June 15, 2016

Market Abuse Regulation

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The Market Abuse Regulation ("MAR")[1] will take effect on 3 July 2016. MAR contains the rules on insider dealing, unlawful disclosure of inside information and market manipulation that will apply throughout the European Economic Area ("EEA"). It updates the existing market abuse regime, adding a great deal more detail to the existing rules and widening its scope to a range of financial instruments traded on venues other than the main EEA exchanges.

There is a separate Directive on Criminal Sanctions for Market Abuse ("CSMAD"),[2] which will apply on the same date. The UK (which already has a criminal offence of insider dealing and criminal offences relating to misleading statements and impressions) will not implement CSMAD into UK law for the time being. In terms of financial instruments, markets and trading venues, the scope of CSMAD is the same as MAR.

This Alert discusses the impact of MAR on investment managers and other buy-side firms that trade in financial instruments that are subject to MAR. The rules effect any firm (and its personnel) which trades on an in-scope EEA market, regardless of whether the firm is within or outside the EEA.

1. Scope of MAR

MAR covers trading in financial instruments[3] that are:

- **Admitted to trading on a regulated market.** Regulated markets are the principal EEA exchanges that are authorized as such under the Markets in Financial Instruments Directive ("MiFID").[4] MAR also covers instruments for which a request for admission to trading on a regulated market has been made, covering grey market trading in to-be-issued securities.

- **Traded on a multilateral trading facility ("MTF").** MTFs encompass many broker-operated trading venues and listing venues that are not "regulated markets", such as the Irish Global Exchange Market and Luxembourg EuroMTF.[5] This is a significant extension of the regime. Whilst, in practice, many market participants have observed the same restrictions on insider dealing and market manipulation in trading venues that may not be "regulated markets", it is clear that enhancements will be needed to existing policies and procedures, including to take into account dual-listed securities.

- **Traded on an organized trading facility ("OTF").** OTFs are order execution facilities that may not be MTFs because the operator exercises discretion in executing the order. OTFs will not exist until the application date of MiFID II, January 2018. OTFs will likely encompass some existing non-equity broker

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[1] Regulation No 596/2014 on Market Abuse.
[2] Directive 2014/57/EU on Criminal Sanctions for Market Abuse.
[3] Financial instruments are listed in section C of Annex 1 to MiFID II.
[4] Regulated markets in the UK include the London Stock Exchange (LSE), London International Financial Futures and Options Exchange (LIFFE) and the London Metal Exchange (LME).
[5] ESMA maintains a list of MTFs here.

crossing networks and trading platforms. In the future, various types of cleared OTC derivatives will also be traded on OTFs.[6]

- **Instruments which the price or value of which depends on, or has an effect on, the price or value of a financial instrument,** including OTC derivatives where the reference assets are an "in-scope" shares or bonds, including index derivatives and credit default swaps.

MAR also covers trading in emissions allowances.

MAR also applies to any off-market trading in any of the instruments referred to above, including private trading in, for instance, debt securities admitted to trading on an MTF. Market participants must consider MAR's broad scope in relation to all the instruments they trade, including OTC derivatives.

Commodity Markets

MAR applies to commodity derivatives that are traded in the trading venues listed above. MAR does not directly apply to trading on spot commodity markets, but extends the scope of inside information in relation to commodity derivatives to include information relating to the spot commodity contracts. MAR also extends the scope of the market manipulation offence to cross-market manipulation, which is where transactions in the derivatives markets are used to manipulate the price of the related spot markets, and vice versa.[7]

Jurisdiction

MAR applies extra-territorially – it applies to a market abuse offence that relates to an EEA exchange or trading venue, regardless of whether the offence is committed in or outside the EEA, or by an EEA or non-EEA entity. The FCA has taken enforcement action for market abuse offences against non-UK persons and will continue to cooperate with foreign regulators in this regard.

2. Market Abuse Offences

MAR covers the offences of insider dealing, unlawful disclosure of inside information and market manipulation. They are defined in broadly similar terms to the existing offences under the original Market Abuse Directive.

