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Financial Services and Markets

MAD 2 and MAR: Overhaul of the European Market Abuse Regime

On 20 October 2011, the European Commission published its long-awaited formal legislative proposal for new EU laws to replace the Market Abuse Directive ("MAD"), which dates from 2003. The changes will now be negotiated between MEPs and Member States before being finalised and are expected to be implemented in Member States some time in 2014. Although the proposals are wide-ranging, for those familiar with the current regime applicable to the UK equity and UK debt markets there will be only a few really significant changes. Other UK and EU markets and trading venues, and particular types of market participant, will be affected more profoundly.

New laws and yet more acronyms

- The principal new EU law will take the form of a Regulation ("MAR"). MAR will have direct effect in the UK and other Member States without needing to be implemented through domestic legislation. This is therefore the latest in a series of "EU rule books", which will confer considerable powers on the European Securities and Markets Authority ("ESMA"), based in Paris. In relation to these new rules, the UK FSA will be only a supervisory and enforcement authority: it will have little opportunity to adopt its own interpretation. MAR requires Member States to bring the possible penalties for the "civil offences" of market abuse up to minimum levels, including fines of up to €5m for individuals and 10% of turnover for firms (or their groups). ESMA guidelines will specify in some detail the factors which must be taken into account when deciding on a penalty. An earlier proposal for mandatory minimum fines has been deferred pending a review by the European Commission around 2016.

- Alongside MAR, a new Directive ("MAD 2") will require Member States to introduce criminal sanctions for intentional market abuse. The UK is in a privileged position (as is Ireland) of being able to choose whether to opt in to the Directive, because of special provisions in the Lisbon Treaty relating to its criminal laws generally. The UK already has a criminal offence of insider dealing, under the Criminal Justice Act 1993 ("CJA"). If it were to opt in, Parliament would need to amend the CJA: a new offence of criminal market manipulation would need to be introduced (to cover, for example, price positioning and effecting abusive squeezes). In addition, the existing criminal offence of insider dealing would need to be adapted, for example to extend it so that it applies to undertakings as well as natural persons and extends to a broader range of inchoate offences. In the current climate, it is likely that the UK Government will make these changes.

- MAR and MAD 2 need to be read alongside not only MiFIR and MiFID2 but also the new European Regulation on short selling and credit default swaps, on which the EU institutions reached political agreement last week, and which we expect to be voted into law by the European Parliament very soon. That Regulation is expected to come into force sooner than this package of measures, most likely in November 2012.

- Many of the changes brought about by MAR have been long trailed. The European Commission consulted on revisions to MAD in summer 2010. Please refer to our briefing here. This note does not repeat explanations given in that earlier paper.

Significant changes for firms dealing in the UK equity and UK debt markets

- The most contentious proposal is to extend the definition of "inside information" to information, not public, that a reasonable investor would regard as relevant *when deciding the terms of a transaction*. If that test were met, it would not be necessary to show that the information was also: (a) precise; or (b) expected to have a significant effect on the price of the relevant instrument. This is a wholly new test, setting a much lower threshold. A vast range of information could fall within this concept: those who are "inside" in relation to a company will often be in possession of "relevant" albeit not price sensitive information. It appears, though, that issuers are not to be put under any obligation to disclose an equivalent category of information to the market, which will prompt questions about market efficacy, such as how those in possession of this new

type of information will ever be cleansed of it. This is a very significant change, not trailed in the summer 2010 consultation process. It is likely to be the subject of extensive lobbying.

- Another key change is to increase significantly the number of instruments in relation to which the regime will apply. Foremost amongst them are securities listed on non-EU markets but tradable on MTFs, such as Chi-X and BATS, and derivatives of such securities. Compliance officers have in the past struggled to identify all instruments within the scope of the overlapping market abuse regimes, and their job will only get harder.

    - At the moment, MAD applies to instruments tradable on EU regulated markets, those in respect of which an application for admission to trading has been made, and derivatives of them.

    - UK law extends this to instruments tradable on selected other markets, such as AIM, and their derivatives.

    - MAR will extend further to instruments tradable on any EU multilateral trading facility (MTF) (of which AIM is an example) or tradable on a new breed of organised trading facility (OTF) to be regulated by MiFID 2, and derivatives of those. This will include many additional EU trading venues.

    - In addition, as MiFIR extends the range of venues which are regulated, many more derivatives previously traded entirely OTC will come into scope in their own right (i.e. even if the underlying is not a tradable instrument).

- Finally, *attempting* to manipulate markets will become an offence for the first time.

