The Regulation of Market Abuse

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The Regulation of Market Abuse
The new regime

A new market abuse regime came into force in the EU on 3 July 2016. It comprises:

- Regulation (EU) No 596/2014 on market abuse (**the "Market Abuse Regulation" or "MAR"**)
- Directive 2014/57/EU on criminal sanctions for market abuse (**"CSMAD", not applicable in the U.K.**)

These two measures are commonly and collectively referred to as "**MAD II**". They repeal and replace Directive 2003/6/EC on insider dealing and market manipulation (the "**Market Abuse Directive**" or "**MAD I**")

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The Regulation of Market Abuse
Changes introduced by the new regime

Key changes introduced by MAD II include, *inter alia*:

- extending the existing regime to apply beyond **regulated markets** to financial instruments on trading platforms such as multilateral trading facilities (**MTFs**, *as established in accordance with MiFID*) and organised trading facilities (**OTFs**, *from January 2018, as established in accordance with MiFID II*);
- bringing the manipulation of benchmarks expressly within the market manipulation offence;
- introducing a new prohibition on *attempted* market manipulation;
- extending the market abuse rules to cover all MiFID financial instruments, including EU emissions allowances.

The Regulation of Market Abuse
MAR Articles 12 to 15

- According to MAR Article 1, market abuse is behaviour in one of three categories:
  1. Dealing on inside information (or recommending that another person deals)
  2. Unlawfully disclosing inside information
  3. Market manipulation, see Articles 12 and 13
- The prohibitions on market abuse are set out in Article 14 (inside information) and Article 15 (market manipulation).
- Articles 22, 23 and 30 provide that the national competent authority shall have the necessary powers to enforce the prohibitions in Article 14 and 15.

The Regulation of Market Abuse
U.K. Implementation: FCA enforcement

S. 123 Financial Services and Markets Act 2000, as amended by The Financial Services and Markets Act 2000 (Market Abuse) Regulations 2016

"Administrative sanctions

Power to impose penalties or issue censure

123.—(1) The FCA may exercise its power under subsection (2) if it is satisfied that—

(a) a person has contravened Article 14 (prohibition of insider dealing and of unlawful disclosure of inside information) or Article 15 (prohibition of market manipulation) of the market abuse regulation;

(b) a person has contravened, or been knowingly concerned in the contravention of—

(i) a provision of the market abuse regulation other than Article 14 or 15 of that regulation; or

(ii) a provision of a supplementary EU regulation; or

(c) a person other than an authorised person has contravened any requirement—

(i) imposed on that person under section 122A, 122B, 122C, 122G, 122H, 122I, 123A or 123B; or

(ii) relating to the market abuse regulation or any supplementary EU regulation imposed on that person under Part 11.

(2) The FCA's power under this subsection is a power to impose a penalty of such amount as it considers appropriate on the person.

(3) The FCA may, instead of imposing a penalty on a person, publish a statement censuring the person.

The Regulation of Market Abuse
Dealing on inside information

- "Inside information", defined in Article 7, has been interpreted widely by ECJ under MAD I. To trigger the prohibition, information must be "precise", non-public and price-sensitive.
- Under Article 8, a breach occurs where a person possesses inside information and uses it by acquiring or disposing of (related) financial instruments or by cancelling or amending an order where the order was placed before the person obtained inside information.
- MAR creates a presumption that a person in possession of inside information who carries out transactions connected with that information is deemed to have used that information, reflecting the ECJ decision in *Spector Photo Group v CBFA* [2009] C-45/08.
- Under Article 9 the presumption is rebuttable where one of the following legitimately occurs:
  1. the natural person who decides to enter into a transaction on behalf of a legal entity is not himself in possession of inside information or influenced by one who is (a "**Chinese Wall**" defence);
  2. a market-maker or broker is acting in the normal course of that function;
  3. the person who trades is subject to a **pre-existing obligation** to enter into the transaction when he acquires the inside information;
  4. the insider is proceeding with a merger or takeover, prior to public disclosure, and the information relates to that activity;
  5. the inside information is that the insider himself has decided to make this trade.
- There is no general defence in respect of due care and diligence or safe systems and controls.

