

Insight: Regulatory

October 2011

The European Commission publishes legislative proposals for a new criminal and civil market abuse regime

Adopted in January 2003, the Market Abuse Directive (MAD) 2003/6/EC, together with other implementing legislation, established an EU-wide framework for preventing and tackling market abuse. The European Commission embarked on a review of MAD in 2010, culminating in the publication of legislative proposals on 20 October 2011. These consist of a draft Regulation (the "Regulation"), which sets out a revised and harmonised civil market abuse regime and ancillary requirements, and a draft Directive ("MAD 2"), which contains a new criminal market abuse regime. The existing directive, MAD, will be repealed in its entirety.

The Commission's legislative proposals for a new market abuse regime have to be considered also in conjunction with its parallel proposals, published on the same day, for a revised Markets in Financial Instruments Directive (MiFID II) and an accompanying Markets in Financial Instruments Regulation (MiFIR). These would introduce a wider set of trading venues, including, apart from regulated markets and multilateral trading facilities, so-called organised trading facilities. MAD 2 and the Regulation would create civil and criminal offences in relation to securities that are admitted to trading on any of these MiFID II trading venues. MAD 2 and the Regulation would also track the anticipated wider scope of MiFID II, which would treat emission allowance certificates as financial instruments.

This client note explores the main changes to MAD envisaged by these legislative proposals.

The proposed civil market abuse regime and requirements for the protection and disclosure of inside information

The proposed Regulation would replace MAD. It covers similar ground but broadens the scope of the civil market abuse framework, adjusts the insider dealing and market manipulation offences as well as the requirements for the protection and disclosure of inside information and enhances the powers available to competent authorities.

Scope extensions

Extending the civil market abuse regime to other trading platforms and certain OTC transactions

MAD applies to financial instruments admitted (or subject to an application for admission) to trading on regulated markets, wherever the trading actually occurs. The scope of the proposed Regulation extends also to instruments admitted (or subject to an application for admission) to multilateral trading facilities and, in the wake of the legislative proposals for MiFID II, organised trading facilities.

The proposed Regulation would additionally cover certain related instruments, for example derivative instruments for the transfer of credit risk relating to traded securities (for example credit default swaps), even if traded only over the counter. This goes beyond MAD, which applies to related instruments only in connection with the insider dealing provisions, not the market manipulation provisions.



For more information please contact:

Stuart Willey
**Counsel, Head of the London
 Regulatory Practice**
 + 44 20 7532 1508
 swilley@whitecase.com

Carmen Reynolds
Partner, London
 + 44 20 7532 1421
 creynolds@whitecase.com

White & Case LLP
 5 Old Broad Street
 London EC2N 1DW
 Tel: + 44 20 7532 1000
 Fax: + 44 20 7532 1001

This publication is prepared for the general information of our clients and other interested persons. It is not, and does not attempt to be, comprehensive in nature. Due to the general nature of its content, it should not be regarded as legal advice.

Capturing market abuse that cuts across commodity derivatives and related spot markets

MAD applies to financial and derivatives markets, but not to the related spot markets. The proposed Regulation seeks to capture conduct which cuts across the derivatives and underlying spot markets. It broadens the definition of inside information in relation to commodity derivatives to take account of connections between such derivatives and the related spot commodity contracts. It also extends the definition of market manipulation to cover transactions in the derivatives markets which serve to manipulate related spot markets and, conversely, transactions in the spot market which manipulate the derivatives market.

Treating emission allowances as financial instruments

MiFID II includes emission allowances recognized under the Emissions Trading Scheme Directive (2003/87/EC) in its definition of financial instruments. As a result, they would fall within the scope of the proposed Regulation. In fact, the Regulation makes specific reference also to the process of auctioning emission allowances in its description of insider dealing and market manipulation. However, emission allowances have special features, including that they are issued by public authorities implementing the EU's climate policies. The Regulation places obligations to publicly disclose inside information and maintain insider lists relating to emission allowances on each emission allowance market participant, subject to a threshold, rather than on the issuers of allowances. The threshold is to be specified by the Commission in a delegated act but is likely to exempt market participants from these obligations if their activities do not have a material impact on the price formation of emission allowances. The intention appears to be to place market disclosure obligations only upon the largest emitters in the EU Emissions Trading Scheme rather than upon firms that may merely trade allowances.

Insider dealing

Broadening the definition of "inside information"

MAD defines inside information as precise and non-public information which would be likely to have a significant effect on the prices of relevant financial instruments.

The proposed Regulation would broaden the definition of 'inside information' to also include non-public information which would be regarded as relevant by a reasonable investor who regularly deals on the market and in the financial instrument or a related spot commodity derivative contract when deciding the terms on which transactions in financial instruments or related spot commodity contracts should be effected. This new limb of the definition does not include any express references to precision and price-sensitivity, thus making it potentially easier for competent authorities to show that information amounts to inside information and hence, that an insider dealing offence has been committed.

