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Twice as MAD: Legislative Proposals to Amend the European Regulation of Market Abuse

The European Commission has published its legislative proposal to revise the Market Abuse Directive. The proposal takes the form of a directive and a regulation. Firms and individuals will need to prepare for the expanded scope of the new measures, which seek to close gaps in European market regulation and bolster the powers of national regulators. This memorandum summarises the main proposals.

Introduction

The Market Abuse Directive ("**MAD**")[1] came into force in early 2003 and introduced a harmonised framework within the European Union to regulate insider dealing (trading while in possession of inside information) and market manipulation (behaviours such as spreading false information and conducting trades which skew prices). These practices collectively constitute "**market abuse**".

The legislative proposals of the European Commission (the "**Commission**") are intended to address various gaps and perceived weaknesses in the regulation of market abuse, acknowledging the need to reflect technological developments and the fragmentation of trading. The review of MAD is one of a number of current EU initiatives aimed at strengthening financial regulation, and will sit alongside the proposed European Market Infrastructure Regulation ("**EMIR**"),[2] which proposes mandatory clearing and reporting of over-the-counter ("**OTC**") derivatives; the proposed Short Selling Regulation, which restricts certain types of short selling and credit default swaps; the Regulation on Energy Market Integrity and Transparency ("**REMIT**"), which establishes rules prohibiting abusive practices affecting the wholesale energy markets in the European Union; and proposed amendments[3] to the Markets in Financial Instruments Directive ("**MiFID**"), which, among other things, will widen the regulatory perimeter for financial institutions and users of financial services.[4]

[1] Directive 2003/6/EC.

[2] See Shearman & Sterling publications "OTC Derivatives Regulation and Extraterritoriality" dated 10 October 2011 and "A New Panorama for the Clearing and Recording of Over-the-Counter Derivatives in Europe: the Proposed European Market Infrastructure Regulation" dated 29 September 2010.

[3] See European Commission, Proposal for a Directive of the European Parliament and the Council on Markets in Financial Instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (COM (2011) 656/4) (recast).

[4] See Shearman & Sterling Publication "Proposed Regulation of EU Emissions Allowances as Financial Instruments" dated 8 November 2011.

Under the Commission's proposals, the amended market abuse regime will address the following:

- market abusive behaviour in relation to products traded on a wider range of platforms, venues and even some OTC trading;
- market abusive behaviour in relation to spot commodity trading;
- cross-market manipulation;
- emissions trading;
- ambiguities in the original MAD;
- attempts at abusive behaviour; and
- enhanced enforcement powers.

The Legislative Proposal and Relationship with Other Initiatives

The Commission proposes to replace MAD with a market abuse regulation ("**MAR**") and to create a new directive to introduce mandatory criminal sanctions for market abuse ("**CSMAD**").[5]

An EU regulation, unlike a directive, is directly applicable in the law of member states and so does not require national implementing legislation. The MAR proposal aims to ensure a harmonised set of rules across the EU and to address certain divergences in the national legislative measures employed to implement MAD. For example, there are currently variations in member states' application and understanding of "accepted market practices", a recognised defence under MAD,[6] their approach to permitting delays in disclosing inside information to the market[7] and other practices endorsed by particular national regulators.[8] Under MAR, administrative and regulatory sanctions will also apply for market abuse which will ensure regulatory convergence in this respect too.

CSMAD seeks to harmonise criminal sanctions for market abuse across the EU by providing for a minimum set of penalties for market abuse offences. The proposals do not aim to prevent market abuse from also being treated as an administrative offence.

These proposals were released on the same day as the proposals to revise MiFID.[9] Both measures complement one another in terms of a significant widening of the business trading practices and instruments now falling within their scope and in bringing in stricter and more extensive regulations. In particular, both initiatives:

- will regulate instruments traded on a Multilateral Trading Facility ("**MTF**") or an Organised Trading Facility ("**OTF**") — the new MiFID II category of trading venue — as well as certain types of OTC trading;
- broaden the scope of regulation to regulate the trading of emissions allowances; and
- reflect certain concerns associated with algorithmic or high frequency trading ("**HFT**").