The Regulation of Market Abuse
Unlawfully disclosing inside information

- Unlawful disclosure arises where a person:
  1. possesses inside information and discloses that information other than in the course of his duties (Article 10(1)); or
  2. a person onwardly transmits a recommendation or inducement to trade (a "**tip**") which he knows or ought to know was based on inside information (Article 10(2))
- Special rules apply to the recipients of market soundings. Two new Level 2 Measures—Commission Delegated Regulation 2016/960 and Commission Implementing Regulation 2016/959—set out technical standards for disclosing market participants ("DMP"s).
- Article 11(7) requires a person receiving a market sounding (an "MSR") to assess whether he is in possession of inside information. ESMA has issued guidelines addressed to MSRs in a Final Report dated 13 July 2016.

An earlier presentation focused on the challenges facing asset managers, fund managers and other buy-side institutions when receiving and controlling access to inside information.

The Regulation of Market Abuse
Market manipulation, types I to IV

- Article 12(1)(a) to (d) lists four types of market manipulation:
  I. Manipulative transactions
  II. Behaviour which employs fictitious devices
  III. Disseminating misleading information
  IV. Manipulating the calculation of a benchmark

- Article 12(2) lists five general types of behaviour which "shall be considered as market manipulation". These include:
  - individual or collusive conduct to secure a dominant position over supply or demand;
  - buying and selling financial instruments during a price determination phase with misleading effect;
  - placing orders or entering into transactions with an effect which misleads investors or distorts the market by (i) disrupting the trading system, (ii) making it more difficult for others to identify genuine orders or (iii) creating a false or misleading signal;
  - taking advantage of media to voice an opinion about an instrument in which one has taken a position to one's profit and without full disclosure;
  - buying or selling emissions allowances with the effect of fixing the auction clearing price.
- Article 12(5) refers to Annex I, where one can find "indicators of manipulative behaviour" of types I and II above. These indicators are "without prejudice" to Article 12(2)—can a practice can be manipulative without any indicators being present?

The Regulation of Market Abuse
I. Manipulative transactions

Non-exhaustive "indicators" of manipulative transactions are listed in MAR, Annex I(A). In addition, practices specifying manipulative transactions are identified in Commission Delegated Regulation 2016/522:

- **colluding in the IPO after-market** (using an order in the secondary market artificially to drive up prices for the offering)
- **creation of a floor, or a ceiling in the price pattern** (using transactions to maintain the strike price of an instrument)
- **ping orders** (using a small order to test the market)
- **phishing** (executing orders to obtain information about positioning by other market participants)
- **an abusive squeeze** (abusing a dominant position)
- **inter-trading venues manipulation** (entering into trades on one venue to influence prices on another)
- **cross-product manipulation** (any behaviour on one product designed to influence the price of a related product)
- **wash trades** (trades between parties which do not transfer risk on a net basis)
- **painting the tape** (trades or orders designed to give a false impression of market activity)
- **improper matched orders** (trades or orders designed to give a false impression of a price being fixed)
- **concealing ownership** (trades which breach disclosure rules)
- **pump and dump** (trading long or disseminating positive investment information prior to a short trade)
- **trash and cash** (trading short or disseminating negative investment information prior to a long trade)
- **quote stuffing** (placing orders to overwhelm and retard the market)
- **momentum ignition** (placing orders to set or exacerbate a trend in the hope of closing-out at an advantage)
- **marking the close** (entering multiple orders during a price determination phase to influence the price)
- **layering and spoofing** (entering multiple orders to set a trend and take advantage on the other side of the book)
- **placing orders with no intention of executing them**
- **abusing a dominant position so as to impose excessive bid offer spreads**
- **advancing the bid** (entering bids solely in order to drive up the bid price and move the transacted price higher)
- **smoking** (posting attractive orders to entice investors and then rapidly switching to less generous contract terms)

The Regulation of Market Abuse
Legitimate reasons, accepted market practices

- The prohibition against market manipulation shall not apply to activities involving manipulative transactions provided that the person "establishes that such transaction, order or behaviour have [*sic*] been carried out for legitimate reasons **and** conform [*sic*] with an accepted market practice" under Article 13(1).
- Commission Delegated Regulation 2016/908 sets out the criteria, procedure and requirements for establishing an accepted market practice. These include: transparency, safeguards against impact on supply and demand, impact on liquidity, impact on proper market functioning, and any risks for the integrity of related markets.
- Under Article 13(2) a national competent authority may establish an accepted market practice.
- In the U.K., the FCA has not established any accepted market practices for the new regime (see MAR 1, Annex 2) but the FCA Handbook retains earlier guidance on "legitimate reasons" in MAR 1.6.
- Does this suggest that "legitimate reasons" are a defence by themselves, i.e. in the absence of an accepted market practice? The conjunctive "and" in Article 13(1) may suggest otherwise.
- How clear is the inter-relationship of the Article 13(1) safe-harbour and the lists of abusive practices in Article 12(2), Annex I and the Commission Delegated Regulation 2016/522? These practices are manipulative but not prohibited if Article 13(1) applies.

