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# EU Market Abuse Regulation and asset managers – six months to go

In less than six months' time, on 3 July 2016, the majority of the EU Market Abuse Regulation (MAR) regime will be law. MAR, and its associated technical standards, will sweep away the existing regime and replace it with a set of directly applicable European laws. Only certain provisions, which are dependent upon the entry into force of MiFID II (for example, those relating to organised trading facilities, SME growth markets or emission allowances), will be delayed until the corresponding provisions themselves take effect (which is likely to be on 3 January 2018).

While the new regime builds on the existing Market Abuse Directive regime, and therefore carries forward many concepts with which firms should be familiar, there are some fundamental changes and even at this late stage the Level 2 technical standards (the details in which many devils may be found) are still yet to be finalised.

It is important to note that, unlike MiFID II, none of these changes is likely to be postponed. The market has been told that they will come into effect on 3 July 2016 without fail and without any transitional relief. The FCA has given a clear warning to the industry that there will be no "regulatory forbearance" when MAR goes live.

In this briefing we focus on three broad issues relevant to asset managers in their preparations.

## SCOPE

### More instruments, more market venues

MAR will apply to a wider range of securities and derivatives admitted to trading on a broader range of markets than under the current regime:

- *New venues*: MAR will cover abusive behaviour in relation to "financial instruments" (as defined in MiFID) where those instruments have been admitted to trading not only on regulated markets but also on multilateral trading facilities (MTFs) and any "related investments" (and, as and when MiFID II becomes effective, this will be extended further to capture trading in financial instruments admitted to trading on organised trading facilities (OTFs) too) – although investments admitted to trading on certain domestic MTFs are already subject to the existing UK market abuse regime.

- *Spot commodity contracts*: abuse of the financial markets through behaviour on or in relation to the spot commodity markets will be caught.

- *Benchmarks*: behaviour in relation to benchmarks will be in the scope of the market manipulation provisions of MAR. The term "benchmark" is broadly defined meaning that MAR will go beyond the existing domestic UK regime which currently specifies only seven "relevant benchmarks" for the purposes of the criminal regime governing the making of false or misleading statements or the creation of a false or misleading impression.

- *Emission allowances*: from the entry into force of MiFID II, MAR will go further than the existing EU ETS Auctioning Regulation to capture behaviour or transactions in relation to emission allowances and other related auctioned products (including where auctioned products are not financial instruments).

### How will firms know whether an instrument is traded on a regulated market, MTF or OTF?

It follows that the range of instruments caught by the new market abuse regime will be much wider than now (and even now it is not always that straightforward to identify whether you are dealing with an in-scope instrument). To address the practical difficulties presented by a greater range of in-scope instruments and venues, the MAR regime introduces a process of notification and consolidated listing so that there is a centralised reference point.

All operators of regulated markets and MTFs will be required to notify their relevant competent authorities, without delay, of any financial instrument for which a request for admission to trading is made, which is admitted to trading or which is traded for the first time. The same obligation will apply to operators of OTFs when MiFID II comes into effect.

Having received a notification from a market venue operator, each relevant competent authority will be required to transmit that information onwards to ESMA "without delay" and ESMA will be required to publish the notifications it has received on its website. The resulting list of notifications should appear in an *electronic, downloadable and machine readable* form on the ESMA website.

It remains to be seen how well this process of notification from operator to NCA and from NCA to ESMA will work in practice, or how reliable ESMA's consolidated list will be. Article 4(2) of MAR says that the list shall not limit the scope of the Regulation, so on the face of it firms would not be protected in the event that they had obtained a "false negative" from the ESMA list because someone in the chain – operator, NCA or ESMA – had failed to notify a financial instrument as being in-scope.

Firms will need to ensure that their market abuse surveillance systems (see further below) are able to take into account additions to (and deletions from) the ESMA consolidated list from time to time.

## MARKET SOUNDINGS

A market sounding comprises the communication of information to potential investors, prior to the announcement of a transaction, in order to gauge the interest of those investors in a possible transaction and the conditions relating to it, such as its potential size or pricing. Such a sounding may be made by an issuer, a secondary offeror of a financial instrument, or a third party on the "sell side" acting on behalf of any such issuer or offeror. A market sounding may or may not involve the disclosure of inside information.