Issuers will be interested in how this modified definition might affect their obligation to disclose inside information. On the one hand, the proposed Regulation states that the disclosure obligation does not extend to the proposed new limb of the definition of inside information. On the other, in determining whether information is price-sensitive for purposes of the familiar limb of the definition of inside information, issuers would have to consider whether it is information which a reasonable investor would be likely to use as part of the basis of his investment decision. The proposed provisions leave the position somewhat unclear. However, it would appear that information to be disclosed by issuers must at least be of a sufficiently precise nature, as required by the familiar limb of the definition of inside information.

Clarifying the scope of the insider dealing offences

Like MAD, the proposed Regulation prohibits dealings and attempted dealings on the basis of inside information, recommending or inducing another person to engage in insider dealing and improper disclosure of inside information. The Regulation also clarifies that insider dealing includes the use of inside information to cancel or amend an order in a financial instrument.

Taking into consideration Chinese walls

Under the proposed Regulation a firm would not be treated as engaging in insider dealing if it put in place Chinese walls and other effective arrangements to ensure that no person in possession of inside information had any involvement in the relevant transaction or could have transmitted the inside information to those involved.

Market manipulation

Broadening the definition of market manipulation

The proposed definition of market manipulation covers (a) any transactions, order or other conduct which is likely to give false or misleading signals or secure the price of instruments at an artificial level, (b) any transactions, order or other conduct which employs a fictitious device or any other form of deception or contrivance and (c) dissemination of information known to be false and misleading which has the impact described under (a). This is slightly broader than the definition of market manipulation under MAD, which, in connection with (a) and (b) above, refers only to transactions and orders. In addition, unlike MAD, the Regulation would prohibit attempts to engage in market manipulation. Finally, the Regulation does not offer the possibility of a defence on the basis of accepted market practices.

Addressing market manipulation through algorithmic trading

The definition of market manipulation in MAD captures conduct regardless of whether traditional or algorithmic trading strategies are followed. The proposed Regulation adds examples of how algorithmic and in particular high-frequency trading strategies could be used to commit market abuse, for example by layering or quote stuffing.

Protection and disclosure of inside information

Informing the competent authority about decisions to delay the disclosure of inside information

Under MAD, an issuer of financial instruments must inform the public as soon as possible of inside information which directly concerns it. However, an issuer may delay this disclosure in certain circumstances. The Regulation would require an issuer to notify their competent authority of any such decision to delay the disclosure of inside information as soon as the disclosure is made. This would facilitate any subsequent investigation by the competent authority of the issuer's conduct and, specifically, the decision to delay disclosure.

Adapting disclosure requirements for issuers admitted to trading on SME growth markets

The proposed Regulation would adjust the disclosure requirements for issuers admitted to trading on SME growth markets. Inside information relating to such issuers could be published by SME growth markets on their behalf. Such issuers would also be exempt from the requirement to maintain insider lists, but might still have to provide such a list to their competent authority on request.

Introducing a threshold for managers' transaction reporting

Currently, persons discharging managerial responsibilities within an issuer and persons closely associated with them must make public information about their transactions in shares of the issuer or related financial instruments. The Regulation clarifies that such transactions would also include the pledging or lending of financial instruments by such persons or transactions undertaken by a portfolio manager or other intermediary on behalf of such persons.

The Regulation would introduce a threshold of EUR 20,000 below which managers' transactions would not need to be reported. This would tend to reduce compliance costs.

Suspicious transactions

Consistent with its wider scope, the proposed Regulation would require any person operating a trading venue to maintain effective arrangements and procedures in accordance with MiFID II aimed at preventing and detecting market manipulation practices. Any material distinction between the monitoring systems and controls to be maintained by regulated markets, multilateral trading facilities and organised trading facilities would be removed. Also, any person professionally arranging or executing transactions in financial instruments would have to establish systems to detect and report orders and transactions that might constitute actual or attempted insider trading or market manipulation.

Investigative and sanctioning powers of competent authorities

Enhancing investigative powers

The Regulation would strengthen the investigative powers available to competent authorities. Where a reasonable suspicion exists that this may be relevant to prove insider dealing or market manipulation under the Regulation or MAD 2, they could (a) with prior authorisation from the national courts, enter private premises to seize documents; and/or (b) require existing telephone and data traffic records held by telecommunications operators or investment firms. In relation to derivatives on commodities, the proposed Regulation expressly authorises competent authorities to request information from market participants on related spot markets according to standardized formats, obtain transaction reports and access traders' systems.

Encouraging whistleblowing

Member States would have to establish procedures to facilitate the reporting of breaches of the Regulation while affording appropriate protection to whistleblowers. Member States could additionally offer financial incentives to whistleblowers in certain circumstances.