5 European Commission, Proposals for a regulation on Market Abuse and Proposals for a directive on criminal sanctions for Market Abuse, 20 October 2011.

6 For example, MAD Article 1.1.

7 MAD, Article 6.2.

8 See, for example, ESME Report "Market Abuse EU Legal Framework and its Implementation by Member States: a First Evaluation", June 2007, p. 8.

9 See Shearman & Sterling Publication "A Changing Landscape: The MiFID II Legislative Proposal" dated 20 October 2011.

Both MAR and MiFID II also include various proposed measures aimed at easing the regulatory burden on SMEs by removing some of the barriers arising from cross-border compliance costs for smaller firms.[10]

Current UK Regime

The UK currently imposes both administrative and criminal sanctions for various types of market abusive behaviour. The UK retained certain provisions[11] from the pre-FSMA UK market abuse regime (hence it is "super-equivalent" to MAD or has "gold-plated" it). This has resulted in a wider definition of market abuse in the UK than that which exists in many other member states. For example, in addition to the existing species of abusive behaviour (insider dealing, market manipulation, dissemination of rumours), the UK characterises behaviour that "is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market"[12] as market abuse. The UK government has announced that it will end the practice of "gold-plating" future EU directives.[13] The current gold-plated provisions have been extended until 31 December 2014, to reflect the existing policy of aligning any changes with the outcome of the MAD review,[14] but are expected to fall away once MAR has been implemented. This raises questions as to how certain supposedly questionable behaviour which principally falls foul of the UK specific offences — such as the pre-hedging or "icing" of convertible bond issuances[15] — will be treated.

Developments and Expansion in MAR

MAR will further develop and expand the market abuse regime across the EU. It seeks to provide for a "single European rulebook", with updated definitions of key terms, and clarifications as to the obligations of firms in relation to the detection and prevention of market abuse. There will also be an expansion of scope to cover trading venues, trading practices and cross-market manipulative strategies not covered by MAD. The legislation will also introduce, in conjunction with the Commission's MiFID II proposals, specific disclosure requirements for inside information related to emissions trading.

Expanded Definition: Insider Dealing

MAR makes small changes to the definition of "inside information" contained in MAD. This definition is key not only to the offences but to the disclosure regime for issuers. The definition retains the concept that "inside information" must have a significant effect on price if made public. Market users must also expect to receive such information in accordance with market practice. Similar wording to both new provisions is included in the UK's current definition of market abuse,[16] and in the MAD implementing directive.[17] A separate definition applies to commodity derivatives (see below).

[10] Commission Staff Working Paper: Impact Assessment ("**Impact Assessment**"), p. 35.

[11] Now FSMA, Sections 118(4) - misuse of information and 118(8) - misleading behaviour and market distortion.

[12] FSMA, Section 118(8).

[13] BIS Press release, 15 December 2010.

[14] Financial Services and Markets Act 2000 (Market Abuse) Regulations 2011 (SI 2011/2928).

[15] FSA's Consultation paper CP149, "Market abuse - Pre-hedging convertible and exchangeable bond issues", July 2002.

[16] FSMA, Sections 118(4) and (6).

[17] Directive 2003/124/EC, Article 1.2.

MAR also creates a new category of inside information, defined as information which is not generally available but which would be relevant to a reasonable investor.[18] Such information appears to be intended to include matters such as the state of contract negotiations, provisional contract terms, marketing conditions and provisional terms of placements.[19] Trading on the basis of such information would therefore be prohibited. However, this sort of information will not always require disclosure. There will continue to be an exception[20] to the obligation on issuers to disclose information to the market where the information is insufficiently precise.[21]

