FINANCIAL MARKETS LAW COMMITTEE

The Regulation of Market Abuse

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Slide 1—The Regulation of Market Abuse

Hello. I am not sure whether the slot immediately following afternoon tea is better thought of as the warm up for grand finale or simply the first sitting of the graveyard shift. Either way I think something lively and engaging is called for.

It is with some trepidation therefore that what I offer instead is a technical overview of European market abuse legislation.

If we bear in mind, however, that this legislation is a coordinated and comprehensive response by European Authorities to what is now being termed the second financial crisis—that is, the crisis of scandal and misconduct, the reverberations from which are being felt around the world today—we may, perhaps, conclude that the subject is well worth our considered analysis.

What I hope to be able to do in the short half hour ahead is to draw out for you some of the ways in which the new rules succeed in meeting their objectives as well as some of the ways in which the drafting leaves a little to be desired.

I say that I am about to give an overview but necessarily there are one or two subjects which I can't address in the time available. One important topic, which I shall leave to others, is the need for proactive monitoring in relation to market abuse and the new reporting regime. This is a vitally important subject and I am glad that surveillance is being dealt with in at least two other sessions today.

Slide 2—The New Regime

The new market abuse regime came into force in the E.U. on 3 July 2016. It comprises:

- A new regulation on market abuse (which I will refer to as **"MAR"**)
- And a directive on criminal sanctions for market abuse (which is not applicable in the U.K. where HM Government has said it will, instead, develop a bespoke regime for criminal market abuse).

These two measures repeal and replace a 2003 directive on insider dealing and market manipulation (often and, perhaps, ironically referred to as "**MAD**").

Slide 3—Changes Introduced by the New Regime

MAR introduces a number of key changes the first of which is to expand the instruments within scope by referring not just to those traded on regulated markets but also to securities admitted to trading on MTFs and OTFs.

It is worth noting that under Article 4 of MAR, ESMA is obliged to publish and keep updated a list of all financial instruments admitted to trading or for which a request for admission to trading has been made. The requirement for ESMA to publish the Article 4 list has been postponed until MiFID II goes live in January 2018.

Importantly, when the list does become available, checking the list will not offer a fail-safe guarantee. First, abuse can take place in relation to instruments admitted to trading which have not yet made it onto the list (Recital 9).

Second, in scope financial instruments are not only financial instruments on this list but also, under Article 2(1)(d), any financial instrument the price or value of which depends or has an effect upon the price or value of a financial instrument admitted to trading in the EU.

For other important changes introduced by the new Regulation, see the slide.

Slide 4—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 most important thing to emphasise at the outset is that abusive behaviour can comprise either action or inaction AND, in relation to the civil offences established by MAR (as opposed to the criminal offences established under CSMAD and U.K. statutes, which we will discuss later), crucially, there is no mental element required. A breach of the prohibitions can occur without the person in question having acted intentionally or even recklessly.

Slide 5—FCA Enforcement

The 2016 U.K. Market Abuse Regulations amend U.K. law to make it compatible with MAR. For those familiar with the previous regime, there has been a substantial rewrite of Parts 6 and 8 of the **Financial Services and Markets Act 2000** (c.8) ("**FSMA**").

The Financial Conduct Authority ("**FCA**") is given new powers to police MAR, including powers to monitor the financial markets and gather information, require the publication of corrective statements and other information, and to suspend the trading of financial instruments.

The FCA is also given enforcement powers in respect of contraventions of MAR, to allow it to impose financial penalties and other administrative sanctions such as prohibitions on trading in financial instruments or working in investment firms.

The FCA's investigative and disciplinary powers have also been updated.

The provision on the slide is an amended version of section 123 of FSMA, which grants the FCA power to sanction breaches of the prohibitions in Articles 14 and 15 of MAR. I have highlighted subsection (2) which allows the FCA to impose a penalty of such amount as it considers appropriate.

Slide 6—Dealing on Inside Information

The first category of abusive behaviour prohibited by MAR is insider dealing. The definition of inside information has not changed—it must still be precise, non-public and price-sensitive—but, in the U.K. (at least), the scope of the offence has changed quite considerably.

That is because the implementation of MAD I in FSMA incorporated a general defence in section 118 which permitted an insider to make a trade provided that he or she had exercised due care or diligence so as not to make use of inside information. That section was out of line with a decision by the European Court of Justice ("**ECJ**") that a person in possession of inside information who trades in the relevant security is presumptively in breach of the prohibition. It is the ECJ decision that is now reflected in MAR and the defence in section 118 has been abrogated accordingly.

The list of specific defences or safe-harbours, which has been adopted by MAR in place of a general one, is extremely limited.

Here is a theoretical instance of the shift having a practical impact: under section 118, an asset manager who traded proportionally across his stock portfolio to meet client redemption requests, for example, could probably have argued that, although in possession of inside information in respect of one stock, his trade was made purely for liquidity reasons and he did have a defence to an enforcement action.

