WHITE & CASE

Insight: Capital Markets

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The New European Market Abuse Rules – Looking Towards 2016

Overview

Significant changes to the European laws on market abuse are due to come into effect in July 2016. On implementation, the new measures will replace the four current European directives on market abuse.

This Insight looks at the main changes being made, as follows:

- a new European Market Abuse Directive (**MAD 2**)[1] introduces a pan-European **criminal regime** for "serious cases" of market abuse
- a new Market Abuse Regulation (**MAR**)[2] covers other cases of market abuse
- Both legislative measures extend to:
  - a wider range of markets and types of issuer than under the current European law, including SME markets and issuers
  - Cross-manipulation of spot commodities markets
  - Certain high frequency/algorithmic trading strategies
  - Benchmark manipulation
- MAR creates a new regime relating to the taking of market soundings. This will be highly relevant to issuers and their advisers as well as buy-side firms which are sounded out

The legislation also covers all areas currently covered by the existing market abuse directives, including insider dealing, improper disclosure of inside information, market manipulation, stabilisation and share buy backs, timely disclosure of inside information, insider lists, transactions by Persons Discharging Managerial Responsibilities (**PDMRs**), analysts' independence/conflicts of interest, suspicious transaction reporting and off-market trades.

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1 Directive 2014/57/EU on Criminal Sanctions for Market Abuse

2 Regulation (EU) No 596/2014 on Market Abuse

Timeline

The key milestones are as follows:

12 June 2014	MAD 2 and MAR were published in the Official Journal of the European Union
2 July 2014	MAD 2 and MAR entered into force
3 February 2015	The European Securities and Markets Authority (**ESMA**) published technical advice to the European Commission on delegated acts to be adopted by the Commission. The advice addressed, amongst other things, the specification of indicators of market manipulation; notification requirements for PDMR transactions and PDMR trading in a closed period
3 July 2015	The date by which draft technical standards are to be submitted by ESMA to the Commission. The standards will cover buy-backs and stabilisation, market soundings, suspicious order and transaction reporting, insider lists and the technical means for the disclosure of inside information. ESMA issued a consultation paper on these draft standards in July 2014
TBC	ESMA will produce guidelines: (i) covering issues related to the receipt and handling of inside information by market sounding recipients, and (ii) concerning the delayed disclosure of inside information
July 2015 onwards	National regulators likely to consult on changes to local laws necessitated by the new provisions
August 2015	Anticipated date for the UK Financial Conduct Authority (**FCA**) consultation on rule changes
3 July 2016	The date by which further draft technical standards must be submitted by ESMA to the Commission, covering procedures and forms for cooperation and information sharing between Competent Authorities and ESMA
3 July 2016	Implementation date for most of MAD 2 and MAR
3 January 2017	Implementation date for certain provisions of MAD 2 and MAR relating to organised trading facilities, SME growth markets and emission allowances, effectively to tie in with implementation of the new Markets in Financial Instruments Directive (**MiFID 2**)

Impact on English Legislation and Financial Conduct Authority Rules

Although the UK has opted out of MAD 2, which requires criminal sanctions for serious cases of market abuse, the Government has indicated that the English criminal law framework will be amended to ensure, as a minimum, coverage of the scope of MAD 2. In addition, the joint consultation review of wholesale market regulation launched by HM Treasury, the Bank of England and the FCA in 2014 may lead to further English legislative changes.

It is anticipated that changes to the Financial Services and Markets Act 2001 (**FSMA**) and statutory instruments made under it, along with current FCA Rules, will need to be made to reflect the new European regime. Since MAR is a Regulation, it has direct effect in EU/EEA member states. Consequently, significant portions of Chapters MAR and DTR of the FCA's Handbook will need to be amended or removed from the Handbook and it is currently anticipated that the FCA will be consulting on these changes in August 2015, after publication of the technical standards. It is expected that corresponding changes will need to be made to the London Stock Exchange's Alternative Investment Market (**AIM**) Rules as shares traded on AIM will fall within the scope of the MAD 2 and MAR regimes.

Criminal Regime Under MAD 2

MAD 2 introduces a new mandatory EU/EEA criminal regime for "*serious cases*" of market abuse which are *"committed intentionally"*. Insider dealing, improper disclosure of inside information and market manipulation are all addressed by MAD 2, which specifies that market manipulation carried out by a person working in the financial sector will be deemed to be serious.

