CLIENT MEMORANDUM

New EU Market Abuse Regulation: Implications for Asset Managers

July 7, 2016

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Overview

On July 3, 2016, the Market Abuse Regulation ("MAR") came into effect in the European Union. MAR builds on and replaces the Market Abuse Directive ("MAD").

MAR contains rules on insider dealing, unlawful disclosure of inside information and market manipulation. MAR has direct effect in each member state with the intention of creating a harmonised regime in Europe. MAR is wider in scope than MAD since it applies to a significantly wider range of financial instruments (including U.S. stocks that are cross-listed in the EU, which is the case for a number of stocks in the S&P 500) and trading venues. In addition, it extends the offence of market manipulation to a wider range of behaviours, including attempted market manipulation and prohibiting abusive behaviour in relation to benchmarks. It establishes a rebuttable presumption of insider dealing if a person who comes into possession of inside information amends or cancels an outstanding order concerning a financial instrument to which the information relates, placed prior to possession of the inside information.

MAR and its sanctions and penalties can have extraterritorial effect. Therefore in addition to firms operating in the EU, this briefing will also be of relevance to any non-EU firms such as asset or investment managers trading financial instruments which are traded on EU trading venues, or whose behaviour even from outside the EU could impact such financial instruments. MAR also applies to non-EU incorporated issuers with financial instruments listed or admitted for trading on a range of EU markets.

This briefing focuses on the implications for investment managers and buy-side firms.

Financial instruments within scope of MAR

The range of financial instruments and trading venues covered by MAR has been expanded from those covered by MAD and are drafted widely. MAR covers financial instruments (whether equity or debt securities or derivatives, including commodity derivatives):

- admitted to trading on a regulated market, or for which a request for admission to trading on a regulated market has been made, such as grey-market trading in to-be-issued securities;
- traded on a multilateral trading facility ("MTF"), or for which a request for admission to trading on an MTF has been made;
- traded on an organised trading facility ("OTF") (as from January 3, 2018 when MiFID II[1] is implemented);
- where the price or value of which depends on, or has an effect on, the price or value of a financial instrument. This can include OTC derivatives where the reference assets are in scope financial instruments, such as credit default swaps, or off-market trading of securities that are listed for trading on any of the above venues; and
- Emissions allowances (not covered further in this briefing).

The offences under MAR

There are three types of market abuse behaviours that are prohibited under MAR: (i) insider dealing; (ii) unlawful disclosure of inside information; and (iii) market manipulation. These are broadly similar to the offences under MAD, however, they have been expanded.

Insider dealing

The offence of insider dealing arises where a person in possession of inside information uses that information by acquiring or disposing of, for the person's own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates. Unlike U.S. law, use does not require that the person in possession of inside information "purchase or sell" a financial instrument.

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[1] Markets in Financial Instruments Directive 2015/65 EU

MAR has expanded the offence to extend to cancelling or amending an order where the order was placed before the person concerned possessed the inside information. The extension of the offence to include cancellation of orders creates a conflict with the laws of some jurisdictions outside the EU, for example in the U.S., where there may be a requirement to cancel an order once a person obtains inside information following the placement of an order. Firms may need to review their procedures concerning cancellation of orders and to take advice in establishing new procedures. It is hoped that within the EU, the European Securities and Markets Authority ("ESMA") will provide guidance through its Q&A on this point.

The offence also covers attempts to engage in insider dealing and where a person possessing inside information induces or recommends another person to engage in insider dealing.

Unlawful disclosure of inside information

Unlawful disclosure arises when a person possesses inside information and discloses that information to any other person, except where such disclosure is made in the normal course of their employment, profession or duties.

Legitimate behaviour defence to insider dealing and unlawful disclosure

There are some important defences to insider dealing for firms that establish effective information barriers. In such cases, individuals who do not possess inside information held behind an information barrier established by the firm and who transact in the affected securities will not be dealing on the basis of inside information.

There are also defences for persons dealing on behalf of third parties on the instructions of that third party in the normal course of their employment, defences in relation to the activities of market-makers and defences for persons fulfilling obligations entered into prior to obtaining inside information or to satisfy a legal or regulatory obligation.

Market manipulation

Market manipulation covers a range of behaviours that could occur on or outside a trading venue, including entering into transactions or placing orders that give, or are likely to give, false or misleading signals as to the supply of, demand for or price of a financial instrument or a related spot commodity contract or which secure, or are likely to secure, the price of a financial instrument or related spot commodity contract at an abnormal or artificial level.

The market manipulation offences apply therefore where the behaviour could affect different markets, including the related spot commodity markets.

Market manipulation can also occur where information is disseminated through the media or by any other means which gives, or is likely to give, false signals as to the supply, demand or price of financial instruments, or is likely to secure prices at an abnormal or artificial level.

Following the scandals in relation to LIBOR and other benchmarks, a new offence includes providing false or misleading inputs in relation to benchmarks, or any other behaviour that manipulates the calculation of a benchmark.

Similarly, to reflect increased regulatory concerns regarding algorithmic and high frequency trading, market manipulation also captures algorithmic or high frequency trading undertaken without an intention to trade, but for the purpose, for example, of disrupting or delaying the trading system or, creating a false signal as to the supply, demand or price of a financial instrument. Familiar examples include "spoofing," "layering" and "quote stuffing."

This is consistent with the additional duties being placed on firms under MiFID II with respect to high frequency algorithmic trading due to be implemented in 2018.