Imposing effective and dissuasive sanctions

As under MAD, Member States would have to impose effective, proportionate and dissuasive sanctions for breaches of the Regulation. The Regulation would require Member States to apply certain criteria when determining sanctions, including the profit made or loss avoided as a result of the breach. Sanctions at the disposal of competent authorities should at least include, among other things, "naming and shaming"; withdrawal of authorisation of an investment firm, temporary prohibition on exercising functions in investment firms, suspension of trading of financial instruments, the freezing or sequestration

of assets and fines. Fines could be up to twice the amount of the profits gained or losses avoided because of the breach where those can be determined and, in any case, up to EUR 5 million¹ in respect of a natural person (i.e. an individual) or up to 10% of turnover in the preceding business year in respect of a legal person such as a firm. Member States may provide for additional sanctions and higher levels of fine. ESMA will issue guidelines to competent authorities on sanctions and levels of fines.

Enhanced cooperation

MAD already obliges competent authorities to cooperate in tackling market abuse. MAR would additionally require cooperation with the regulatory authorities responsible for the spot markets underlying commodity derivatives markets. MAR would also call on competent authorities to develop cooperation arrangements with their counterparts in third countries to ensure at least an efficient exchange of information.

ESMA would assume a coordinating role and develop implementing technical standards for this purpose.

The proposed criminal market abuse regime

MAD neither imposed criminal sanctions for market abuse nor prevented Member States from doing so. MAD 2 would lay the foundation for a more harmonised approach in this area, with a view to ensuring that the civil market abuse regime set out in MAR is supplemented by a criminal market abuse regime.

Criminal market abuse offences

Insider dealing and market manipulation

MAD 2 would create the criminal offences of insider dealing and market manipulation. Their actus reus is quite similar to that of the civil offences set out in the proposed Regulation, but they also have a mens rea element. I.e. they need to be committed intentionally.

¹ This figure appears in square brackets in the legislative proposal and may be subject to change.

Inchoate offences

Attempts to commit certain forms of insider dealing (other than through improper disclosure of inside information) or market abuse (other than through dissemination of information which gives false or misleading signals) would amount to criminal offences.

Secondary offences

Inciting, aiding and abetting the criminal offences of insider dealing and market abuse would also be punishable as a criminal offence.

Persons capable of committing the market abuse offences

The criminal market abuse offences could be committed by natural persons as well as, in some circumstances, legal persons. In particular, subject to certain conditions, a legal person could be held liable where criminal market abuse offences are committed for their benefit by or under the supervision of a person with a leading position within the legal person.

Criminal sanctions

MAD 2 would merely require Member States to ensure that the sanctions for the criminal market abuse offences are effective, proportionate and dissuasive. That leaves considerable discretion to Member States. However, the Commission would report to the European Parliament and the Council on the application of MAD 2 within four years after its entry into force. The report should consider whether it is appropriate to introduce common minimum rules on types or levels of criminal sanctions or otherwise review MAD 2. This would present an opportunity for the Commission to submit a suitable legislative proposal.

Timeline

Under the ordinary legislative process, the proposed Regulation and MAD 2 would pass into law if approved by the European Parliament and the Council. This might be achieved by the end of 2012. However, it would take another two years² for the Regulation to become fully applicable and for MAD 2 to be implemented by Member States.

Impact on national legislation

It remains to be seen how the Regulation and MAD 2, once adopted, will be reflected in national legislation.

The proposed Regulation will be directly applicable in member states of the EU and will not require any separate national implementation. The Regulation is intended to be part of a new European Rule Book which is maximum harmonising, leaving little or no scope for national discretion, except perhaps as expressly provided for, for example in connection with sanctions. According to recital (4) of the proposed Regulation, there is *"a need to establish a uniform framework in order to preserve market integrity and to avoid potential regulatory arbitrage as well as to provide more legal certainty and less regulatory complexity for market participants."* As a result, some of the detail of national market abuse regimes and ancillary requirements would fall away. In the UK, this would include, among other things, the Code of Market Conduct (at least in its current form) and the useful guidance it contains. The proposed Regulation envisages that delegated acts and implementing technical standards will need to be adopted to amplify the framework it sets out.

MAD 2 would give Member States greater flexibility in relation to criminal market abuse. However, as mentioned, this would be subject to a subsequent review by the Commission.

Concluding Remarks

The Commission's stated aim is to establish a more harmonised market abuse framework in the EU. The impact would vary across Member States, depending on the market abuse regimes and regulatory requirements currently in place.

The legislative proposals certainly represent a step change relative to MAD. In particular, they recognize a wider range of financial instruments and trading platforms, the connections between commodity derivatives market and the underlying spot markets and the status of emission allowances as financial instruments.

The definitions of the market abuse and insider dealing offences are also broadened. The proposed changes to the disclosure regime are pragmatic attempts to achieve incremental improvements.

Finally, the legislative proposals seek to address concerns that investigative and sanctioning powers available to some competent authorities may not be sufficient to deter market abuse. They aim to facilitate detection of market abuse while ensuring that effective civil or criminal sanctions could be imposed where appropriate.

In the long term, a harmonised EU-wide market abuse framework has the potential to mitigate the risk of insider dealing and market manipulation and thus to enhance market confidence. In the short term, however, the legislative proposals increase legal uncertainty as much of the details remain to be worked out.

² This timeline is specified in square brackets in the legislative proposals and may be subject to change.