Trading both on and off market is covered by MAD 2. Also, legal persons must be capable of being held liable for market abuse offences under the Directive where the market abuse has been conducted by a person having a leading position within the organisation or where the lack of supervision or control by such a natural person has made the commission of an offence possible.

A Wider Range of Markets, Issuer and Instruments

MAD 2 and MAR apply to a wider range of markets and issuers than the existing regime. The main extensions of scope are as follows:

Markets and issuers	MAD 2 and MAR apply to financial instruments which are admitted to trading (or subject to an admission request) on a regulated market, multilateral trading facility (**MTF**) or organised trading facility (**OTF**). Accordingly, instruments traded on markets such as the UK's AIM and Luxembourg's EuroMTF and the issuers of such instruments will be covered by the new market abuse rules and, potentially, the disclosure and transparency rules

Related instruments	Financial instruments where the price or value depends, or has an effect, on the price or value of financial instruments admitted to trading on a regulated market, MTF or OTF are within scope of MAD 2 and MAR. This could include credit default swaps and contracts for differences
Emission allowances	Behaviour, transactions and bids relating to the auctioning of emission allowances on an auction platform which is a regulated market, or relating to products based on such allowances, are within scope
Spot commodities markets	Transactions in spot commodities which are not wholesale energy products are within scope where the transaction, order or behaviour has, or is likely to have, an effect on the value of a financial instrument traded on a regulated market, MTF or OTF. Other instruments, including derivatives and credit risk derivatives which have an effect on the price or value of a spot commodity contract whose price or value depends on the price or value of those financial instruments are also covered
Benchmarks	The transmission of false or misleading information or the provision of false or misleading inputs or any other behaviour which manipulates the calculation of a specified financial benchmark (e.g. LIBOR) is specifically stated to amount to market manipulation
Algorithmic trading	The legislation specifies an indicative list of algorithmic and high-frequency trading (**HFT**) strategies which would amount to market manipulation. Trading for the purpose of disrupting or delaying the functioning of the trading system of the trading venue (so-called "quote stuffing"), making it harder for other persons to identify genuine orders on the trading system of the trading venue or creating (or being likely to create) a false or misleading impression about the supply of, or demand for, a financial instrument is market abuse
Attempted market manipulation	Attempted market manipulation, for example, where a transaction is not completed because of failed technology, will fall within the new regime
Suspicious order reporting	Financial institutions will be obliged to report suspicious orders, as well as suspicious transactions

Improper Disclosure of Inside Information: A New Regime for Market Soundings and Wall Crossing of Investors

The new regime on market soundings has been designed to tackle issues associated with the leakage and misuse of inside information prior the announcement of a significant transaction. It is an important new area which could affect the way in which issuers, takeover bidders, professional investors and their advisers conduct their business.

Whilst the legislation will provide a useful safe harbour in relation to the disclosure of inside information if market soundings are conducted in accordance with the regime, certain provisions, including the requirements relating to record keeping, will extend to all market soundings, irrespective of whether or not inside information is imparted in such a sounding. Issuers, offerors and persons acting for them, along with professional investors will all face an additional compliance burden, along with enhanced enforcement and reputational risk under the new regime.

To date, ESMA has produced consultation draft technical standards on the market sounding regime, which are reflected in the commentary below. Finalised draft standards are to be produced by early July of this year. ESMA guidelines for the buy side are also currently awaited. These may be expected to take into account the FCA's recently published thematic review on asset managers and the risk of market abuse.

What is a market sounding?

A market sounding includes:

- The communication of information to one or more potential investors prior to the announcement of a transaction in order to gauge the interest of potential investors, and conditions relating to the transaction, such as potential size or pricing, and
- Communications in connection with takeover bids where the communication is necessary to enable shareholders to form an opinion on a potential offer and such shareholder's willingness to accept the offer is reasonably required for the decision whether to make an offer.

In practice, determining what information can be disclosed, and what would fall within the safe harbour, may require the exercise of careful judgement and caution by disclosing market participants (**DMPs**). ESMA has indicated that, generally, the information that it is appropriate to disclose will relate to the exact characteristics of the possible transaction, although it may be permissable to include other information which provides important context to it. It is to be expected that the disclosure of inside information which is not transaction specific is more at risk of falling outside the parameters of the safe harbour and thus of attracting regulatory sanction.

