international arena have shown.

To prevent such potential pitfalls, the Committee proposes amending the first sentence in the first item under the basic rule to say something like:

Where producers of relevant information – including the individual preparer and his/her employer or any affiliate of the employer – have interests in financial or derivative instruments of the company or companies covered by the report that may impact the producers’ objectivity, or a conflict of interest with respect to issuers of these instruments, the nature of such interests or conflicts must be indicated clearly and prominently.

Regarding the issue of thresholds proposed on page 38 of the CP, the Committee is equally concerned about setting the bar at all in level 2. Such specific thresholds have the potential to prevent local regulators from taking actions against entities or individuals who may not technically exceed the threshold but are nonetheless able to have a profound abusive effect on the prices of securities.

For example, as described above, leverage associated with derivative financial instruments can produce an impact on the prices of the shares of underlying stocks far beyond the amount

invested. Moreover, an owner of such instruments can have this impact without reaching the specified thresholds. Likewise, objectivity of an analyst can become impaired with the ownership or control of just 100 call or put options, a position that is unlikely to exceed the proposed threshold.

While the proposed threshold is a reduction from the 10% threshold of EU law, it still runs counter to practice in other markets. As CESR points out in the footnote to Question 22, the New York Stock Exchange and NASDAQ Market in the United States recently reduced the threshold for disclosures on beneficial ownership to just 1%. Furthermore, some of the largest investment banking firms in the world have taken matters a step further by prohibiting analysts from owning any shares or related instruments of the companies their analysts cover.

In light of these concerns and recent events in the marketplace, the Committee urges CESR to adopt a more general approach to its level 2 advice and reserve specific thresholds to level 3 measures. A possible way to amend the proposed level 2 advice would be to say that firms and analysts should disclose any holdings or interests in shares, bonds or other financial instruments that may impair the objectivity of the research report. CESR could then tackle the issue of determining at what point those holdings or interests may impair objectivity in level 3.

Question 23: What kind of content can CESR request to achieve disclosure of business relationships without revealing nonpublic events?

This question relates to a continuation of the level 2 advice covered by Question 22. The continuation provides a list of “other significant relationships” between the analyst or his firm, and the subject company that may impair the objectivity of the relevant research.

Again, the Committee is concerned that the suggested advice is too specific for level 2 and might, therefore, limit regulatory flexibility in ensuring proper disclosures in EU markets. Please see our answers to Question 22 for how to correct this potential difficulty.

Question 24: Are the time periods set out in the above requirements and elsewhere in the research section appropriate?

While reiterating its urging that CESR not include these proposed scenarios for requiring disclosure in level 2, but as possible level 3 measures, the Committee feels that the time periods described in the proposed rules are appropriate.

Question 25: Should this rule also cover the analyst’s immediate family? How can it be done?

The rule mentioned in Question 25 would require analysts to disclose in their research reports, holdings the analysts may have in the subject of a research report, or in competitors of the subject company. The question asks respondents to consider whether CESR should expand its advice to cover the analysts’ immediate families.

As it has done throughout Article 6(4), the Committee urges CESR not to include in its level 2 advice to the Commission the suggestions in this section that relate to disclosure of interests and conflicts of interests of investment firms and credit institutions. The detailed nature of the advice is so specific and precise that it would hinder the ability of regulators to amend, alter, change and supplement their approach to regulating the activities of analysts in their markets.

As we have done previously, the Committee urges CESR to apply the suggestions made in this section to level 3 advice, though with some modifications. First, the Committee is concerned that expanding the rule to cover the analyst's immediate family could create problems. First, the issue raises a number of cultural questions. In some countries immediate family may include a significant number of people, not all of whom live with the analyst in question, or, in others, may exclude an unrelated person or persons living under the same roof as the analyst. Such confusion could make enforcement of the law more difficult without a clearer definition of immediate family.

CESR might consider following the approach taken in other markets that places limits solely on spouses, siblings, children and parents. A definition of this type might make it easier to determine whether someone with inside information recommended a share to a relative who then took advantage of the tip.

Question 26: Should CESR require analysts to disclose the purchase price, date of acquisition and number of shares the analyst receives or buys in a transaction prior to an IPO?

The Committee's view is that, yes, analysts should have to disclose the purchase price, date of acquisition and number of shares received or purchased in a transaction prior to an IPO. However, the Committee urges CESR to include rules governing such activity in level 3 measures. Factors such as these change over time as circumstances change. If the measures that address them are included at level 2, it would hamper the ability of regulators to adapt its rules to new environments without having to seek new legislation for revisions.

Likewise, the Committee believes that all of the rules for disclosure, described between Question 25 and Question 26 on page 40 of the CP, are more appropriate for level 3 than level 2.