Insider Dealing and Unlawful Disclosure

MAR prohibits engaging in (or attempting to engage in) insider dealing, which is using inside information to acquire or dispose of financial instruments to which that information relates. MAR also prohibits the use of inside information to cancel or amend orders or bids placed before the person possessed the inside information, which will also constitute insider dealing.[8] There has been some industry debate recently whether this rule will prohibit firms from cancelling an order that is in the process of being executed, when the firm possesses relevant insider information. This involves detailed examination of a manager's particular circumstances (and should take into account any relevant non-EU requirements), and care is needed before reaching a determination. MAR also prohibits recommending or inducing another person to engage in insider dealing[9] and prohibits unlawful disclosure of inside information, which is disclosure of information to a person otherwise than in the normal exercise of an employment, a profession or duties.[10] The insider dealing offence applies to any person who possesses inside information in

[6] Provisions in MAR that refer to organized trading facilities (OTFs) will not apply until MiFID II applies.
[7] Where the transaction, order or behaviour has or is likely or intended to have an effect on the price or value of a financial instrument (Article 2(2)(a)) and where the transaction, order or behaviour has or is likely or intended to have an effect on the price or value of a spot commodity contract, where the price or value depends on the price or value of those financial instruments (Article 2(2)(b)).
[8] Article 8(1).
[9] Article 8(2).
[10] Article 10.

circumstances such as having access to the information through employment, or in any other circumstance where that person knows or ought to know that it is inside information (i.e., possession as an "insider").[11]

The definition in MAR of "inside information" has not changed from the original Market Abuse Directive. Inside information is information of a precise nature, which has not been made public; relating, directly or indirectly, to one or more issuers of financial instruments or to one or more financial instruments; and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of a related derivative.[12] MAR has introduced a number of qualifications to this definition, in part reflecting recent decisions of the European Court of Justice.[13] In particular, MAR now provides that there is a rebuttable presumption that a person in possession of inside information who carries out transactions connected with that information is deemed to have used the information.[14] However, there is an express defence to this presumption where the information has been held on the other side of an effective information barrier (or Chinese wall).[15] Applying these rules in practice is quite involved, and great care is needed as detailed guidance underlies the criteria set out here.

Market Manipulation

Market manipulation covers giving false or misleading signals as to the supply, demand or price of a financial instrument (in particular, by placing orders that may not be executed), disseminating through the media (or other means) false or misleading information to give false signals as to the supply or demand of financial instruments, or to secure the price at an abnormal or artificial level; and providing false or misleading inputs in relation to a benchmark, or any other behaviour that manipulates the calculation of a benchmark.

MAR gives a non-exhaustive list of examples of specific behaviours (such as disrupting trading by high frequency trading, as further detailed below) that would amount to market manipulation.[16]

Market manipulation may take the form of using related financial instruments, such as derivatives. Financial instruments may be manipulated through behavior occurring inside or outside a trading venue.

MAR captures attempted as well as actual insider dealing and market manipulation. Attempted market manipulation is where a transaction is intended for abusive purposes but is not successfully executed (e.g., due to technology failure or a refusal to act on an instruction to trade), although there are questions as to how a firm might detect this type of activity.[17]

An Annex to MAR, and a Delegated Regulation, include a list of indicators and practices relating to giving false or misleading signals as to supply or demand and the employment of fictitious devices, such as disseminating false information through the media.[18]

Market Manipulation by Algorithmic and High Frequency Trading

Regulators have identified certain automated strategies that, if carried out, are manipulative and likely to constitute market abuse. These include:

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[11] Article 8(4).
[12] Article 7(1)(a).
[13] Article 7(3) confirms the decision of the European Court of Justice in *Markus Geltl v Daimler AG* [C-19/11].
[14] This reflects the decision by the European Court of Justice in *Spector Photo Group NV Van Raemdonck v* CBFA [2009] EUECJ C-45/08).
[15] Article 9(1).
[16] Article 12(2).
[17] Recital 46 states that attempted manipulation includes placing orders which may not be executed.
[18] Delegated Regulation (EU) 2016/522 includes a list of practices specifying indicators of manipulative behaviour relating to (i) false or misleading signals and to price securing at an abnormal or artificial level and (ii) employment of a fictitious device or other form of deception or contrivance.