As regards the mental element of the market abuse offences, the new proposal does not address the effect of the controversial decision in the *Spector Photo* case,[22] in which the European Court of Justice circumscribed the requirement to demonstrate intention on the part of someone trading on the basis of inside information. It was held that MAD did not provide that prohibited transactions be carried out "with full knowledge of the facts" but merely prohibited insiders from using inside information when entering into market transactions. The ECJ noted that not every primary insider in possession of inside information who enters into a market transaction would be caught and that it is only the use of information that goes against the purpose of MAD that constitutes insider dealing.[23] One interpretation of the decision is that where a person holds inside information, there is a presumption of an intention to base trading decisions on that information. Another interpretation is that the judgment merely restates the point that MAD does not require proof by the regulator of a person's intention to prove insider dealing. Following the *Spector Photo* case, the FSA amended the Code of Market Conduct in the FSA Handbook to state that it is not necessary to provide evidence of a person's intention in order to prove insider dealing.[24] Under the UK's primary legislation, an offence is committed where dealings are made "on the basis of" inside information, which is generally thought to be a similar, if not identical, concept. The FSA did not consider that UK legislation needed amending following the ECJ decision.[25] Nevertheless, any perceived discrepancy between the UK and EU mental element of the test will be eliminated once MAR enters into force, since the regulation will be directly applicable in the UK.

Expanded Definition: Market Manipulation

MAR extends the obligation on market operators to adopt structural provisions aimed at preventing and detecting market manipulation to operators of all MTFs and OTFs, in line with MiFID II.[26] MAR is intended to curtail market manipulation by prohibiting all behaviour that will secure prices at an "abnormal or artificial level",[27] as well as attempts

[18] MAR, Article 6.1(e).

[19] MAR, recital 14.

[20] MAR, Article 12.3.

[21] MAR, Article 12.3 and recital 14.

[22] C-45/08 *Spector Photo Group NV v Commissie voor het Bank, Financie-en Assurantiewezen* [2009] EUECJ.

[23] See Shearman & Sterling publication "The Spector Photo case: ECJ rules on the interpretation of the Market Abuse Directive" dated 5 February 2010.

[24] The FSA consulted on the amendment in October 2010. The amendment came into force on 6 March 2011.

[25] The proposed amendments to FSMA following the UK government's plans to overhaul the financial regulatory framework in the UK do not include any amendments to the relevant provision.

[26] MiFID, Article 11.1.

[27] MAR, Article 8.1(a).

to manipulate markets (whilst only attempted insider dealing is prohibited under MAD), whether or not successful.[28] Cancelling or amending an order while in possession of inside information will also be prohibited under MAR.[29]

Expanded Obligation: Disclosure of Inside Information

MAD permits issuers to delay public disclosure of inside information so as not to prejudice legitimate interests, provided that such delay would not be likely to mislead the public and provided also that the issuer is able to ensure the confidentiality of that information.[30] MAR maintains this flexibility, but in addition, requires issuers, once the information is finally disclosed, to inform national regulators of their decision to delay disclosure.[31] National regulators would therefore be systematically informed of delayed disclosure and could impose sanctions for non-compliance with MAR. MAR also empowers national regulators to delay disclosure of systemically important inside information when it is in the public interest to do so.[32]

Despite strong opposition to the proposals from institutions such as the CBI, which argued that there was "*[no] evidence within the UK regulated markets that an obligation to notify the competent authority in these circumstances would improve the overall level of compliance with the obligation to disclose inside information*",[33] the Commission expects that the combination of these provisions will enhance the certainty of the disclosure rules, and ensure the smooth and fair operation of European markets. This requirement could lead to significant changes to how M&A deals are notified to regulators.

Expanded Scope: Closing Gaps in the Regulation of New Markets and New Practices

Currently, a financial instrument which is traded only OTC or on an MTF, and is not traded on a regulated market, is not covered by MAD. The UK's market abuse offence has historically been wider, applying to some MTFs and to trading in instruments which, although not themselves traded on-exchange, are "related investments", whose price or value depends on that of a qualifying investment.

MAR extends the scope of the EU market abuse framework to any financial instrument admitted to trading on an MTF or OTF,[34] as well as to any related financial instruments traded OTC which can have an effect on an underlying market that is covered by MAR.[35] Under MAR, only those instruments *exclusively* traded OTC, and which are not related derivative financial instruments to those otherwise covered by MAR, would remain unregulated.[36] Market participants may find it difficult in practice to identify which instruments are traded on an MTF or OTF, particularly since some platforms admit instruments by class. The London Stock Exchange includes large numbers of foreign issuers in its

[28] MAR, Article 8.2.