FCA Handbook MAR 1.6

Factors to be taken into account: legitimate reasons

MAR 1.6.5
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03/07/2016

The following factors are to be taken into account when considering whether behaviour is for legitimate reasons in relation to article 12(1)(a) of the *Market Abuse Regulation*, and are indications that it is not:

(1) if the *person* has an actuating purpose behind the transaction to induce others to trade in, bid for or to position or move the price of, a *financial instrument*;

(2) if the *person* has another, illegitimate, reason behind the transactions, bid or order to trade; and

(3) if the transaction was executed in a particular way with the purpose of creating a false or misleading impression.

MAR 1.6.6
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03/07/2016

The following factors are to be taken into account when considering whether behaviour is for legitimate reasons in relation to article 12(1)(a) of the *Market Abuse Regulation*, and are indications that it is:

(1) if the transaction is pursuant to a prior legal or regulatory obligation owed to a third party;

(2) if the transaction is executed in a way which takes into account the need for the market or auction platform as a whole to operate fairly and efficiently;

(3) the extent to which the transaction generally opens a new position, so creating an exposure to market risk, rather than closes out a position and so removes market risk; and

(4) if the transaction complied with the rules of the relevant *trading venue* about how transactions are to be executed in a proper way (for example, rules on reporting and executing cross-transactions).

MAR 1.6.7
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03/07/2016

It is unlikely that the behaviour of *trading venue* users when dealing at times and in sizes most beneficial to them (whether for the purpose of long term investment objectives, risk management or short term speculation) and seeking the maximum profit from their dealings will of itself amount to manipulation. Such behaviour, generally speaking, improves the liquidity and efficiency of *trading venues*.

MAR 1.6.8
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01/07/2005

It is unlikely that prices in the market which are trading outside their normal range will necessarily be indicative that someone has engaged in behaviour with the purpose of positioning prices at a distorted level. High or low prices relative to a trading range can be the result of the proper interplay of supply and demand.

The Regulation of Market Abuse
II. Fictitious devices

See the non-exhaustive "indicators" listed in MAR, Annex I(B), which ask whether orders or transactions are preceded or followed by

- **false or misleading information;**
- **investment recommendations which are erroneous, biased, or demonstrably influenced by material interest.**

Practices specifying fictitious devices identified in Commission Delegated Regulation 2016/522 include:

- **disseminating false or misleading information through public or private media**
- **opening a position and closing it immediately after its public disclosure**
- **pump and dump** (see previous slide)
- **trash and cash** (see previous slide)
- **concealing ownership**
- **moving commodities in order to give a false impression of supply and/or demand**
- **moving empty ships in order to give a false impression of supply and/or demand**

NB in the case of fictitious devices, there is <u>no defence of legitimate reasons and/or accepted market practices</u>.

The Regulation of Market Abuse
III. Disseminating misleading information

- Orders and transactions preceded or followed by the dissemination of misleading information will amount to manipulative activities within types I and/or II.
- Type III—which does not require an order or transaction, a profit or profit-motive—is designed to deal with parties acting otherwise than from an investment-related motive.
- The extent to which "misleading information" must be either "precise" or "public" (i.e. adjectives which qualify "inside information") is unclear:
  - The dissemination of "rumours" is mentioned in Article 12(1)(c), which may suggest, for example, that convening an *ad hoc* creditors' committee without justification would suffice.
  - The information must be transmitted "through the media, the internet, or by any other means" but "disseminating" is not otherwise defined.
- Article 12(1) refers to information relating to "*the supply of, demand for, or price of, a financial instrument*" but Article 12(2)(d) makes clear that disseminating information about the *issuer* of an instrument will be enough.
- In the U.K. examples of FCA enforcement action under a similar provision in MAD I include:
  - the CEO of a listed company causing the company to make inaccurate announcements about a related party transaction; and
  - a managing director of a company causing it to publish false information about the credit quality of its loan book.

