

## MAD II – Revision to the Market Abuse Directive

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### Filling in the gaps and introducing tougher sanctions – amendments to the Market Abuse Directive announced

On 20 October 2011, the European Commission (EC) published its proposed revisions to the Market Abuse Directive (MAD) in a draft Regulation. The draft Regulation provides for:

- an extension to the scope of MAD to cover additional financial instruments and markets, including financial instruments traded solely on multilateral trading facilities (MTFs) or organised trading facilities (OTFs)<sup>1</sup>;
- a new definition of inside information for commodity derivatives and new powers for regulators to request information on spot commodity markets;
- bringing emission allowances into the scope of the market abuse regime;
- a new offence of attempted market manipulation;
- broadening and clarifying the definition of market manipulation;
- amendments to the disclosure requirements; and
- strengthening the investigative powers of regulators.

The EC also published on 20 October 2011 a draft Directive on criminal sanctions for insider dealing and market abuse. The draft Directive proposes harmonised administrative sanctions and new minimum criminal sanctions for market abuse.

### Background and timetable

MAD (which came into effect in 2003) introduced a comprehensive EU-wide framework for dealing with market abuse. MAD prohibits those who possess inside information from trading in related financial instruments and from manipulating the market. Since MAD came into force, there have been a number of market and regulatory changes which have led to perceived gaps in the market abuse regime. The draft Regulation seeks to plug the gaps identified by the EC, while the draft Directive seeks to introduce tougher sanctions for market abuse.

The draft Regulation and Directive will now be passed to the European Parliament and the Council of the European Union. It is anticipated that political agreement on the amendments to MAD will be reached by late 2012. Once adopted, the Regulation will apply two years after its entry into force (on which date MAD I will be repealed). Member States will have two years to transpose the Directive into national law.

### Extending the scope of MAD to include additional financial instruments and markets and to ensure MTFs and OTFs are covered

The issue:

MAD currently uses the definition of financial instruments from the Investment Services Directive (ISD), although the ISD was replaced by the Markets in Financial Instruments Directive (MiFID) on 1 November 2007. MiFID contains a broader definition of financial instruments and introduced a new investment service of operating an MTF. MAD currently only prohibits insider dealing or market manipulation in financial instruments which are admitted to trading on a regulated market.

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<sup>1</sup> These are a new category of trading venue under MiFID II, proposals for which were also published on 20 October 2011. OTFs are defined by MiFID II as “any system or facility which is not a regulated market or MTF, operated by an investment firm or market operator, in which multiple third-parties buying and selling interests in financial instruments are able to interact in the system in a way that results in a contract.” This should capture trading venues, such as broker crossing networks, which are not currently classified as regulated markets, MTFs or systematic internalisers.

However, financial instruments are increasingly traded on MTFs, on other types of OTFs or only traded over the counter (OTC).

The change:

The draft Regulation brings the definition of financial instruments in MAD in line with that used in MIFID. MAD will apply to any financial instrument:

- admitted to trading on an MTF or OTF, irrespective of whether or not the behaviour or transaction actually takes place on that market; or
- whose value depends on the financial instruments traded on a regulated market, MTF or OTF (e.g. OTC derivatives referenced to such financial instruments).

As a result, financial instruments which are currently outside the scope of MAD, such as credit default swaps, will now be caught.

To ensure a level playing field, operators of regulated markets, MTFs and OTFs will be required to ensure that they have mechanisms in place for preventing and detecting market manipulation and insider dealing.

The impact:

Extending the market abuse regime (and consequently obligations on transaction reporting) to include instruments traded on any MTF or OTF will substantially increase the burden on firms across the EU that have to comply with the market abuse regime.

With such a large number of markets and financial instruments potentially caught by the new market abuse regime, it will be interesting to see the extent to which regulators (outside the major EU financial jurisdictions at least) seek to monitor such markets and take action in respect of any abusive behaviour identified.

## A new definition of inside information for commodity derivatives and new powers for regulators to request information on spot commodity markets

The issue:

MAD contains a specific definition of inside information for commodity derivatives, referring to information which market users would expect to receive and supplemented by the MAD implementing directive. The current definition is, however, considered unclear.

In addition, a person can benefit from inside information in relation to the spot markets by trading on a financial market, although the current definition of inside information includes information that relates to the derivative but not information that relates to the spot commodity contract. This can lead to information asymmetries in connection with related spot markets.