[29] MAR, Article 7.1.

[30] MAD, Article 6.2.

[31] MAR, Article 12.4.

[32] MAR, Article 12.5.

[33] European Commission Consultation on Market Abuse Directive, Response from Confederation of British Industry, August 2010, p. 3.

[34] MAR, Article 2.1(b).

[35] MAR, Article 2.3.

[36] Impact Assessment, p. 67.

international order book, for example. The proposed expanded scope may therefore lead to a lack of legal certainty as to when behaviour is covered by MAR and defensive market behaviour. It is hoped that market participants can identify the instruments that are subject to MAR.

Certain technologically advanced trading systems, such as broker crossing networks and swap execution facilities are not currently expressly addressed by MAD,[37] although the definition of market manipulation in MAD is broad and capable of applying to abusive behaviour regardless of the trading medium employed.[38] Specific examples of strategies used by algorithmic and high frequency traders are now identified in MAR as falling within the prohibition against market manipulation.[39] The Commission intends that this, and future identification of further abusive strategies, will ensure a consistent approach in monitoring and enforcement by national regulators.

Expanded Scope: Commodity and Commodity Derivatives

MAR will introduce more comprehensive market abuse regulation to the derivatives markets. MAR will work in conjunction with REMIT (discussed below) to curtail certain cross-market manipulative strategies that have been perceived to fall outside the MAD regime, even though they can have an impact on other markets. For example, a person could stock-pile physical assets, enter into a futures contract in relation to those assets, and then make physical delivery of the stock-piled assets to satisfy the derivative contract. The Commission wishes to ensure that non-financial activities would also be covered.[40]

Market abuse in relation to wholesale energy markets is restricted by REMIT,[41] which from January 2012 introduces a new market abuse and monitoring regime for the European wholesale energy markets, including spot markets, but not financial instruments that are regulated by MAD.[42] This regulation will work in combination with MAR, which aligns the definition of inside information in relation to commodity derivatives with that applicable to other financial instruments[43] and also extends the definition of market manipulation to cover abusive squeezes, whereby a trader seeks to secure a dominant position over the supply of or demand for a financial instrument or related spot commodity contract, with the effect of manipulating the financial market.[44]

[37] In particular, the Commission is concerned about quote stuffing (a tactic of quickly entering and withdrawing large orders in an attempt to flood the market with quotes that competitors have to process, thus slowing down order management by other traders), spoofing (a technique for manipulating prices on securities markets by entering and withdrawing orders that the trader never intended to execute) and layering (a directional type of spoofing, whereby a trader enters several orders to improve the price of a trade in the opposite direction).

[38] Proposal for a regulation, p. 8.

[39] MAR, Article 8.3(c).

[40] MAD, Article 2 renders illegal only the distortion of the price of financial instruments, rather than derivatives trading which distorts the prices of physical markets.

[41] REMIT, Articles 3 and 5.

[42] REMIT, Article 1.2.

[43] MAR, Article 6.

[44] MAR, Article 8.3.

Expanded Scope: Emissions Allowances

The regulation of emissions allowances under MAR and MiFID II is discussed in a separate client note.[45] In addition to the applicability of the market abuse offences to these instruments, persons engaging in transactions involving the trading of emissions allowances would, under certain circumstances, also have a duty to publicly disclose inside information (or face committing market abuse if they did not do so). The duty to disclose inside information would effectively only be placed on the very largest emitters, whose physical activities could significantly affect the market price of allowances.

Expanding Powers: Bolstering National Regulators

It is thought by the Commission that the MAD regime is weakened by (i) a lack of data on suspicious transactions in OTC derivatives, which it says have the potential to be used for insider dealing and market manipulation, and (ii) a lack of access for regulators to data traffic in some member states. MAR expands the powers of national regulators to obtain such data,[46] and closes the information gap for the spot commodity markets.[47] National regulators will have the power to requisition existing telephone and other data traffic records held by a telecommunication operator, or by an investment firm, where a reasonable suspicion exists that such records may be relevant to proving insider dealing or market manipulation.[48] Co-operation between the European Securities and Markets Authority ("**ESMA**") and other national regulators will be enhanced.