While market soundings are not new in the market, the express reference to them in EU market abuse legislation is. Market soundings are included under MAR as an explicit "defence" to the prohibition on disclosure of inside information but only if highly detailed requirements are met.

While the detailed conditions and requirements as set out in MAR and in ESMA's draft regulatory technical standards largely apply to the "disclosing market participant" (e.g. the issuer or the sell-side firm) and therefore will not, for the most part, impose direct obligations on the buy-side, asset managers as recipients of market soundings should nonetheless note the following:

- *Separate obligation on recipient to determine whether information is inside information and when inside information is "cleansed"*: Despite the obligations on the disclosing market participant, a person receiving a market sounding is required to assess for itself whether it is in possession of inside information or when it ceases to be in possession of inside information. This imposes an independent obligation on the buy-side firm, even though the sell-side firm is likely to be in a much better position to determine whether or not information is inside information.

- *Impending ESMA guidelines to recipients of market soundings*: Following on from the previous point, ESMA is expected to issue a consultation paper in Q1 2016 on guidelines for recipients of market soundings. These guidelines will address:

  - the factors that recipient firms should take into account when information is disclosed to them as part of a market sounding in order for them to assess whether the information amounts to inside information;

  - the steps that recipient firms should take if inside information has been disclosed to them in order to comply with the insider dealing and unlawful disclosure provisions of MAR; and

  - the records that recipient firms should maintain in order to demonstrate that they have complied with the insider dealing and unlawful disclosure provisions of MAR.

- *Recorded telephone lines*: MAR envisages that market soundings may be made in a number of ways: meetings, telephone calls (including video calls), fax or email. However, the draft regulatory technical standards make it increasingly likely that asset managers will be asked to receive market soundings over recorded telephone lines, especially where the sell-side firm already has access to such facilities.

- *Recipients' wishes regarding soundings*: Recipient firms have the flexibility to express their wishes as regards market soundings (either in relation to all potential transactions or particular types of transactions) and those wishes should be recorded by the disclosing market participant.

- *Contact for soundings at asset manager*: ESMA's consultation paper had suggested that there should be a designated contact point responsible for receiving sounding approaches on behalf of the recipient firm. In its Final Report ESMA dropped this proposal . However, firms should note that in its Thematic Review paper earlier this year, Asset management firms and the risk of market abuse (TR15/1, February 2015), the FCA expressed concern that most asset management firms it had sampled did not have effective policies for when inside information is unintentionally received from a conversation about a proposed wall crossing (sounding) when that wall crossing is not taken up and warned that firms should review their practices in this area. Amongst the good practice that the FCA had identified, was the establishment by some firms of an initial point of contact for soundings that was independent of the individual fund managers (enabling soundings to be rejected without sharing any information with those managers). The FCA is likely to continue to consider this to be good practice.

- *Soundings through unrecorded meetings/telephone calls*: Where a market sounding is to take place during an unrecorded meeting or telephone conversation, the disclosing market participant is required to draw up written minutes or notes of the telephone conversation/meeting. The written minutes or notes should be agreed and signed by both parties within five working days after the market sounding. Where the parties have failed to agree a single set of minutes/notes within that timeframe, the disclosing market participant should record both its signed version of the minutes or notes and the version provided by and signed by the recipient firm. Where the recipient has failed to provide the disclosing market participant with any signed written minutes/notes within five working days after the market sounding, the disclosing market participant is only required to keep its signed version. Therefore, if the asset manager disagrees with the disclosing market participant's minute or note, it is important that it provides its minute/note setting out its understanding of what was said within five working days after the sounding. The rather laborious process of drawing up minutes and agreeing them within a relatively tight timeframe may lead to more soundings taking place through recorded telephone lines (see above).

The FCA will be issuing a consultation paper on the market soundings regime early in 2016 and, as stated above, ESMA's guidelines specifically addressed to market sounding recipients are scheduled for Q1 2016.

## SURVEILLANCE, DETECTION AND REPORTING

### Establishment and maintenance of arrangements, systems and procedures: automation?

Asset managers involved in arranging or executing transactions will be required to establish and maintain effective arrangements, systems and procedures to detect and report suspicious orders and transactions.

ESMA has delivered draft regulatory technical standards to determine the appropriate arrangements, systems and procedures which firms must institute, as well as the notification templates to be used.