By way of guidance, Annex I of MAR lists indicators of manipulative behaviour relating to (i) false or misleading signals; (ii) price securing; and (iii) the employment of fictitious devices that will be taken into account in the event any transaction is investigated.

Inside information

The definition of "inside information" is broadly the same as under MAD. It is "information of a precise nature that has not been made public, relating directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the price of those financial instruments or on the price of related derivative financial instruments."

This is further clarified by stating that "information would be likely to have a significant effect on the price" if a "reasonable investor would be likely to use [the information] as part of the basis of his or her investment decision."

When an asset manager receives confidential information that it is assessing as to whether or not it is inside information, not only will it have to determine whether the information is precise and price-sensitive, but also whether a reasonable investor would use such information as part of its decision whether or not to trade. The reasonable investor test is not new in the UK, but it may be for other jurisdictions. For persons operating outside the EU who have different tests as to when information may be inside information, the different rules and tests may need to be emphasised in any training programme and relevant procedures.

To reflect the expanded scope of MAR with respect to commodity derivatives, the definition of inside information includes information that is relevant to the related spot commodity contract.

Market soundings and record-keeping

An area of MAR that has attracted considerable comment relates to the rules on "market soundings". Market soundings occur where information is communicated prior to the announcement of a transaction in order to gauge the interest of potential investors in a possible transaction by an issuer or a broker (for example, in relation to an IPO, block trade or private placement). Some asset managers will be market sounding recipients ("MSRs").

MAR allows for inside information to be disclosed in the course of market soundings without it being unlawful disclosure of inside information, provided that a number of detailed conditions are met.

Before the disclosure is made, the disclosing market participant, such as a broker, must: (a) obtain the consent of the MSR to receive inside information; (b) inform the MSR that it is prohibited from using that information either to acquire or dispose of, or cancel or amend, an order that has already been placed concerning a financial instrument to which the information relates; and (c) inform the MSR that it is obliged to keep the information confidential. Despite the consent required under (a), not all market soundings will necessarily involve the disclosure of inside information.

It is up to the MSR to determine whether or not it is in possession of inside information or when it ceases to be in possession of it, and to keep appropriate records of the information received and their determination. Normally this will be clear.

ESMA has issued draft guidelines on market soundings addressed to MSRs regarding: (a) the factors that such persons are to take into account when information is disclosed as part of a market sounding to assess whether the information amounts to inside information; (b) the steps such persons are to take to comply with MAR; and (c) the records they should maintain to show compliance with MAR.

Many investment and fund managers already have established practices that are consistent with the draft guidelines. These are likely to include conducting their own analysis as to whether information received should be classified as "inside information" and as to procedures that ensure information is distributed only on a "need to know" basis in compliance with either a restricted list or an information barrier process. Many firms will have record-keeping procedures to enable effective proof of compliance with inside information rules in the event of a supervisory visit or investigation.

Although the guidelines do not have the force of law, compliance with them will provide good evidence as to compliance with MAR. Firms, both in and outside the EU will want to review their current procedures and make any amendments as necessary and ensure appropriate training is provided.

For MSRs that are not based in the EU, we are waiting for the final guidelines to see if ESMA will comment on the extent to which the market soundings provisions are to apply globally. Lobbyists have requested ESMA to consider a proportionate approach to the market soundings regime when dealing with third-country firms, reflecting concerns that some investors may not wish to receive information under such conditions which may, arguably, inhibit some capital raisings. Third-country investors will want to consider whether they are happy to receive market soundings or if they would rather not receive inside information. To the extent they do receive inside information, they will want to assess any increased legal and regulatory risk and any increased compliance burden.

Suspicious transaction and order reports

For firms, including AIFMs, UCITS managers and other investment firms, operating in the EU, there are obligations to maintain effective arrangements, systems and procedures to detect and report suspicious orders and transactions. This regime applies to both transactions and orders as well as to any cancellations or amendments to orders. This is more onerous than under MAD and is likely to require a significant investment in automated surveillance systems.

Application of MAR to asset managers

Asset managers will need to review and regularly monitor the full range of instruments that they trade and where they are traded. All asset managers, including non-EU managers, will need to ensure that they have policies and procedures that cover all in-scope instruments, including certain OTC derivatives and spot commodity contracts. Even where the trading takes place outside the EU, MAR will apply to them if it is of an instrument traded or admitted to trading on an EU trading venue, which now extends to a wide range of trading platforms and broker-crossing networks, or where its behaviour could impact the price, etc., of a financial instrument within scope.

ESMA has an obligation to publish a list of all financial instruments that are admitted to trading that will in due course aid a market participant's ability to monitor relevant financial instruments in scope. Unfortunately, ESMA has said it is unlikely to be able to have the relevant systems in place to comply with this until 2018.

Further, where any asset manager employs high frequency algorithmic trading techniques and/or trades in the spot commodity markets, managers will want to check their systems and controls and their ability to monitor them to ensure that no market manipulation occurs.

As MAR specifies significantly more detailed rules and technical standards, firms will want to review and update their policies and procedures.

Application of MAR to non-EU issuers

MAR will apply to issuers of securities that are admitted to trading on exchanges and other trading venues in the EU, whether equity or debt and whether the issuer is EU or non-EU. There are detailed provisions for issuers, including with respect to the control and disclosure of inside information, the keeping of insider lists, rules concerning dealings by senior managers, exemptions for buy-back and stabilisation programmes and other ongoing obligations. The detailed rules relating to issuers are not addressed in this briefing.

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