The Regulation of Market Abuse
IV. Benchmark manipulation

- Article 12(1)(d) defines as benchmark manipulation as the activity of:

  > *"transmitting false or misleading information or providing false or misleading inputs in relation to a benchmark where the person who made the transmission or provided the input knew or ought to have known that it was false or misleading, or any other behaviour which manipulates the calculation of a benchmark"*

- No further specification is given in MAR or Commission delegated legislation.
- The new Benchmarks Regulation 2016/1011 ("BMR") requires administrators to establish adequate systems and controls in order to be able to identify and report conduct that may involve the manipulation of a benchmark (Article 14) and requires contributors to adopt governance and control requirements to ensure the integrity of submissions to the benchmark (Article 16).
- In the UK, the Financial Services Act 2012 established new criminal offences in relation to benchmark manipulation and conferred power on the FCA to make regulations (now to be found in MAR 8). Currently, only eight benchmarks are "specified" for the purposes of UK regulation.
- The UK rules will have to be updated prior to the application date of the BMR (January 2018).

The BMR has been discussed comprehensively elsewhere.

The Regulation of Market Abuse
NB A word about geographical scope

- MAD I did not set out rules specifying geographical scope, but a recital indicated that "*establishing a level playing field in Community financial markets requires wide geographical application*"
- Article 2(4) of MAR stipulates that the prohibitions in Articles 14 and 15 apply to any act or omission, whether in the EU or in a third country, provided that the instruments which are the subject of the abuse are themselves within the geographical scope of the Regulation.
- Under Article 2(1)(d) of MAR, its provisions apply to instruments whose price or value depends on [e.g. a derivative] or has an effect on [e.g. an underlying] the price of a financial instrument admitted to trading on one of the specified platforms.
- This entails that market abuse can be committed in respect of instruments which are not themselves admitted to trading in the EU but which are in any way connected to EU-traded securities.
- The drafting suggests that the connections mentioned in Article 2(1)(d) will be interpreted exclusively as causal connections. Some, however, have suggested that a wider interpretation should be adopted: for example, where the prices of both instruments are correlated because both depend on a third factor such as the creditworthiness of the issuer.

The Regulation of Market Abuse
Criminal sanctions

- CSMAD applies in most EU Member States but not in the UK.
- In the UK:
  - criminal insider dealing is an offence under Part V of the Criminal Justice Act 1993, and
  - criminal market manipulation is an offence under sections 89-91 of the Financial Services Act 2012, see:
    - section 89 (*misleading statements*)
    - section 90 (*misleading impressions*)
    - section 91 (*misleading statements etc in relation to benchmarks*);
  - the offences can be committed intentionally or recklessly or, in the case of misleading statements, through dishonest concealment of material facts; and
  - criminal sanctions for insider dealing and market manipulation can incur custodial sentences of up to 7 years and unlimited fines.

The Regulation of Market Abuse in the wholesale energy markets

- MAR applies to most spot commodity contracts but NOT to wholesale energy products by virtue of Article 2(2)(a).
- Market manipulation of wholesale energy products (including spot products and derivatives) is regulated by EU Regulation 1227/2011 on Wholesale Energy Market Integrity and Transparency ("**REMIT**"). In particular, Articles 3 and 5 prohibit the *use of inside information* and *market manipulation.*
- Criminal sanctions for breaches of these provisions came into force in the UK in April 2015 following the passing of the Electricity and Gas (Market Integrity and Transparency) (Criminal Sanctions) Regulations 2015.
- A person guilty of an offence, which may be committed intentionally or recklessly, is liable on conviction on indictment to imprisonment for a term not exceeding <u>two years</u> or a fine.
- The rules mean that the UK has joined a group of EU countries which have a stricter-than-average set of penalties for breaches of REMIT. (Some other Member States have instituted fines without imposing prison sentences, others have yet to institute penalties.)
- They also entail, however, that in the UK manipulation of the wholesale energy market is treated less severely than other forms of market manipulation.
- AND that the maximum penalty for market abuse in relation to <u>energy derivatives</u> in the UK will depend on the statutory regime which is being enforced (REMIT vs MAR).

The Regulation of Market Abuse
Conclusion

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