Question 27: How can CESR clarify the disclosure of certain forms of compensation and the extent to which compensation arrangements are disclosed?

The Committee believes such issues are not appropriate for level 2 measures.

If included as part of level 3 measures, however, the Committee thinks CESR's proposal to disclose compensation arrangements as part of a broader discussion of interests and conflicts of interests are appropriate. The question posed, however, is how to clarify the disclosure and the extent to which those arrangements are disclosed. To do so, we suggest that the disclosures also discuss whether the analysts are compensated for investment banking or corporate finance deals,

and whether the analysts have participated in marketing road shows with their firms' investment banking teams.

Question 28: Are the rules for disseminators of relevant information appropriate?

The Committee agrees with CESR that level 2 measures should require the disclosure of such arrangements. However, it feels the language and detail included in the advice are inappropriate for level 2. As such, the Committee urges CESR to amend its level 2 advice, possibly by requiring that disseminators of third-party information identify both the preparer and the disseminator; and that the disseminator take reasonable precautions to ensure the information is true, accurate and complete with no material omissions, misstatements or misrepresentations of any kind.

ARTICLE 8

Safe Harbors

Question 29: Should CESR harmonize the indicated level 3 measures at level 2 or should CESR consider different approaches to incorporating the level 3 measures?

According to the CP, the purpose of this section is to create standards for share buyback and stabilization schemes that would ensure that such programs are able to operate under the protection of safe harbors while also preventing abusive activity by issuers and their agents. As part of this effort, CESR said it would present a number of ex-post level 3 measures to recommend to relevant authorities for inclusion in local regulation. Those measures are the ones mentioned in Question 29. However, they are not introduced until page 49, five pages after the submission of Question 29, and deal with requirements for daily reporting, materiality and reduced disclosure as they relate to buy-back schemes.

The Committee agrees with CESR that the appropriate place for those ex-post measures referred to in Question 29 is level 3. As such, it is the Committee's view that they do not belong in the level 2 measures CESR will propose to the Commission.

Question 30: Are these measures appropriate to mitigate the insider dealing risks?

While the question mentions "measures," the text of the CP does not provide explicit advice for level 2 implementing measures with regard to this question. As such, it is unclear exactly what measures the question is discussing.

Based on the context of the document, however, we have concluded that the question relates to the circumstances under which issuers would not benefit from the safe harbor and the restrictions to prevent such circumstances. Specifically, CESR lists three circumstances during which the safe harbor would cease: transactions in redeemable shares; trading in own shares for risk-management purposes; or execution of liquidity agreements with investment firms.

If these are, indeed, the measures to which the question refers, then the Committee is in agreement that, yes, the measures should substantially mitigate insider dealing risks from buyback schemes. However, the Committee is concerned that unless care is given to the writing of the level 2 advice, some market participants may construe the list of restrictions as comprehensive. The Committee, therefore, urges CESR to consider level 2 advice suggesting that companies that trade their own shares during the buy-back period would not receive the safe harbor for their buy-back schemes. By leaving the advice general, CESR could develop more flexible and restrictive regulatory advice for level 3 measures.

Also, the Committee is concerned about the provision that exempts programs managed by third-party administrators. First, the view of the EAC is that this issue is more appropriately addressed at level 3 than at level 2. Second, CESR should take care in writing the level 3 measures to ensure that to achieve such an exemption, third-party administrators and firms must have a contractually established and pre-set schedule of share purchases, setting out either the price, timing and/or volume of the buy-back transactions to ensure that such transactions are not influenced by management and inside information.

Finally, in its level 3 measures, CESR also should consider preventing companies from implementing buy-back programs after deciding to delay disclosure of inside information. To permit such activity would provide a loophole that companies could use to trade on inside information, thereby taking advantage of their shareholders for the benefit of management.

Question 31: Do these proposals achieve an appropriate balance between market integrity and efficient allocation of capital? Is there any way to introduce more flexibility into this area?

The proposals referred to in Question 31 relate to CESR's belief that selling one's own shares during a buy-back program should eliminate the safe harbor for the program. While it offered an exemption for programs managed by third-party administrators, CESR was worried that eliminating the safe harbor in all other circumstances would reduce the flexibility of the issuer to manage the program and asked for guidance on how to introduce some flexibility.

As discussed in our answer to Question 30, the Committee is concerned about exemptions granted to programs managed by third-party administrators. Without proper safeguards, such arrangements are just as likely to result in abusive behavior as company-managed programs.