Under MAR, no general defence of this sort is available any longer and extreme caution should be exercised in making any trade in the stock in respect of which inside information has been obtained.

There are two express safe-harbours in Article 9 MAR that may help in this situation: one for Chinese walls and one for pre-existing obligations.

If those who trade to meet redemption requests are isolated behind Chinese walls this will provide a defence. Similarly, a contractual agreement with investors that a redemption request will trigger a proportional trade across the entire portfolio is likely to fall within the safe harbour for pre-existing obligations.

It should be emphasised that cancelling or amending an order on the basis of inside information acquired after the order was placed is also caught by the prohibition.

Slide 7—Unlawfully Disclosing Inside Information

The second category of market abuse prohibited by MAR is unlawful disclosure, which can comprise either the disclosure itself or the onward transmission of, say, a stock tip in suspicious circumstances.

The general rule under MAR Article 10 is that inside information may only be disclosed to another person if the disclosure is made in the normal exercise of an employment, profession or duty.

Disclosure of inside information by a person intending to make a takeover bid or a merger is generally permitted, however, and disclosures made in the course of a "market sounding" may be lawful so long as certain requirements are met.

All other instances will be presumed to constitute unlawful disclosure.

Special guidelines have been published addressed to the recipients of market soundings. This topic has been addressed in detail in an earlier presentation today and I do not intend to dwell on it.

Slide 8—Market Manipulation, Types I to IV

The third type of market abuse is market manipulation. This is a broad category of abuse introduced in Article 12, which the Regulation divides into four sub-types.

Changes reflect the regulatory concern with benchmark manipulation, which was at the forefront following the LIBOR and EURIBOR scandals when the Commission's proposal for a regulation was being debated. MAR also reflects a relatively recent regulatory preoccupation with high-frequency trading. This explains some of the behaviours highlighted in the second paragraph of Article 12, specifically the third bullet point on this slide.

More generally, Article 12(2) is the first of three sub-layers of regulation specifying in ever-increasing detail what is meant by the concept of market manipulation in the first two categories listed in Article 12(1).

The second layer can be found in an Annex to the Regulation where *indicators* of manipulative behaviour are given. What is meant by "indicators" can perhaps best be conveyed by saying that all the bullet points in the annex begin with the phrases like "the extent to which…" (…orders are given during a price determination phase) or "whether orders are given…" (… by persons demonstrably influenced by material interest). In other words, the indicators describe certain aspects or dimensions of trading activity, which may increase the chances of it being found abusive.

It should be noted that the language of the Article 12 is mandatory. This means that behaviour in one of these categories in Article 12(2) will be regarded as manipulative, regardless of whether other indicators are present.

Slide 9—I. Manipulative Transactions

I mentioned three layers of sub-regulation. The third layer is to be found in a Commission Delegated Regulation, which lists specific instances of abusive practices.

When I read the relevant provisions, it occurred to me that there is certain poetry in the language of the poacher, which the gamekeeper, it seems, cannot hope to emulate. Therefore, we are fortunate from a literary perspective when the gamekeeper, in this case the European Commission, decides to transpose the poacher's dictionary wholesale. And here we have it in all its glory… *momentum ignition, ping orders, spoofing, phishing, smoking and washing, pump and dump, trash and cash, advancing the bid, marking the close*…

One member of the Monetary Policy Committee has reportedly called for a Dr Seuss approach to making monetary policy more accessible. Well, here, at least, we have a promising start in market conduct regulation.

The instances given on this slide relate purely to manipulative transactions. However, not all transactions that are manipulative are prohibited by MAR.

Slide 10—Legitimate Reasons, Accepted Market Practices

Article 13 provides that 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).

Under Article 13(2) a national competent authority may establish an accepted market practice but the FCA has not yet established any for the new regime (see *FCA Handbook MAR 1, Annex 2*).

Nevertheless, the FCA Handbook retains earlier guidance on "legitimate reasons" in MAR 1.6.

The question arises now, as it did under MAD I, whether "legitimate reasons" are a defence by themselves, i.e. in the absence of an accepted market practice. The fact that the FCA retains the guidance in MAR 1.6, without identifying any practices in MAR 1 Annex 2 suggests that legitimate reasons are a sufficient defence on their own. The conjunctive "and" in Article 13(1), however, could suggest otherwise.

Slide 11—FCA Handbook: MAR 1.6

Speaking of the *Market Conduct* sourcebook…

The provision highlighted in red on the slide has been retained in the FCA Handbook. Previously market participants drew considerable reassurance from this.

Four aspects of MAR militate against drawing too much comfort from this guidance.

The first is that Article 12 is mandatory; the trading patterns listed in Article 12(2) will constitute market manipulation regardless of statements elsewhere about what may and may not amount to manipulation.

