Joint Guidance on Auction Manipulation
July 2010

The financial regulators from a number of European countries believe that it is necessary to provide clarification, with respect to the regulation regarding auction price manipulation used to benefit unduly from arbitrage between correlated financial instruments (e.g. warrants vs. shares). This is particularly relevant in the context of rights issues given the importance of rights issues as a fund-raising route for companies in general -especially in the current economic situation- and taking possible further developments into consideration.

This letter from the financial regulators of Belgium (Banking, Finance and Insurance Commission - CBFA), France (Autorité des Marchés Financiers - AMF), Portugal (Comissão do Mercado de Valores Mobiliários - CMVM) and the Netherlands (Autoriteit Financiële Markten - AFM) provides joint guidance on avoiding market manipulation.

It should be noted that this guidance does not contain any new regulatory elements. In fact, the provisions of the Market Abuse Directive[1] avoiding market manipulation have been incorporated into national law for a number of years. The regulators have already imposed and/or published formal sanctions related to market manipulation (eg KBC Securities S.A.-press release AFM 14 March 2008). In addition, the Committee of European Securities Regulators (CESR) has previously provided guidance on the common operation of the Directive.[2] In this guidance auction price manipulation was specifically described as a form of market manipulation:

'Possible signals of Market Manipulation (…)
'(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'[3]

The regulators would like to emphasize that they consider the following activities as possible market abuse.

Creating or enhancing arbitrage possibilities in the context of rights issues by manipulating the (theoretical) opening or (theoretical) closing price of the rights
A rights issue is a form of raising capital by which existing shareholders (free of charge) receive tradable rights per share held. Subject to restrictions described in the prospectus, shareholders then have the

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1 Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse).
2 Market Abuse Directive. Level 3 – first set of CESR guidance and information on the common operation of the Directive. Ref: CESR/04-505b.
3 http://www.cesr-eu.org/data/document/06_562b.pdf.

following options: to exercise the rights and subscribe to new shares at the discounted issue price; sell the rights on the relevant stock exchange; or let the rights expire.

The theoretical price of the rights can be calculated after the offering is announced but before the right expires. In theory the value of a right should equal the difference between the current market value of a share and the issue price of new shares offered, adjusted for the number of shares rights holders can subscribe for in relation to subscription rights that they hold.

The difference between the actual value of a right and the theoretical value of a right provides opportunities for arbitrage between the rights and the related share.

In the course of 2009 the regulators saw a number of instances of (potential) manipulation. In these instances the theoretical opening/closing price of rights was manipulated by market participants, by cancelling - a few seconds prior to the order book being frozen for computation of the auction price - a relatively large order that was not intended to be executed. This manipulative behaviour, in a number of instances, occurred in combination with arbitrage trading in the context of rights issues.

An example of this conduct is described in the footnote [4]below to illustrate the regulator's concerns relating to market manipulation in the context of rights issues.

Sanctions

The regulators stress that auction manipulation in general when creating or enhancing arbitrage possibilities between correlated financial instruments and, more specific, the market behavior in the context of rights issues described above, shall be considered a violation of market abuse regulation. Please note that the regulators will continue to monitor markets. In the event of a possible violation of market abuse regulation being established, investigative and enforcement actions may be undertaken as well as formal sanctions which can be imposed in accordance with respective national market abuse regulation.

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[4] Example:

i. Market participant A enters a relatively large buying order in rights X prior to the opening or closing auction of the rights (during the pre-opening/closing phase the theoretical price is calculated continuously).
ii. Prior to the same auction market participant A, simultaneously enters a smaller buying order in rights X at a lower price.
iii. The buying orders have an impact on the future opening/closing price of the rights (in general, a larger order has more impact on the theoretical auction price). All combined orders in rights X, including the orders by market participant A, are used to compute a theoretical opening or closing price.
iv. Within a few seconds prior to the start of the opening/closing auction, market participant A cancels the large buying order in rights X. As a result, the theoretical price of the rights decreases sharply (arbitrage opportunities immediately increase) while other market participants do not have sufficient time to respond to the new theoretical price (price of share X remains stable and therefore does not provide rationale for cancelling the large buying order in rights X).
v. During the auction, market participant A buys rights X for a lower price. This lower price is for the most part caused by the manipulative actions of market participant A prior to the auction. The lower price of the rights provides enhanced arbitrage opportunities in relation to share X.
vi. In anticipation of the lower price of the rights resulting from the large buying order cancellation , market participant A also entered selling orders in share X to secure the potential benefits of the arbitrage between rights X and share X.

As a consequence of the above described manipulation of the price of the rights, market participant A has an advantage in terms of arbitrage opportunities compared to other market participants. Clearly, the other market participants could not anticipate the sudden decrease of the value of rights X in the last seconds prior to the auction due to the cancellation of a large buying order that was never intended to be executed.