



CNMV CRITERIA ON THE DETECTION AND REPORTING OF SUSPICIOUS TRANSACTIONS

SECONDARY MARKETS DIRECTORATE

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1. INTRODUCTION

Under article 83 quater of the Securities Market Act (Act 24/1988, dated 28 July), since 2006 firms which provide investment services must notify the CNMV of transactions that are suspect of constituting market abuse.

The Initiative Against Market Abuse (ICAM) launched by the CNMV in 2006 included, among its main components, promoting the filing of Suspicious Transactions Reports (STRs) in an effort to combat market abuse. After all, the integrity of the securities markets has become one of the key indicators of quality among the most developed markets in competing to attract issuers and participants.

While it was once considered novel in Spanish regulation to demand greater collaboration in such a sensitive area, today it is a necessary duty in order to enable our markets to rank among the best in terms of integrity. The information provided to the CNMV through suspicious transaction reporting is extremely useful for supervising market integrity, especially when that information refers to aspects of the client that are known only to the reporting firm and are crucial for detection, such as its business profile, professional or personal relationships, its form of processing orders, and details of its operations.

The CNMV's programme of activities for 2007-2008 included the development of procedures for suspicious transaction reporting, which led to the creation of a group of industry experts to identify and debate those regulatory aspects that require clarification. This group highlighted the need to unify the criteria applicable in identifying suspicious transactions and to establish measures within their organisations aimed at correct compliance with this duty.

As a result, the CNMV decided to draft a document with the key aspects to be considered when complying with this duty. They are based on CESR guidelines in the area of market abuse¹, the best practices of specific firms, and criteria established in this field by other countries.

The document's content will be updated by the CNMV, which will include potential changes that may arise from new CESR documents and from new regulation in this area. It may also be elevated to the status of regulation in accordance with the powers contained in article 2 of Royal Decree 1333/2005, among others.

This compilation document aims to facilitate, clarify and encourage compliance with the legal duty to report suspicious transactions, without prejudice to measures that may be applicable in the event of non-compliance, which is classified as a serious violation under the Securities Market Act.

The duty to report suspicious transactions lies with each firm as a whole. However, organisational decisions and the responsibilities assumed by a firm's departments and employees play a key role in compliance, especially in raising awareness among personnel as to the need to comply with this duty.

This document addresses those firms obligated under article 83 quater of the Securities Market Act, recommending that they provide the document to all employees in their

¹ CESR/04-505b and 08/274: "Market Abuse Directive - Level 3 – First/Third set of CESR guidance and information on the common operation of the Directive. 11 May, 2005/May 2008 in Public Consultation".

organisation who may participate in or contribute towards the process of detecting, analysing and, if necessary, reporting suspicious transactions.

The CNMV also considers it appropriate that the content of the document be available to investors and firms' clients; accordingly, it will promote its public dissemination.

2. ORGANISATIONAL AND PROCEDURAL CRITERIA

In compliance with article 70 ter 1 of the Securities Market Act, the procedures and policies each firm adopts in this area will depend on its size, type and activities and, except where otherwise indicated, the recommendations which follow need not necessarily apply uniformly to all firms.

With a view to confirming their suitability, the CNMV, acting within its supervisory powers, may review the operating procedures established by firms to comply with provisions of article 83 quater of Securities Market Act.

2.1 ORGANISATIONAL MATTERS

Firms must have a unit, independent of their business areas, which will assume the following functions:

- Receive all information and documentation regarding suspicious transactions detected by any of the firm's employees or departments.
- Ensure that all reports are logged, studied and evaluated on a case-by-base basis.
- Decide whether or not to file a suspicious transaction report with the CNMV.

The compliance unit is generally in an ideal position to take on these functions. Each firm is free to decide the unit to which to assign these responsibilities, depending on its size, activity and type.

The unit must have sufficient staff and material resources to satisfactorily assume its assigned responsibilities. The unit's independence to decide whether or not to report a transaction to the CNMV should be safeguarded, and directors, executives outside the unit and account managers and managers of business areas should not have any influence in this case.

2.2 INTERNAL PROCEDURES

Each firm must establish internal procedures for the detection, analysis and, if appropriate, reporting of suspicious transactions depending on the activity of each of its areas that is potentially involved in work related to suspicious transactions reporting. The procedures will include a definition of the responsibilities and duties of employees and heads of the business areas involved in the identification and analysis process, and the functions of the unit described in the previous section.