The second is that MAR itself does not appear to contemplate a defence of legitimate reasons the absence of an accepted market practice.

The third is that legitimate reasons, even when coupled with an accepted market practice, cannot —as this passage implies—sanitise a trade and remove its manipulative status. At the most, legitimate reasons can take a manipulative transaction out of scope of the general prohibition.

The fourth, as we shall see, is that the Article 13 provisions are a safe-harbour only from the rules on manipulative transactions but a trading pattern may could be recharacterised and penalised as a wholly different form of market manipulation.

Slide 12—II. Fictitious Devices

Turning now to fictitious devices, these are specified in the same three layers of regulation as manipulative transactions.

First, there are the behaviours listed in 12(2), which we saw on an earlier slide. These are supplemented by the indicators listed in an Annex. The indicators for fictitious devices are mercifully brief and I have listed them both here. Finally, there is a list of specific practices in the Commission Delegated Regulation.

The thing to note about the specific practices listed for fictitious devices is that there is a great deal of overlap with the practices listed for manipulative transactions. That is worth stressing not least because while the same trading pattern can be penalised under either category, the defences set out in Article 13 are only available in relation to the first category of manipulative transactions.

Slide 13—III. Disseminating Misleading Information

Not everyone with a reason to disseminate misleading information is necessarily engaged in trading and so we have third category of market manipulation that sweeps up the activities of those with a different kind of incentive to raise the profile of securities through misleading communications.

This category was reflected in MAD I and in the pre-2016 U.K. civil and criminal regimes for market abuse. Those penalised under this section have included managers and directors who have caused their companies to publish misleadingly positive financial statements in order to push up the share price.

Slide 14—Benchmark Manipulation

Benchmark manipulation is a new addition to the categories of market manipulation.

It has been comprehensively discussed elsewhere, including at a conference earlier this year at which RIMEs generously invited me to offer remarks on the introduction of the new European Benchmarks Regulation ("BMR"). I don't intend, therefore, to address the topic here other than to observe that, although one may find useful definitions describing the infrastructure of benchmarks in several other places (including the BMR), it is to Article 12 of the Market Abuse Regulation we must now look to discover what is meant by benchmark *manipulation*.

Slide 15—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 E.U. 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 E.U. 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.

Slide 16—Criminal Sanctions

On the subject of criminal sanctions, I have said that CSMAD applies in the other E.U. Member States but not in the U.K. In the U.K., we are still covered by statutory provisions which were finalised in 2012. These include:

- Part V of the Criminal Justice Act 1993 (criminal insider dealing), and
- sections 89-91 of the Financial Services Act 2012 (criminal market manipulation); 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. Criminal sanctions for insider dealing and market manipulation can incur custodial sentences of up to 7 years and unlimited fines.

Slide 17—The Regulation of Market Abuse in the Wholesale Energy Markets

Finally, as a matter of interest and curiosity, I thought I would draw to your attention the situation with regard to manipulation in the wholesale energy markets.

The Article 15 prohibition on manipulation in 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 E.U. 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.*

Throughout the E.U., manipulation of the wholesale energy markets is typically less stringently penalised than other kinds of market abuse. Some other Member States have instituted fines without imposing prison sentences; others have yet to institute penalties.

In the U.K., criminal sanctions for breaches of Articles 3 and 5 of REMIT came into force 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 not only that in the U.K. manipulation of the wholesale energy market is treated less severely than other forms of market manipulation but may also mean that the maximum penalty for market abuse in relation to energy futures admitted to trading in the E.U. will depend, in the U.K., on the statutory regime which is being enforced.

Slide 18—Conclusion

So what can we say about MAR?

We can say that it raises at least as many questions as it answers. Some I have mentioned in the course of this presentation. Others—*What is an attempt? When does an expression of interest become an order to trade?* —will be addressed by Level 3 regulation and developing case law in due course.

Certainly, the buy-side is likely to face a period of increased uncertainty as a result of losing the detailed rules with which the U.K. had implemented MAD I and the loss of the FCA's Code of Market Conduct in particular. The most significant loss here is probably the section 118 (FSMA) general defence, which allowed traders to rely on reasonable grounds, due care or due diligence as a defence to a charge of insider trading. The shift to the *Spector* presumption that a trade is abusive if the trader is in possession of inside information when an order is placed is arguably the most significant change introduced into the U.K. by the regulation.

We can also say, however, that this Regulation reflects a courageous and coordinated attempt by the European authorities to grapple with the scandals of the past and the trading patterns of the future whilst observing regulatory standards and principles, which have been set not regionally but intentionally by the G20 and standard-setting bodies like IOSCO. Changes that have been introduced by MAR include provisions to address high-frequency trading and to reflect the reality that trading is no longer defined by territorial boundaries. Regulation has adapted to a new world order in the markets. It is time for the markets to adapt to a new world order in regulation.