MAD also gives regulators the power to demand information from any person to investigate suspicions of market abuse. However, this information may not be sufficient if there is no authority supervising the sector as is the case with spot commodity markets (although this will change with the introduction of the new Regulation on Energy Market Integrity and Transparency known as "REMIT").

The change:

The draft Regulation amends the definition of inside information for commodity derivatives by bringing it in line with the general definition, so that it covers all precise information which is likely to have a significant effect on the price of, and is relevant to, either the related spot commodity contract or the derivative itself.

The draft Regulation also gives regulators access to continuous data on spot commodity markets, delivered to them in a specified format to assist them in identifying insider dealing and market manipulation in commodity derivatives.

The impact:

The new definition of inside information for commodity derivatives is intended to provide clarity for the market and for regulators. However, it is seen as extremely broad and creating some uncertainty. It remains to be seen how the definition will interplay with the equivalent definition of inside information in REMIT.

Regulators will have the tools they have requested to monitor spot commodity markets on a real-time basis and to identify and take action against market abuse. However, this will potentially increase the reporting burden on firms.

## Bringing emission allowances into the scope of the market abuse regime

The issue:

The majority of emissions allowances are traded in the form of derivatives (futures, forwards and options), which are included in the MiFID definition of financial instruments. However, transactions for immediate delivery of allowances ("spot" transactions) are currently not included in the MiFID definition of financial instruments. The proposals for MiFID II expand the definition of financial instruments to include emissions allowance spot transactions.

The change:

As a result of the reclassification of emission allowances as financial instruments under the MiFID II proposals, emission allowances will fall within the scope of the market abuse regime. The draft Regulation introduces a specific definition of inside information for emission allowances.

Participants in the emission allowances market will face obligations to disclose inside information, create and update insider lists and report transactions. These obligations will fall on participants rather than issuers, as it is participants rather than issuers who will possess the relevant information.

Smaller participants whose activities on an individual basis may have no material impact on the price of emission allowances or the risks of insider trading will not be required to comply with these obligations. Thresholds for the classification of participants, expressed in terms of emissions or thermal input or a combination of both, have yet to be set.

The impact:

Bringing emissions allowances into the scope of the market abuse regime will have a great impact on participants in these markets, who will now be required to put in place mechanisms to comply with MAD. The requirements for the maintenance and upkeep of insider lists in particular could entail large costs.

## A new offence of attempted market manipulation

The issue:

MAD currently prohibits insider dealing and attempts to engage in insider dealing. While market manipulation is also an offence, attempting to engage in market manipulation is not. Regulators have found it difficult to take action for market manipulation under MAD as, in some markets, such as the commodity markets, there may be many reasons for changes in prices. The draft Regulation seeks to address this issue by introducing a new offence of attempted market manipulation.

The change:

Attempted market manipulation will be prohibited. It is defined in the draft Regulation as "*attempting to enter into a transaction, trying to place an order to trade or trying to engage in any other behaviour [which constitutes market manipulation].*"

The impact:

The prohibition of attempts to engage in market manipulation will enable regulators to take action in respect of market manipulation even if it cannot be proven that behaviour intended to manipulate the market had that effect (i.e. no causal link need be proven between the behaviour and any price movements). This will make it easier for regulators to take action in relation to markets such as commodity markets where there may be many reasons for changes in price.

## Broadening and clarifying the definition of market manipulation

The issue:

The definition of market manipulation in section 118 of FSMA is already broader than the MAD definition. The definition of market manipulation, however, needs to be sufficiently broad to capture new forms of trading or new strategies that emerge that may be abusive.

The change:

The definition of market manipulation will be extended to capture "*entering into a transaction, placing an order to trade or any other behaviour which:*

- *gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument or a related spot contract; or*

- *secures, or is likely to secure, the price of one or several financial instruments or related spot commodity contracts at an abnormal or artificial level.”*

The draft Regulation provides a number of examples of market manipulation. These include abusive activities which may be carried out by algorithmic trading, such as high frequency trading, reflecting the increasingly automated nature of trading of financial instruments.

The impact:

The draft Regulation will bring additional clarity to the definition of market manipulation. The examples of market manipulation will highlight the range of ways in which the market may be manipulated, particularly through new automated trading technology.