The procedures must be established in writing, must be approved by the firm's senior management and must be reviewed annually and, if necessary, must be updated by the compliance department, which will evaluate their appropriateness and effectiveness. The internal audit must also routinely check that the procedures are actually being applied.

The systems established by firms must make it possible to review the aforementioned procedures and check that they are being complied with.

It is recommendable to publicise the established procedures and query channels within the firm so that employees and executives can obtain quick, clear and consistent answers during the process of detecting and analysing a potentially suspicious transaction.

The query channels should ensure maximum confidentiality of the information that they process. In addition to the appropriate internal regulations on confidentiality, it is recommended that the analysis and reporting processes involve only those people in the organisation who are strictly necessary, avoiding as far as possible any intermediate steps that lengthen the chain of communication, unnecessarily broaden the circle of people aware of the information or prevent expeditious compliance with reporting as required by the Securities Market Act.

2.3 EMPLOYEE TRAINING

Training must be given to the firm's employees and executives who, because of the nature of their assigned duties, are in a position to detect and report suspicious transactions. In some firms, this group may include a large number of people, including those who interact directly with the client, even if they are not part of the securities or treasury departments. Employee and executive training must be based on the following principles:

- There should be exhaustive discussion of the regulation, the compulsory nature of STR, and the consequences of non-compliance.
- Emphasis should be placed on internal procedures and reporting channels.
- The training should be tailored to the type, size and operations of each firm.
- The training programmes should be tailored to each employee's functions.
- The contents should be updated in line with any regulatory changes and developments in market practices.
- Employee attendance should be monitored and employees should be evaluated regularly, as appropriate.

2.4 DETECTION VIA INFORMATION PROCESSING SYSTEMS

The CNMV believes that information processing systems used to support the systematic detection of potentially suspicious transactions could be useful in very large firms or those that engage in highly complex brokerage or portfolio management activities. However, these systems may be inefficient in smaller firms, where the detection of suspicious transactions may rely entirely on employees and the systems already in place. Therefore, each firm must decide whether these information processing systems are appropriate for its business.

Firms that opt to rely on specific systems should define the most appropriate detection parameters, depending on their size and operations, and not uncritically adopt systems specifically designed for firms of a different size or in a different field.

It is important to point out that information systems are not a substitute for the efforts of the firm's employees and executives but, rather, an additional support; it is ultimately the firm's responsibility to evaluate the reasonableness in each case. Employees in the departments involved, with their training, knowledge of the market and the client, and experience, should employ their best efforts in identifying potentially suspicious transactions.

2.5 FORMATS AND CHANNELS FOR REPORTING TO THE CNMV

The CNMV recommends the use of the CIFRADOCC/CNMV application in its electronic registry, which is available to all investment firms and credit institutions, with a view to guaranteeing confidentiality, security and speed in reporting. An exclusive process has been designed for this purpose.

For sending Suspicious Transaction Reports by any other method allowed by the Act, the CNMV has posted a standard form on its web site to facilitate the process.

STRs sent by other means should be addressed to the Secondary Markets Directorate at the CNMV.

2.6 INFORMATION AND ANSWERING QUERIES

Firms may send queries relating to STR to the CNMV's Secondary Markets Directorate.

With a view to unifying criteria to be applied in identifying and reporting suspicious transactions, the CNMV, in cooperation with firms and associations, will promote activities involving training and the exchange of experiences, such as industry and thematic workshops.

3. CRITERIA AND GUIDELINES TO APPLY IN DETECTING AND REPORTING SUSPICIOUS TRANSACTIONS

In coherence with this document, the criteria and guidelines below aim to help in the compliance with this duty, facilitating the interpretation of the applicable regulation in more complicated situations.