When it comes to *detection* of suspicious orders and transactions, the RTS provides that firms will need to have in place a system which:

- provides effective monitoring of every on- and off-market transaction executed and order placed, modified, cancelled or rejected;
- produces alerts for further (human) analysis;
- covers the full range of trading activities undertaken.

MAR itself does not mandate automation, but ESMA's view is that in the "large majority of cases" these system requirements in the RTS will necessitate an automated surveillance system; and that once a firm starts to undertake a "certain level of activity" it will be very difficult to detect suspicious orders and transactions without an automated system.

Buying and installing an automated surveillance system for an asset manager that does not already have one is likely to be a costly and time-consuming exercise, particularly for small firms. Firms will need to assess the likely volume and frequency of their trading in the future, bearing in mind the wider scope of MAR compared to the current market abuse regime in terms of instruments and trading venues. Any manual, non-automated system will have to be capable of analysing, individually and comparatively, each and every order or transaction across the range of trading activities undertaken by the firm. Such a system may be justifiable in the case of a small, single-strategy firm with limited involvement in instruments and derivatives caught by MAR. The bigger the firm and the more complex its trading strategies, the more likely that some degree of automation will be required. The system must be capable of reviewing orders or transactions across all relevant asset classes in which the firm is active and must produce alerts based on specific parameters.

Firms will need to be in a position to explain to the FCA why the level of automation they have chosen is appropriate for their business. Firms will be able to outsource monitoring, although they will retain responsibility for the outsourced function.

The quality of post-trade surveillance is a key issue for the FCA. In TR15/1 one of the FCA's findings was that firms generally need to improve the effectiveness of their post-trade surveillance. Only two firms in its thematic review sample had a post-trade surveillance programme that was considered effective in identifying market abuse. Generally the FCA found that there was some considerable room for improvement amongst asset managers. This finding, taken together with the fact that the FCA has said that there will be no regulatory forbearance when MAR takes effect, suggests that the establishment and maintenance of appropriate arrangements, systems and procedures designed to detect suspicious orders and transactions will be a high priority for the regulator.

### Human analysis and staff training

A surveillance system (automated or otherwise) is not enough by itself. Regardless of the level of automation in the surveillance system, there should always be an "appropriate level of human analysis" in the monitoring, detection and identification of potentially abusive orders and transactions.

In addition, a firm's arrangements and procedures must include "comprehensive training genuinely dedicated to monitoring, detecting and reporting suspicions of market abuse or attempted market abuse". Firms will need to ensure that their existing training programmes are updated in anticipation of MAR and rolled out to all relevant members of staff so that they are capable of identifying suspicious behaviour.

### STORs

Where the firm has a reasonable suspicion that an order or transaction in any financial instrument, whether placed or executed on or outside a trading venue, could constitute insider dealing or market manipulation (or an attempt at either offence), the firm must notify its relevant competent authority without delay.

There are a number of points to note arising out of this obligation:

- In an extension to the existing regime, firms will be required to report suspicious "orders" as well as "transactions". Consequently:
  - the existing STRs will be replaced by Suspicious Transaction and Order Reports (STORs) – a template will be provided;
  - there will be an explicit obligation to report suspicions in relation to orders, even if they do not proceed to execution (e.g. because of an IT breakdown or a refusal to act on an instruction to trade), as well a requirement to report transactions that "could" constitute market abuse or attempted market abuse.
- The obligation to submit STORs extends to suspicions arising in the context of OTC derivatives trading, where the underlying instrument is traded on a regulated market or an MTF (or, when MiFID II becomes effective, an OTF).
- STORs must be used to report not only suspicious orders and transactions but also the cancellation or modification of such transactions and orders.
- STORs should be made "without delay" once a reasonable suspicion has formed. This does not mean that firms are at leisure to ponder the circumstances in determining whether or not there is a suspicion. ESMA's view is that, where some kind of preliminary analysis of the facts is required, this should be conducted as quickly as possible. This will no doubt be FCA's view too.
- The fact that STORs should be made "without delay" also means that firms should not wait for a "critical mass" of suspicious orders or transactions to accumulate before reporting; the obligation applies in relation to each reasonable suspicion as it arises.
- Even if there was no reasonable suspicion at the outset, STORs should be made if subsequent events or information cause a suspicion to arise some time after the order is placed or transaction executed.

The FCA is in the process of building a platform for the receipt of STORs which should be up and running in time for the July "go live" date.

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