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Brexit Alert

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Keeping Calm and Carrying On: the EU Market Abuse Regulations

The EU Market Abuse Regulation ("MAR"), which came into effect across the EU yesterday (3rd July), is a timely reminder in the aftermath of the UK's Brexit referendum, that, for the time being at least, the UK remains a member of the European Union and that EU financial services legislation continues to have effect.

As an EU regulation, MAR has direct effect in each member state of the EU. MAR will apply in the UK for so long as it remains a member of the EU (and potentially may continue to apply in the event of a negotiated "soft-Brexit").

Key elements of MAR of which buy-side firms should be aware include the following:

I. MAR is wide in jurisdictional scope. It applies to all trading in securities admitted to trading on an EU-regulated market, multi-lateral trading facility ("MTF") and, when they come into existence, Organised Trading Facility ("OTF") (an "EU Listed Security") as well as to trading in spot commodity contracts and emission allowances. It also applies to all trading in securities the price or value of which depends on or has an effect on the price of an EU Listed Security. Accordingly, trading from any country outside the EU (for example, the USA) on an EU-market will be subject to MAR. However, MAR also applies to any trading in a security whose price is linked to an EU Listed Security. This means, for example, that a New York manager trading on the New York Stock Exchange in a US name could, technically, fall within the scope of MAR if that name has a secondary listing on an EU market. Similarly, an OTC derivative trade between two US counterparties could fall within the scope of MAR if the underlying is or includes an EU Listed Security.

II. MAR, broadly, defines inside information as information which is of a precise nature, has not been made public, relates, 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 prices of those financial instruments (or the price of any related derivative financial instruments). MAR contains explanatory language requiring market participants to interpret information that, if it were made public, would be "*likely to have a significant effect on the price of a financial instrument*" to mean "*information a reasonable investor would be likely to use as part of the basis of his investment decision*". Unlike in the US, MAR does not require that an insider trades in breach of a duty (typically owed either as a result of his relationship to the issuer or as a duty of confidentiality to the person who provides him with the information).

III. The definitions of inside information and of the insider trading and market manipulation offences remain broadly the same as under the previous regime. However, MAR introduces a new offence of "cancelling or amending an order" on the basis of inside information. This is a departure from the previous position in the EU (and the current position in the US) which requires there to be a trade in order for there to be insider dealing.

IV. MAR introduces ambiguities to existing exclusions that may be problematic for activist investors. Although MAR expressly excludes from the definition of inside information both: (i) a person's knowledge of his own intention to trade; and (ii) research and estimates based on publicly available data, it also introduces limitations to these exclusions that cast doubt on their effectiveness. In particular Recital 28 indicates that where a "recognised market commentator or institution" publishes or releases information (including the results of their research or their opinion of a particular security) which may have a market impact, it may constitute inside information (and that trading in advance of that information being released would be insider trading). It will therefore be important for market participants to carefully consider how to manage trading in advance of making any statement or publishing research in respect of an issuer.

V. MAR provides a framework for disclosing inside information in the course of market soundings. Where sell-side firms comply with certain requirements, they will be protected against the allegation of improper disclosure. The disclosing market participant ("DMP") will be required to comply with a strict procedure prescribed by MAR (which, broadly, includes an obligation to obtain consent from the market sounding recipient ("MSR") to receive inside information, remind the MSR of the prohibition to use inside information to trade, ensure that the MSR keeps the information confidential, and keep appropriate records). ESMA is currently in the process of finalising guidelines by which MSRs are expected to comply which correspond with the MAR market sounding procedures applicable to DMPs. However, the market sounding regime offers little protection for buy-side firms. The MSR remains responsible for making its own assessment of whether the information it has received is inside information. Buy-side firms should be cautious about relying on a MSR which tells it that the relevant information is not "inside".

VI. MAR requires any person "professionally arranging or executing transactions" (which will include most investment managers) to have in place effective systems and procedures to detect and report suspicious transactions and orders. European Securities and Markets Authority ("ESMA"), in its final report on draft technical standards on the Market Abuse Regulation, states that "in the large majority of cases this will necessitate an automated surveillance system" which "should include software capable of deferred automated reading, replaying and analysis of order book data on an ex post basis." Firms must retain records of their analyses of any trades identified as potentially suspicious for five years. Any order or transaction that is determined to be suspicious must be reported to the relevant regulator in the form specified by MAR.

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