- a) The STR regulation requires that the persons bound by it decide in each case if there are reasonable motives for suspecting a transaction. The list of indications and signs below is not exhaustive or definitive; its goal is simply to provide a starting point. Firms bound by the regulation should apply them using common sense, taking into account the specific circumstances surrounding each case before deciding whether or not to report a transaction; it should not be interpreted literally, as some transactions that match the characteristics may be legitimate and, therefore, offer no reason to be considered suspicious.
- b) The CNMV does not consider it appropriate to establish quantitative parameters that determine when a transaction or movement in the market is unusual, atypical or suspicious. This does not prevent firms from defining and establishing internal protocols or systems that contain the aforementioned parameters to help in the detection of suspicious transactions, depending on their size, operations, types of clients, etc.
- c) The CNMV will classify general reports that are filed systematically and indiscriminately as being contrary to the regulation due to failure to consider each transaction on a case-by-case basis where there are reasonable motives for suspicion. The CNMV, like the other members of the CESR, is more interested in the quality of the reports than their quantity. It will pay special attention to those cases in which firms bound by the regulation report transactions without seriously considering if they reasonably qualify as suspicious. The CNMV also believes that the lack of suspicious transaction reports from a firm during a prolonged period, considering the size, complexity and nature of its activities, makes it advisable to conduct an internal review its procedures and policies in this area to ensure that it is complying with its obligations to report transactions of this type.

- d) Firms bound by this regulation must not only report those transactions they consider to be suspicious at the time they are made; they must also report those that they consider to be suspicious after the fact, in view of subsequent events or information (e.g. the publication of financial results or profit warnings or the announcement of a takeover bid in connection with the security in question). However, this does not mean that firms are obliged to systematically review past transactions after an event has taken place or information has come to light.
- e) Like the rest of the members of the CESR, the CNMV recommends that firms required to report suspicious transactions also report any transactions which they reject on the basis of grounded suspicions that, if executed, they might violate the regulation on market abuse. The CNMV considers point 4 of article 83 quater in Securities Market Law to be applicable to these reports; they are also subject to the CNMV confidentiality regulations rules stipulated in article 90 of Securities Market Act.
- f) The duty to report suspicious transactions applies to financial instruments (including derivatives) regulated by the Securities Market Act and, therefore, no distinctions should be made between transactions on regulated markets, other organised markets and OTC transactions.
- g) The CNMV will inform firms, periodically and on an individual basis, of the conclusions drawn from the STRs it receives, as well as observations and commentaries that might require their analysis.

4. SIGNS OF POSSIBLE SUSPICIOUS TRANSACTIONS

Without prejudice to the indications contained in Chapter I of Royal Decree 1333/2005, the non-exhaustive list of possible indications below is a starting point for the detection of suspicious transactions; they do not, however, necessarily constitute market abuse in all cases.

4.1 SUSPICIOUS TRANSACTIONS OF MARKET ABUSE

- 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).

4.2 POSSIBLE SIGNALS OF INSIDER DEALING

- a) The client opens an account and immediately gives an order to conduct a significant transaction or, in the case of a wholesale client, unexpectedly large or unusual orders 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). Among these kind of signs there can be found cases such as:

- a client who usually invests in funds or diversified portfolios, suddenly decides to sell his holdings and switches into the securities of a specific company.
- a client who usually holds his securities for long periods of time, purchases a particular security just before the announcement of inside information and sells it after the announcement.
- 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 or related third parties before the announcement of important corporate events. Consequently it constitutes a key point for the investment firms to have their knowledge of the client, his professional activities, personal and professional contacts with potential insiders.
- 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.

4.3 POSSIBLE SIGNALS OF MARKET MANIPULATION

- | a) Transactions with no other apparent justification than to increase, decrease or maintain the price of 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, including trades covered with securities loans, when they are identified as such.
- | c) Transactions which appear to have the purpose of impacting on the price of a financial instrument during the days preceding the issue of a related derivative/convertible;
- | d) Transactions which appear to be seeking to modify the valuation of a position while not decreasing/increasing the size of that position;
- | e) Transactions which appear to be seeking to increase/decrease the weighted average price of the day or of a period during the session;
- | f) 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);
- | g) 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);
- | h) When a transaction is to be concluded/executed, changing 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;

- | i) 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;
- | j) 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;
- | k) 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.
- l) Transactions whose apparent aim is to increase the trading volume of a financial instrument and, therefore, are not an accepted market practice and fall outside the framework of transactions considered under Regulation 2273/2003. Particularly sensitive periods (e.g. period for the inclusion or exclusion of a security in a selective index) where there may be incentives to artificially increase the trading volume should be considered in this connection.