## Amendments to the disclosure requirements

The issue:

Issuers are required to inform the public of inside information as soon as possible. They may, however, delay public disclosure under specific conditions. Regulators are not currently notified when a decision to delay disclosure has been made.

The change:

Issuers will be required to inform regulators of their decision to delay the disclosure of inside information immediately after a disclosure is made. Responsibility for deciding whether to delay disclosure or not will remain with issuers.

If inside information is of systemic importance and it is in the public interest to delay disclosure, the regulators will have the power to permit a delay for a limited period in the wider public interest of maintaining the stability of the financial system and avoiding losses which could result from the failure of a systemically important issuer.

To ensure the disclosure requirements are proportionate and issuers whose financial instruments are admitted to trading on SME growth markets are not deterred from raising capital, these issuers will be subject to modified and simplified disclosure requirements. Inside information may be published by SME growth markets on behalf of issuers. The content and format of these disclosures will be standardised. These issuers will also be exempt from the obligation to keep and constantly update insider lists and a different threshold for the reporting of transactions by persons occupying a managerial role within issuers (“managers”) will be applied.

The draft Regulation also clarifies the scope of reporting obligations in relation to managers’ transaction. It states that any transaction made by a person exercising discretion on behalf of a manager or whereby the manager lends or pledges his shares must be disclosed to the regulators and the public. The draft Regulation also introduces a threshold of EUR 20,000 which triggers the obligation to report a manager’s transactions.

The impact:

Regulators will be able to investigate whether in fact the specific conditions for delaying disclosure were met. They will also have the power to sanction delays in the interests of financial stability and to protect investors from losses which may result for the failure of a systemically important issuer.

Manager transaction reporting obligations are aimed at deterring managers from insider dealing. Further clarity around when transactions should be reported may reinforce this deterrent effect.

## Strengthening the investigative powers of regulators

The issue:

Legal provisions allowing regulators to enter private premises, seize documents and demand telephone and data traffic records from investment firms and telecommunications companies are imposed by some, but not all Member States. Provisions such as these often assist regulators with proving that inside information has been transferred from an insider to a person who uses it to trade.

The change:

The draft Regulation provides for measures to strengthen investigations including;

- the power to enter private premises and to seize documents, having obtained prior authorisation from the court of the relevant member state; and

- the power to request existing telephone and data traffic records held by investment firms or telecommunication operators where a reasonable suspicion exists that such records may prove insider dealing or market manipulation.

Member States will also be required to put in place adequate measures encouraging whistleblowers to report suspected market abuse and protecting them from any adverse consequences. The draft Regulation also provides for financial incentives for whistleblowers who provide regulators with salient information that leads to a monetary sanction.

The European Securities and Markets Authority (“ESMA”) will have a strong coordination role and regulators will be required to cooperate and exchange information.

The impact:

The provisions of the draft Regulation which allow regulators to enter private premises and seize documents and demand telephone and data traffic records from investment firms and telecommunications companies will have little impact in the UK as the FSA already has such powers. Under section 176 of FSMA, the FSA already has the power to apply for a warrant to enter premises where documents or information is held. The FSA also currently has the power request telephone and data traffic records from telecommunications companies under the Regulation of Investigatory Powers Act 2000.

While the FSA has in place long-established procedures for dealing with whistleblowers, it does not currently offer financial incentives to whistleblowers.

## Harmonisation of administrative sanctions and new minimum criminal sanctions for market abuse

The issue:

Although EU financial markets are increasingly integrated, Member States adopt different sanctioning regimes. This can lead to regulatory arbitrage.

The change:

The draft Directive introduces minimum rules for administrative measures, sanctions and fines. It provides for the disgorgement of any profits where identified, including interest and, in order to ensure an appropriate deterrent effect, it introduces fines which must exceed any profit gained or loss avoided as a result of a violation of the Regulation. Fines for corporates will be based on a proportion of annual turnover, which is similar to the approach taken to sanctions in EU competition law.

Member States will be required to put in place “effective, proportionate and dissuasive” criminal sanctions for the most serious insider dealing and market manipulation cases.

The impact:

The FSA has already increased the number of criminal prosecutions it pursues and has sought to introduce harsher sanctions in pursuit of “credible deterrence”, but fines are likely to increase even further. The minimum rules will also ensure a more uniform approach across the EU.

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