MAR also introduces several common principles to strengthen and harmonise civil sanctions imposed by national regulators: (1) fines should not be less than the profit made from market abuse where this can be determined; (2) the maximum fine should not be less than twice the value of any such profit;[49] (3) for natural persons, the maximum fine should not be less than €5 million;[50] and (4) for non-natural persons it should not be less than 10% of annual turnover.[51] Member states will be free to impose sanctions which exceed these limits, but may not allow lower sanctions.[52]

Other powers[53] include the power to suspend the trading of a relevant financial instrument, to impose a temporary ban on any member of an investment firm's organisational body or on any other responsible natural person exercising functions in an investment firm, and to impose the criminal sanctions introduced by CSMAD (as discussed below).

Criminal Offences and Sanctions

CSMAD requires member states to establish criminal offences for individuals for insider dealing and market manipulation.[54] Attempts to commit insider dealing and market manipulation will also be criminal offences under

[45] See Shearman & Sterling Publication "Proposed Regulation of EU Emissions Allowances as Financial Instruments" dated 8 November 2011.

[46] MAR, Chapter 4.

[47] MAR, Article 17.2(c).

[48] MAR, Article 17.2(f).

[49] MAR, Article 26.1(k).

[50] MAR, Article 26.1(l).

[51] MAR, Article 26.1(m).

[52] MAR, Article 26.2.

[53] MAR, Article 26.1.

CSMAD, as will inciting or aiding and abetting. This contrasts with MAD, which requires member states to adopt non-criminal sanctions but allows a discretion to impose criminal sanctions.[55]

The UK imposes wide-ranging criminal sanctions for market abuse:[56] insider dealing, market manipulation and misleading statements have long been criminal offences in the UK. These were supplemented by the administrative market abuse offences created by FSMA.[57] Although the slightly lower standard of proof in the administrative regime may make it easier to secure a conviction, the FSA has, in recent years, been committed to using its criminal prosecution powers where possible to further its policy of "credible deterrence" and it has obtained a number of criminal convictions. Such an approach is likely to continue, though based on the new guidance on fines set out in CSMAD.

The criminal offences will encompass all financial instruments, regardless of whether or not the instrument is admitted to trading on a trading venue. In addition, it will be explicitly stated that a legal person (such as a corporation) may be held liable for any of these offences if the offence is committed for its benefit by a person who holds a "leading position" at the firm. This provision has the potential to capture a broad range of senior employees who are authorised to make decisions on behalf of a firm.

Next Steps

Both of the drafts of MAR and CSMAD will now be passed to the European Parliament and the Council for the final text to be agreed and, ultimately, adopted. On adoption, MAR will enter into force after two years. Member states will also have two years to transpose CSMAD into national law. As a result of it being a regulation, MAR will not require national implementing legislation. In the UK, amendments to the Section 118 of FSMA provisions, which have contained the UK market abuse offence since before the first MAD was adopted will likely have to be made. It is anticipated that the process will take three years in total, and the UK has extended the present 'gold-plated' provisions of Section 118 of FSMA on that basis.

Conclusion and Impact in the UK

Although the MAR and CSMAD proposals in many respects tighten up EU laws to reflect matters covered in the UK regime but overlooked in the first MAD, there are significant extensions to the existing ambit of market abuse law. Some of the changes are logical solutions to addressing obvious gaps in the existing regime. However, when taken in conjunction with other Commission proposals, in particular REMIT, EMIR and MiFID II, these initiatives manifest a clear shift in the EU's approach to regulation, to harmonise regulation and regulatory powers in relation to financial and commodity markets across Europe. Concerns have been expressed in the UK that the loss of national discretion may weaken the supervisory and enforcement capabilities of national regulators. Firms and market participants generally are likely to face increased compliance responsibilities and must, in due course, make significant preparations for transition to the new regime.

54 CSMAD, Articles 3 and 4.

55 MAD, Article 14.

56 Part V of the Criminal Justice Act 1993 (CJA) and FSMA, Section 397.

57 FSMA, Section 118.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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