Who can conduct the sounding?

Issuers, secondary market offerors, emission allowance market participants and persons acting for them (e.g. a financial adviser) may conduct soundings designed to gauge the interest of potential investors in a transaction. As such, each such person could be the DMP in relation to a transation of the type mentioned in the first bullet point above.

However, the legislation does not make equivalent provision in the case of takeover bids. For takeover bids, the DMP and thus the person which would be subject to, but may benefit from, the market sounding regime is specified as the potential bidder (only).

In order to be considered to be "acting for" an issuer or other market participant (referred to as a "**market sounding beneficiary**") in taking a sounding, a financial adviser need not have been instructed under a formal mandate or engagement letter. ESMA has indicated in consultation that it is sufficient that the adviser is taking the soundings based on written or oral instructions from the market sounding beneficiary and pursuant to discussions, or a Request for Proposal (**RFP**), initiated by the market sounding beneficiary. In some cases, where soundings are conducted before the RFP process in the form of organised testing, advisers could be regarded as acting for a market sounding beneficiary where the adviser has obtained sufficient information from the market sounding beneficiary to lead it to believe that a deal launch is highly probable.

ESMA recognises that multiple financial advisers or a syndicate may be instructed on a particular transaction. The expectation indicated by ESMA is that, in such cases, agreement should be reached between managers as to what information should be disclosed, whether it is inside information and the steps to be taken to ensure that the same investor is not approached by several syndicate members in relation to the same transaction.

What types of transaction are covered?

Soundings in connection with primary and secondary market placings, including private placements and block trades are capable of falling within the safe harbour, as are takeovers. Buy-backs are not specifically addressed and thus, in the absence of specific provision in the finalised technical standards, market soundings conducted in advance of, say, a share or debt buy-back fall outside the safe harbour provisions.

What needs to be done to fall within the safe harbour?

- Prior to conducting the market sounding, the DMP must:
  - consider whether the information to be disclosed is inside information, and
  - make a record of that assessment with reasons
- Prior to disclosing the inside information, the DMP must:
  - obtain the consent of the person receiving the market sounding to receive inside information (prescribed scripts must be used), and
  - notify the person receiving the market sounding that he cannot use the information or pass it on (again, prescribed scripts to be used)
- After disclosure, the DMP must:
  - tell the person receiving the market sounding as soon as possible when the DMP considers that the information ceases to be inside. In that event, the sounding recipient must nevertheless determine for itself whether it still holds inside information

In complying with these broad obligations, various detailed records must be kept by the DMP, updated as appropriate and made available to the Competent Authority on request. Telephone calls are to be recorded and lists of persons contacted and records of follow up calls are to be maintained. These matters will be the subject of detailed technical standards.

Cleansing

MAR requires that, where inside information that has been disclosed ceases to be inside information according to the view of the DMP, the DMP must inform the recipient of that fact as soon as possible. ESMA draft technical standards apply related requirements, including mandatory provisions at the time of disclosure of inside information for DMPs to tell sounding recipients the anticipated time when the information imparted will cease to be inside and to inform the market sounding recipient how they will be informed in case the anticipated time is no longer valid. Notwithstanding the obligations on the DMP, the recipient of the market sounding must still assess for itself whether it is in possession of inside information or when it ceases to be in possession of such information.

Practical issues

The new regime may necessitate changes in practice for investment advisory and banking firms, for example, as a result of the proposal by ESMA for there to be designated sounding contacts in buy side firms and/or the need to agree the content, classification and communication of sounding approaches with syndicate members. Other compliance and procedural changes may be required as a result of the new regime, for example, changes to internal systems and controls, record keeping arrangements, notification templates, compliance and training, recording of company mobile telephone calls and the development and use of standard scripts. Importantly, the record keeping provisions apply to all market soundings, even those which do not disclose inside information.

The new regime will make it easier for Competent Authorities to trace leaks of information and hence to bring enforcement action in appropriate cases. This enhanced level of potential scrutiny may well increase the regulatory risks for individuals as well as institutions, not only in the event of information being inappropriately disclosed and/or used, but also from the systems and controls perspective.

Disclosure and Transparency Rules for Issuers

The new legislation impacts a number of issuers for the first time, given the wider range of markets covered under the new regime. Accordingly, issuers on SME markets may be subject to rules relating to the disclosure of inside information, maintenance of insider lists and disclosure of transactions relating to persons discharging managerial responsibilities for the first time, although certain relaxations are made for smaller issuers. Disclosure requirements will generally apply where issuers have requested or approved the admission of their financial instruments to trading on a trading venue.