Same old themes, same old uncertainties

- In our "Market Abuse Round-up" of July 2010 (available here), and in advising clients and training their staff, we have been drawing attention to several themes, and several points of uncertainty. MAR reinforces many of those themes but does little to bring certainty. For example:

    - *Inside information – significant effect on price* The FSA takes the view that it may not be necessary for any movement in price to be expected if the information is of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions. As currently drafted, MAR doesn't resolve the debate about whether that interpretation is correct. However, that debate may become irrelevant in light of the new test for inside information summarised above, if that new test survives legislative scrutiny.

    - *"On the basis of"* In the Spector Photo case, the European Court of Justice concluded (in effect) that it may be presumed that a person who trades whilst in possession of inside information has used it. Although the presumption is rebuttable, this has cast a shadow over some market practices, such as formulaic trading, setting an explicit dealing strategy before coming into possession of inside information, or dealing where the expected market impact is counter-directional. As drafted, MAR is unlikely to resolve concerns in this area.

    - *Information barriers* MAR creates a new defence to insider dealing where the information has been held on the other side of an effective information barrier (or Chinese wall). The standard of "effectiveness" will continue to be difficult to meet because MAR contemplates that there must be no contact "whereby the information *could have been* transmitted or its existence *could have been* detected" (our emphasis). This challenge was evidenced, for example, in the April 2010 FSA Final Notice concerning Robin Chabbra.

    - *Enforcement* MAR continues the trend towards higher, truly dissuasive, penalties for market abuse (see above). There will also be mandatory cooperation between supervisors and enforcement authorities, to be coordinated by ESMA.

- In the UK, there will continue to be several overlapping regimes relating to market conduct:

    - These new laws will compel the UK authorities finally to abolish those UK domestic definitions of abusive behaviour which "gold-plated" MAD. One of the authorities' concerns behind the gold-plating was that behaviour off-market which had an effect on instruments traded on a market should be caught (e.g. behaviour in relation to the private debt of a company which also has traded bonds). The UK authorities are likely to be relaxed about removing the gold-plating because MAR (in contrast to MAD) will largely conform EU law to the broader UK tests.

    - On the other hand, it not obvious that MAR will prevent the proposed new UK financial markets regulator – the Financial Conduct Authority – from carrying forward the FSA's "market conduct principle". This requires UK FSA authorised firms to observe proper standards of conduct in markets outside the technical scope of EU law (such as the informal markets for private debt). The FSA has used the principle as a catch-all and as a safety net, and the FCA is likely to wish to do the same.

    - In addition, there will continue to be a criminal regime as well as a civil regime.

- The territorial scope of MAR is expressed to include behaviour anywhere in the world which concerns EU-traded instruments. This has long been the effect of the UK regime in practice.

Effects on particular markets, and particular types of market participant

Commodities and emissions allowances

- Amongst the highest profile changes are the extension of the EU market abuse regime to emissions allowances, and changes in relation to commodity markets.
    - The market manipulation regime will be extended to behaviour in relation to spot commodity contracts where (as presumably in many cases) that behaviour could affect financial instruments (such as futures) admitted to trading in the EU.
    - As widely trailed, MAR will abolish the special test for "inside information" applicable to commodities and harmonise it with that applicable to securities (as modified in the ways described above). We examined this in more detail in our earlier note. An uncertainty we identified then appears not to have been addressed: how will this new regime work in practice in relation to commodity markets which have few requirements for the regular disclosure of information?
    - In respect of the extension of the regime to emissions allowances, though, that same concern is addressed: participants in emissions allowances markets who have inside information about allowances they or their affiliates hold will be obliged to make that information public.

HFT and algorithmic traders

- High-frequency and algorithmic traders will wish to note (although shouldn't be surprised by) a new evidential provision that, if they send orders to a market for the purpose of: (a) disrupting or delaying the trading system; or (b) making it harder to identify genuine orders (as opposed to where they have a genuine intention to trade) they will be presumed to be manipulating the market.

Issuers, their advisers and brokers

- Senior managers of companies listed in the EU, and their advisers and brokers will wish to note proposed changes (some in MAR, some to be developed by ESMA in technical "implementing measures") relating to:
    - the extent of the reporting obligations imposed on senior managers relating to transactions in their company's securities;
    - the scope of obligations to maintain insider lists (restricted in respect of certain SME issuers);
    - reporting clients' suspicious orders (as well as suspicious transactions); and
    - the content of research disclosures.

  We will report on these topics separately as the proposals develop.

Links

The legislative proposal for MAR can be found here.

The legislative proposal for MAD 2 can be found here.

Supporting documents, including press releases, FAQs and impact assessments can be found here.

For further information on these issues please contact one of the following partners in our Financial Services and Markets department or your usual contact at Travers Smith.

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