- "Quote stuffing" (that is, placing and withdrawing large orders quickly to flood the market with quotes to be processed).
- "Layering" (that is, submitting multiple orders, typically on a single stock, to create the impression it is highly liquid).
- "Spoofing" (that is, a trader with direct market access placing an order for a large number of shares, then immediately cancelling it, giving the impression the shares are highly liquid and allowing the trader to sell at a higher price).

To reflect the current regulatory focus, MAR specifies certain examples of strategies using algorithmic trading and high frequency trading that will fall within the prohibition against market manipulation.[19]

3. Market Soundings

MAR introduces new rules for "market soundings". A market sounding is communication of information, prior to the announcement of a transaction, in order to gauge the interest of potential investors in the transaction. This typically involves communication of potentially inside information by the sell side to the buy side.[20]

Disclosure of inside information in the course of market soundings will not constitute unlawful disclosure of inside information, provided that certain conditions are met, including:[21]

- obtaining the consent of the person receiving the market sounding to receive inside information;
- informing the person receiving the market sounding that he is prohibited from using that information; and
- informing the person receiving the market sounding that, by agreeing to receive the information, he is obliged to keep the information confidential.

These provisions are clearly designed to prevent inadvertent disclosures of inside information. MAR also imposes record-keeping obligations on the disclosing party.[22]

MAR makes it clear that the person receiving the market sounding must assess for himself whether he is in possession of inside information or when he ceases to be in possession of inside information.[23] The recipient (usually the buy side participant) must therefore make its own determination of whether it is in possession of inside information, taking into account all the information held by it. Simply agreeing to receive information on a "non-wall-crossed basis" (without due regard to the status of the information) will not be a defence to use of any inside information under MAR.

Moreover, an asset manager receiving the information as part of a market sounding will need to ensure that it has appropriate "wall-crossing" and other procedures for dealing with information received from sell-side brokers. There are draft ESMA guidelines addressed to market-sounding recipients (i.e., investment managers), covering the factors that recipients should take if inside information has been disclosed to them and the records that recipients should keep. These provisions will require updated policies and procedures.

[19] Article 12(2).
[20] Article 11(1).
[21] Article 11(5).
[22] Articles 11(3) and 11(5).
[23] Article 11(7). This confirms the views of the FCA in the *David Einhorn* Final Notice dated 15 February 2012 that an asset manager cannot rely on a prior communication that it should not receive inside information, or rely on an implied suggestion by a disclosing broker that the information received does not preclude the asset manager from dealing in the relevant securities.

4. New Systems and Procedures to Detect Suspicious Orders and Transactions

Asset managers involved in arranging or executing transactions (including portfolio managers that place orders with brokers) will be required to establish and maintain effective arrangements, systems and procedures to detect and report suspicious orders and transactions. Regulatory technical standards specify the appropriate arrangements, systems and procedures that firms must put in place. Firms will need to have a system that provides effective monitoring of every transaction (on- or off-market) executed, as well as orders placed, modified, cancelled or rejected and produces alerts for further (human) analysis.

In practice, once a firm starts to undertake a certain level of trading activity, it will need an automated system to detect suspicious orders and transactions. The system must be capable of reviewing orders or transactions across all relevant asset classes and markets in which the firm is active. There are challenges here for managers that trade on an OTC basis (including OTC derivatives where the underlying instrument is traded on a market within scope) or in "dark" markets in assessing the impact of orders on the market. Firms will be able to outsource monitoring, although they will retain responsibility for the outsourced function. Any automated system will need tailoring to a firm's particular circumstances, and will require a "human" overview.