Some of the main provisions of the new legislation relating to disclosure and transparency are set out below.

Delaying the disclosure of inside information	Issuers must announce inside information directly concerning them as soon as possible. MAR requires issuers to notify and explain to the Competent Authority any decisions to delay the disclosure of inside information immediately after the disclosure is made. Alternatively, Member States may provide that a record of such an explanation is to be provided only upon the request of the Competent Authority. The aim is to facilitate subsequent investigations of decisions for the delayed disclosure of inside information. Technical standards will address the technical means for delaying public disclosure and ESMA guidelines will address the issue of when a delay in disclosure may be justifiable
Insider lists	Insider list requirements are to be harmonized and technical standards will address the precise data to be included in insider lists. Certain relaxations will apply for SME growth market issuers (see further below). Issuers of instruments traded on an MTF or OTF will be subject to the requirements if they have approved the trading on, or requested admission to, that market
SME growth markets	A "SME growth market" is defined as an EU MTF that is registered as an SME growth market. Member States must ensure that MTFs are subject to effective rules, systems and procedures; among other things, these must ensure that at least 50% of the issuers whose financial instruments are admitted to trading on the MTF are SMEs (companies that had an average market capitalization of less than €200,000,000 on the basis of end-year quotes for the previous three calendar years) at the time when the MTF is registered as an SME growth market and in any calendar year thereafter. MAR sets out a more lenient disclosure regime for issuers whose financial instruments are admitted to trading on SME growth markets. For example, inside information may be published by SME growth markets on behalf of these issuers; and such issuers are exempt from the obligation to maintain and constantly update insider lists, subject to certain conditions being met
Transactions by PDMRs and closely associated persons	PDMRs and closely associated persons must notify transactions conducted on their own account in relation to that issuer to that issuer and the Competent Authority. The issuer must then make this information public. Once the transactions executed by a PDMR or a closely associated person within a calendar year cumulatively amount to €5,000 (€20,000 if a competent authority has decided to increase this threshold), every subsequent transaction should be notified regardless of its amount. In either case, the thresholds are to be calculated by adding the amounts of all transactions effected with no netting. Transactions in an issuer's debt, equity or related derivatives or financial instruments must be disclosed, and, in the case of emission allowance market participants, transactions conducted on a PDMR or closely associated person's own account relating to emission allowances, to auction products based thereon or related derivatives. The Regulation also clarifies the types of transaction which are caught by the notification and disclosure requirements. The timeline for notifying transactions is three business days. Technical advice relating to the type of transactions to report and trading during a closed period was published by ESMA in February 2015. Issuers of instruments traded on an MTF or OTF will be subject to the requirements if they have approved the trading on, or requested admission to, that market

Practical Issues and Next Steps

Assuming that ESMA produces the remaining technical standards by July, there will be a one year period in which to prepare for the introduction of the majority of the new regime. Appropriate resource will need to be allocated to ensuring the following, as a minimum:

- Investment banks and financial advisers should review and revise their procedures in relation to market soundings, wall crossing etc as well as internal compliance manuals and procedures relating to market abuse and trading more generally.

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These changes may need to flow through into syndicate arrangements and agreements. Systems changes will be needed in order to address suspicious transaction reporting and insider list requirements; certain company mobile phones may need to be recorded; appropriate staff awareness raising and training should be carried out; appropriate changes to client engagement letters, insider list maintenance agreements/letters and standard documentation relating to clients' continuing obligations will need to be reviewed.

- Buy side firms will need to do the same, including in particular amending procedures, systems and controls to adhere to the new guidelines regarding market sounding;
- Issuers will also need to update their internal procedures and guidelines to directors duties and deliver training as appropriate, especially in relation to changes to PDMR rules, insider lists and the disclosure of inside information. Senior staff will need to be aware of the new market sounding rules and appropriate record keeping arrangements put into place; and
- Persons trading in spot commodity markets should be aware of the new cross manipulation provisions. Appropriate compliance arrangements should be put into place.
- Persons falling within the regime for the first time, e.g. certain MTF or OTF issuers and emission allowance participants, will need to put in place an appropriate compliance and training regime.