Lifting the lid on MAR

The latest consultation paper from ESMA raises some important questions about the market abuse regulation (MAR) but lacks detail in some crucial areas, **Stuart Willey** explains.

On October 3, 2019, the European Securities and Markets Authority (ESMA) published a consultation paper that raised questions about the scope and operation of the Market Abuse Regulation—Regulation 596/2014 of the European Parliament and of the Council.

The background on the paper is Article 38 of MAR, which requires the European Commission to submit a report to the European Parliament and to the Council on the application of MAR together with amending legislative proposals. The focus is therefore on the Level 1 text of MAR and on identifying potential fixes to any problems in that text. To facilitate this, the Commission issued a formal request to ESMA to provide technical advice on a range of points, some of which are contemplated by Article 38 and other additional non-mandatory elements. The Commission issued its mandate to ESMA in March 2019 and asks for ESMA's advice by December 31, 2019. ESMA invited comments on its paper by November 29, 2019.

Spot FX contracts

Possibly the most significant point in the paper is the suggestion that the scope of MAR should be widened to include spot FX contracts. The impetus for this lies in the historic cases of misconduct that occurred in the G10 spot FX market and the resulting public fines imposed on market participants both in Europe and in the US. Some of those improper behaviors involved, for example, the actual or attempted manipulation of FX benchmarks and, as the paper says, such misconduct would in theory be capable of being assimilated into the MAR regime.

The paper reaches no clear conclusion or recommendation but notes a number of factors that would argue against extending the MAR regime to include spot FX contracts:

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- The spot FX market is predominantly an over-the-counter (OTC) market and does not have the characteristics that would enable it easily to fit within the MAR framework
- The concept of "issuer," which is central to many MAR requirements is not present and hence would not fit the spot FX market
- It is not clear that extending MAR to include "spot" FX contracts in the same way as spot commodity contracts would be practicable, for example, expanding the prohibition of market manipulation to cases where a spot FX transaction has an effect on the price or value of a financial instrument. One constraint is that the impact of FX price changes could be very widespread and distinguishing price movements that result from manipulative FX contracts would be very difficult
- The sheer volume of FX spot contracts could make regulatory monitoring an impossible task and
- A significant proportion of the market from 16 countries has already signed up to the FX Global Code of Conduct and it may be desirable to see how compliance with the Code is helping to prevent misconduct

On balance, it would appear that ESMA's current approach is leaning against the inclusion of spot FX contracts, but this is clearly a possibility that needs monitoring given its huge potential significance.

ESMA published a consultation paper on the scope and operation of MAR

Definition of "inside information"

Inside information

According to the definition of MAR, all inside information must be of a precise nature, not be public and, if it were made public, likely to have a significant effect on the prices of relevant financial instruments.

ESMA raises some very general and high-level comments and questions about the adequacy of the definition of inside information in Article 7 of MAR. One such question is whether market participants have encountered difficulties in identifying what constitutes inside information for the purposes of MAR.

ESMA does not specify what those difficulties might be, but for market participants they would include when information is deemed sufficiently "precise" and what is meant by it having a "significant effect" on the prices of relevant financial instruments.

Given the paper's very high-level treatment of and lack of transparency about these important questions, market participants may be reluctant to offer any specific recommendations for changing the basic building blocks of the regime.

Commodity derivatives

In relation to commodity derivatives, MAR says that as well as being precise and sufficiently price sensitive, "inside information" must also be reasonably expected to be disclosed or required to be disclosed in accordance with "legal or regulatory provisions at an EU or national level, market rules, contract, custom or practice on the relevant commodity derivatives markets."

One example of such information is the Joint Organisations Database Initiative for oil & gas. ESMA says that

the additional criterion attaching to the definition of inside information in the case of commodity derivatives is anomalous because a listed commodity producer may be prohibited from disclosing trading information to others (because of the potential impact of the use of the information on, say, the price of the producer's listed securities) whereas a non-listed commodity producer would not be so constrained.

It would appear that any change in the definition of inside information in relation to commodity derivatives and spot commodities would nevertheless need to somehow respect the ability of commodity producers to trade on the basis of knowledge of their own trading intentions and strategies as currently contemplated by Recital 30 of MAR.

Pre-hedging

The paper asks some questions about pre-hedging practices: What market abuse or conduct risks arise from pre-hedging? What benefits flow to firms, client and the market generally?

ESMA appears to have a concern that pre-hedging by brokers following a request to quote may go beyond protecting the broker's legitimate interests and may be used to position a market price against the client and in favor of the broker.

ESMA says clients should be made aware of a broker's ability to pre-hedge a transaction. The paper acknowledges that there is a clear cross-over with other obligations imposed on brokers under MiFID II concerning the management of conflicts, handling client orders and the duty to act in the client's best interests.

Given the very open and high-level nature of ESMA's questions, it is unclear how far it will go in recommending changes to MAR that would clarify in what circumstances pre-hedging amounts to market abuse.

Insider lists

According to MAR, insider lists serve different purposes: they contribute to protect market integrity by allowing NCAs to identify who has access to inside information and by stating the specific date and time on which a piece of information became inside information, and also the date and time when the relevant persons gained access to it. Additionally, insider lists should be helpful for issuers to manage the flows and confidentiality of inside information.

ESMA is concerned that insider lists have suffered "inflation," as issuers and their external service providers have included individuals who in theory might access inside information but who in practice do not do so. They are similarly concerned that lists of permanent insiders extend beyond individuals who have access to all inside information at all times.

The maintenance of insider lists is already administratively onerous, and proposals that might add to the burden placed on issuers need to be weighed alongside the benefit to national competent authorities (NCAs) of, for instance, permanent insider lists being restricted to a few individuals who can be said to have access to all information at all times.

ESMA is also considering whether the obligation in MAR to draw up and maintain an insider list should be extended beyond the issuer and persons acting on their behalf or on their account to include persons performing tasks through which they have gained access to an issuer's inside information. Examples of such other persons include auditors and notaries, but the drafting of any changes to MAR could capture categories of persons such as law firms that are mandated in a transaction to represent banks (but not the issuer).

Competent authorities, market surveillance and cooperation

The paper refers to so-called dividend arbitrage strategies and highlights schemes that involve transactions aimed at creating circumstances that allow persons to obtain refunds on dividend tax that was not paid and that may involve fraud.

ESMA's investigations revealed that such schemes may not involve any violations of MAR, and national competent authorities may have no powers to investigate. ESMA suggests that such tax evasion schemes or improper tax reclaim schemes resulting from trading securities may impact "market integrity" and hence recommends that MAR should be amended to require that NCAs have powers that would enable them to investigate and take action in respect of unfair behaviors that—while not amounting to market abuse—could potentially impact the integrity of the market.

ESMA also recommends that all NCAs in Europe should be given the power to share information with tax authorities, if necessary on a cross-border basis.

Such changes would represent a significant and open-ended extension of investigative and sanctioning powers for regulators. Giving all financial regulators the express power to share information with tax authorities represents a potentially important development.

ESMA's advice to the EC on the implementation of MAR is due by December 31, 2019

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