Regarding the matter of introducing flexibility into such programs, the Committee is not so much concerned about the need for issuer flexibility in the administration of buy-back schemes as it is about the ability of issuers to manipulate the activities of a third-party administrator. As such, it is our view that not only should CESR not introduce any more flexibility into these programs, it also should eliminate the exemptions proposed for schemes run by third parties.

Question 32: Is 18 months an appropriate time limit for buybacks?

CESR pointed out that the Second Company Law Directive limited a buy-back program to a maximum of 18 months, a period CESR considered too long. It suggested a briefer period of 12 months.

Again, it is the Committee's view that such a specific recommendation has no place in level 2. If regulators found that an 18-month period was too long or too short, they would have to seek new legislation to get the time limit changed, a lengthy process at best and a politically charged one at worst.

To avoid such problems, the Committee urges CESR to incorporate specific time limits in level 3 measures. Its level 2 advice should say something to the effect that issuers engaging in buy-back schemes must complete their activities within a prescribed time period, not to exceed 18 months.

Considering that a specific time period is more appropriate for level 3 measures, it is the Committee's view that 18 months is an appropriate time period. Such a time limit would give management time to implement the program and report back to shareholders about its progress. On the other hand, 18 months is a short-enough period to allow shareholders to ensure management accomplishes what it promised.

Question 33: Do short-term programs deserve special consideration? If so, what conditions should be imposed?

In this question, CESR referred to a proposal that would exempt short-term buy-back programs from all or most of the restrictions it would impose on longer-term schemes. The suggestion was that limitations would be removed for programs lasting no more than three months.

The Committee strongly opposes this suggestion and urges CESR not to include it in its advice to the Commission. The problem, in the Committee's view, is that companies can achieve just as much, if not more, abuse in a short period of time as they can in 18 months.

In proposals given later in the CP – specifically, for question 35 – CESR proposes that issuers be restricted to buying no more than 25% of the average daily volume in its securities and be required to exercise “due care” to avoid increasing volatility. By removing restrictions of this type for short-term schemes, the law would give issuers a free hand to buy as much as 100% of a given day's volume, regardless of the volatility it might create and increase the possibility that issuers will act on the basis of inside information. Moreover, such exemptions also likely would encourage issuers to compress even legal buy-back activities in a shorter period of time, creating a possible increase in volatility during the period in which the issuer undertakes the buy-back program.

Question 34: Should off-market transactions be disallowed under the safe harbor provisions?

By off-market transactions, CESR was referring to transactions negotiated privately between the issuer and a seller away from a regulated exchange. As a way to prevent abuse in these

circumstances, CESR suggested requiring such trades to occur at a price at or below the previous day's close and subject to strict disclosure requirements.

The Committee recognizes that there often are legitimate reasons for such off-market transactions. Many, if not most, of such transactions are conducted in compliance with the law and securities regulations.

However, for some, such transactions are a way to create artificial income or losses. More disconcerting is the possibility that issuer and seller may collude to artificially affect market pricing. Adding to the potential for abuse is that while an issuer may readily disclose such transactions that were conducted at the appropriate price level, it would require an in-depth regulatory audit to ensure that the price was, indeed, equal to the previous day's close and not at a higher or lower level.

Nonetheless, we do not see the need for an all-encompassing prohibition of off-market transactions. However, we strongly urge CESR to impose very strict guidelines and monitoring of such activity when it provides the appropriate level 3 advice.

Question 35: Views are sought on the above restrictions particularly with regard to the specific detail that should be included at level 2?

This question relates to paragraphs 135 and 136 in the CP in which CESR proposes limits on buy-back activities. Under the proposals, issuers could not buy more than 25% of their average daily volume and they would have to take "due care" to avoid increasing market volatility.

First, it is the view of the Committee that such restrictions are not appropriate for level 2. Rather, such restrictions are best used as level 3 measures. It also is the view of the EAC that the best way to regulate such activities is on a market-by-market regulatory basis rather than through a blanket legal restriction.

Question 36: Should the Competent Authority have such a power?

The power referred to in the question relates to the ability to suspend a buy-back program for an issuer that has damaged market integrity.

The Committee agrees with the proposal that the Competent Authority should have the power to enforce the laws and regulations when an issuer's activities are damaging market integrity. Furthermore, the Committee feels it is appropriate to include the granting of such power at level 2 to ensure that the law is applied on a consistent basis throughout the EU.

However, the Committee urges CESR not to define what constitutes damaging market integrity at level 2. If it were to do so, it would establish a legal definition that might not apply in every situation and could ultimately allow a large swath of issuers and persons who hurt the integrity of the market to avoid prosecution. On the other hand, when it does create level 3 advice on this issue, it should impose strict limits to ensure that local regulators are not allowed to interfere unnecessarily with legal and carefully run buy-back programs.