Where an EU firm has a reasonable suspicion that an order or transaction could constitute insider dealing or market manipulation (or an attempt at either offence), the firm must notify its relevant competent authority without delay. In an extension to the existing regime, firms will be required to report suspicious "orders", even if they do not proceed to execution (e.g. because of a technology failure or a refusal to act on an instruction to trade) – it is likely that an order only exists when the order is transferred from the manager to the broker or trading venue, and not at an earlier stage (such as when the order is transferred from the portfolio manager to the dealing desk).

5. Enhanced Investigative and Administrative Sanctions

MAR establishes a set of administrative sanctions and other administrative measures to ensure a common approach in EEA member states and to enhance their deterrent effect.[24] These include maximum fines for individuals and legal persons.

MAR also requires member states to ensure that competent authorities put in place effective mechanisms to enable reporting by firms and individuals of actual or potential breaches of MAR (whistle-blowing).[25]

Practical Implications of MAR for Asset Managers

The key practical implications for asset managers are:

- Managers must put staff on notice of the new regime, through training and updates to their internal market abuse and insider dealing policies.
- Any asset manager, including a non-EEA manager, will need to determine the impact of MAR (and particularly inside information issues) to the instruments that it trades, now having regard to instruments, such as bonds, that are traded on an EEA MTF, or securities that are traded both on a non-EEA exchange and an EEA MTF.
- MAR has not introduced any express exemption for hedging, meaning that a market participant that only places a hedging trade, and is in possession of inside information, may be deemed to have engaged in insider trading.[26]

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[24] Article 30(1).
[25] Article 32(1). Commission Implementing Directive (EU) 2015/2392 sets out the procedures for competent authorities for the receipt of reports and infringements, and follow-up.

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- Asset managers will need to have systems in place to detect and report suspicious or unsuccessful orders, as well as transactions, that might amount to market abuse.[27] Managers must determine at what point an order is placed (which will also determine if an order is cancelled).

- Asset managers will need to amend procedures, systems and controls to adhere to the new rules on market soundings, including record-keeping procedures.

- In the UK, there continues to be several overlapping regimes relating to market conduct. It is likely that the FCA will still apply the "market conduct" principle, which requires FCA authorised firms to observe proper standards of conduct in markets outside the technical scope of EEA law (such as the markets for private debt). This has been used by the FCA as a catch-all and as a safety net.

Some further implications for fixed income managers are:

- Debt instruments traded on the secondary market have often been technically outside UK market abuse and insider dealing regimes, because the original MAD only applied to securities listed on "regulated markets". MAR now applies to securities listed on regulated markets, MTFs and OTFs. As a result, MAR will apply to (i) debt securities which are listed on exchanges such as the Irish GEM (an MTF) and (ii) loans that are traded on OTFs under MiFID II (noting that broker-run trading venues may be classified as OTFs under MiFID II). MAR also applies to off-market trading in these types of instruments.

- Debt market participants have observed insider dealing restrictions under basic market conduct principles, particularly under the Guidelines published by the London Markets Association ("LMA"). It remains to be seen how market participants will accommodate the insider dealing regime under MAR with the market conduct principles developed to date, particularly in the context of bilateral off-market trading. An initial view is that MAR will not accommodate the circumstances in the LMA Guidelines, where a lender possessing confidential information can "reasonably make a judgment that it is consistent with appropriate standards of professional integrity and fair dealings to trade".

- MAR will also apply to transactions in debt instruments where the price of the debt instrument has an effect on another instrument. Buying or selling a debt instrument that is not traded on any trading venue will be subject to MAR, if the price of that debt instrument has an effect on or depends on an associated instrument, such as a credit default swap, that is traded on a venue, such as an MTF.

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[26] It has been noted that this is significant in light of the extension of the market abuse regime to commodities derivatives. Natural resources companies should consider establishing firewalls to prevent inside information from their principal operations being passed to their trading arms, even if their trading arms conduct hedging transactions only.
[27] Article 16(1).

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