William Yonge of law firm Morgan Lewis writes on future changes to the European market abuse regime.

Closed to abuse

On June 12, 2014, the European Commission published the Market Abuse Regulation (MAR) and the Criminal Sanctions for Market Abuse Directive (CSMAD), together MAD II. This will replace the existing market abuse directive, MAD I, and become directly applicable in European Union countries from July 3, 2016.

MAD I was perceived as having certain deficiencies, which became apparent after the onset of the financial crisis in 2008 and particularly after the Libor manipulation revelations in 2012. According to the Commission, the new rules on market abuse update and strengthen the existing framework in MAD I to ensure market integrity and investor protection. MAR will help keep pace with market developments such as the growth of new trading platforms, including over-the-counter trading and new technology such as high-frequency trading, and the upcoming overhaul of market regulation under the Markets in Financial Instruments Directive (Mifid II).

MAD II will broaden the scope of the market abuse rules and strengthen regulation to capture these new markets, notably the spot commodities market, multi-lateral trading facilities (MTFs) and related derivative markets and explicitly bans the manipulation of benchmarks such as Libor.

MAR is intended to create a single, directly applicable EU market abuse rule book for regulators that will increase their enforcement powers, in contrast to the patchwork that arose from national implementation of MAD I. CSMAD will require member states to provide harmonised legislation on criminal offences for insider dealing and market manipulation, and to impose criminal penalties, including up to four years' imprisonment for the most serious market abuse offences. The manipulation of benchmarks will be considered criminal behaviour across all EU countries. The UK has exercised its discretion to opt out of CSMAD on the basis of already having an established market abuse regime, which goes beyond CSMAD standards.

Like MAD I, MAR prohibits insider dealing, improper disclosure of inside information and market manipulation. The concept of "inside information" is central to the prohibitions on insider dealing and improper disclosure. Inside information is non-public information that is precise in nature, relates directly or indirectly to an issuer or financial instrument, and would, if it were made public, likely have a significant effect on the price of the financial instrument or the price of related derivatives.

MAR has expanded the definition to include information on commodity derivatives, spot commodity contracts and emission allowances, where the information is "required to be or reasonably expected to be disclosed". While MAR defines inside information similarly to MAD I, there are some changes. Information relating to an intermediate step leading up to a particular event can itself be precise and constitute inside information. There is a rebuttable presumption that a person in possession of inside information, who carries out transactions connected with that information, will be deemed to have used it.

The scope of MAR is wider than that of the existing rules to reflect an increasing trend toward off-market trades. MAR will apply to financial instruments admitted to trading on an EU-regulated market for which a request for admission to trading has been made as per the current regime. In addition, it will capture behaviour regarding financial instruments traded – or for which a request for admission to trade has been made – on MTFs and organised trading facilities (OTFs) and any other conduct or action that can have an effect on such an instrument, regardless of whether it takes place on a trading facility or OTC.

MAR covers abusive trading in spot commodity contracts whose price or value is based on a derivative financial instrument, as well as spot commodity contracts in which financial instruments are referenced. It captures attempted insider dealing and market manipulation activity, where a transaction is intended for "abusive" purposes but is not actually executed.

The regulation clarifies that the use of one's own knowledge of one's intention to acquire or dispose of financial instruments does not constitute use of inside information. This clarification will facilitate stake building ahead of public takeovers or mergers, provided the information is not obtained through access to the target or its management. It is also legitimate under MAR for a legal person to deal with securities while possessing inside information as long as systems are in place whereby the person making the decision to acquire or dispose of the instrument is not in possession of the inside information.

MAR retains the current safe harbour for share buy-backs and stabilisation. It does not apply to shares bought back for the purpose of reducing share capital or redistribution of stock options or call options in debt instruments, despite a company buy-back of its own capital being prima facie trading in possession of inside information. Stabilisation – where investment banks maintain securities prices artificially after an initial public offering – may only be done within limits and within a predetermined period. Buy-backs and stabilisation need to be notified to the competent authority, publicly disclosed and conducted in accordance with applicable standards.

Sounding a safe harbour

There will be a new prescriptive procedure and safe harbour for communication of information prior to the announcement of a transaction, in order to gauge the interest of potential investors in such a transaction and the conditions relating to it, such as its potential size or pricing, toone or more potential investors, known as "market soundings".

For a disclosure to qualify as a market sounding, the disclosing market participant (DMP) must obtain consent from the disclosee and warn that the information must remain confidential and not be used to inform a decision to acquire or dispose of the related financial instrument for both the disclosee's account or the account of others. In particular, the information may not be used to cancel or amend a related existing order.

Before proceeding with the market sounding, the disclosee should be informed that the disclosure is considered inside information. The DMP has the responsibility to characterise its disclosure as inside information or not, and keep a record of any due diligence made, which includes an explanation of the conclusion regarding its nature. The record should include the disclosee's opinion on whether it believes it is inside information.

The DMP must tell informed potential investors when the disclosure is no longer inside information, as this allows the disclosee to deal again. However, it is up to the disclosee to decide whether or not it considers the disclosure inside information and it must be put with other knowledge held, in order to decide whether it is inside information or not.

Asset managers – including those outside the EU – that manage funds or portfolios containing instruments captured by MAR will need to consider a revision of policies and practices. Any instrument admitted to trading on an MTF in the EU will be subject to MAR. New requirements under Mifid II for OTC derivatives to be traded on OTFs will mean that managers will need to consider inside information issues. ■

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