Question 37: Is the above restriction appropriate for buybacks that meet all the other conditions for safe harbor?

It is not entirely clear what restriction Question 37 is discussing, though, based on the context of the level 2 advice preceding this question, it presumably relates to a proposal to prohibit an issuer from continuing a buy-back program after receiving a merger or takeover offer from a third party. It is the view of the Committee that such a restriction is appropriate. Not to impose such restrictions would essentially condone inside trading on the part of the issuer.

However, the Committee's view is that none of the advice preceding this question is appropriate for inclusion in level 2. Again, our concern is that the specific nature of the list of activities that issuers must undertake to benefit from the safe harbor creates an inflexible framework that may become out of date in a number of years. But while the list is inappropriate for level 2, the Committee thinks the requirements are entirely appropriate for level 3 measures.

Question 38: Do you agree with CESR's position?

Questions 38 and 39 both deal with stabilization programs and ensuring that the safe harbor provided for such schemes does not permit abusive activity. Question 38, in particular, is based largely on CESR's paper, "Stabilization and Allotment – a European Supervisory Approach."

Using this paper as its basis, CESR identified two sets of conditions under which such programs could access the safe harbor. The first set a time limit of no more than 30 days from the announcement of the final price for completion of the program. The second condition was that the programs are used exclusively for price support. CESR added that it would recommend individual jurisdictions create additional measures covering prospectus disclosures, disclosure of stabilization activities to shareholders and regulators and the appointment of stabilization managers.

Regarding time periods, the EAC reiterates the position it took in its 31 August 2001 letter to CESR's predecessor, the Forum of European Securities Commissions, that an appropriate time period is 15 days. If the stabilization period extended beyond that, the Committee stated at the time, it would create the potential for market abuse.³

Furthermore, the Committee also pointed out in that letter that operation of an issuing syndicate begins the day it accepts a new issue of securities into inventory and ends once all the shares are sold and the books are finalized. Typically this process takes no more than a couple of days to complete. As a result, allowing issuers and their agents to operate a stabilization period for 15 days affords selling syndicates more than ample time to stabilize an offering. Extending the stabilization period beyond that period encourages efforts to overcome fundamental price shifts

³ AIMR European Advocacy Committee letter to Fabrice Demarigny of The Forum of European Securities Commissions, dated 31 August 2001, regarding *Second Consultation of the Paper "Stabilization and Allotment – a European Supervisory Approach,"* page 2.

or poorly priced issuances and creates short-term inefficiencies in pricing that ultimately unwind, resulting in even more price volatility in the longer term.

More troublesome from the standpoint of fair, free and efficient markets, however, is that longer stabilization periods create additional opportunities for price manipulation and insider trading. Syndicate members can reduce their losses by artificially inflating a security's price to a level that is below the offering price but above the security's "true economic value." Likewise, insiders have more opportunities to sell their shares or short the security under longer stabilization periods through the knowledge that the price will fall once stabilization efforts cease.⁴

Question 39: Do you agree with CESR's position on making these level 3 measures? Or should CESR harmonize the indicated level 3 measures into level 2 implementing measures? Are there other approaches that CESR should consider?

The relevant level 3 measures referred to in Question 39 deal with disclosure of stabilization activity and the appointment of a stabilization manager. The EAC concurs with CESR's position on making these level 3 measures. However, the Committee thinks the public disclosures do not go far enough to alert investors to the significance or insignificance of the program. To enhance the value of such disclosures, the Committee suggests adding to the disclosures information about when the program began, whether it was used at all and the volume of shares involved in the program.

Furthermore, the Committee also urges CESR to include the list of rules beginning in paragraph 149 on page 51 under the heading of "Stabilization Period" in future level 3 measures rather than in level 2 implementing measures. The advice provided in paragraph 148 on that same page provides enough information about time periods – "for a limited time" – to achieve the purpose of level 2 measures by signifying that stabilization activities cannot continue indefinitely. Incorporating the detailed discussion under "Stabilization Period" in level 3 would provide securities regulators sufficient flexibility to alter, amend, add or delete factors that determine the length of stabilization periods.

⁴ Ibid.

Closing Remarks

The EAC appreciates the opportunity to comment on the CESR consultative paper on *Possible Level 2 Implementing Measures for the Proposed Market Abuse Directive*. If you or your staff have questions or seek amplification of our views, please feel free to contact James C. Allen, CFA, by phone at 434.951.5558 or by e-mail at james.allen@aimr.org.

Sincerely,

/s/ Frederic P. Lebel

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Vice-Chair
European Advocacy Committee

/s/ James C. Allen

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