REGULATION ON INSIDER DEALING AND MARKET MANIPULATION ((COM 2011) 651/3)

and

DIRECTIVE ON CRIMINAL SANCTIONS FOR INSIDER DEALING AND MARKET MANIPULATION ((COM 2011 (654/3))

Response by the Futures and Options Association (FOA)

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1 MARKET ABUSE REGULATION AND DIRECTIVE

NB. This draft response paper does not seek to address issues relevant to capital markets business

1.1 Summary of main points

1.1.1 The FOA notes and supports the conclusion, in the Explanatory Memorandum to the original proposal for a Market Abuse Directive, that establishing an effective and consistent approach to defining and enforcing market abuse is a "fundamental pillar" to establishing a coherent single market in financial services.

1.1.2 The FOA agrees with the observation in the Explanatory Memorandum of the Market Abuse Regulation that a regulation will reduce legal complexity and offer greater legal certainty (para 3.1), ensure (so far as practical) that "all persons follow the same rules in all the Union" (Recital 5), enhance customer understanding of what is abusive behaviour and simplify compliance for firms carrying on cross-border business within the EU.

1.1.3 The FOA supports the extension of the regime to cover financial instruments traded on MTFs and OTFs as well as regulated markets and related financial instruments traded OTC, providing that this leads to the setting of appropriate and proportionate regulatory standards.

1.1.4 The FOA believes that closer alignment in the scope of market abuse definitions as they apply to financial and commodity markets is key to the development of common standards and simplified compliance. However, the FOA remains deeply concerned over the inappropriateness of the very broad definition of insider information, particularly as it relates to commodity derivatives, which lacks clarity in defining exactly what is and what is not inside information and will create an unacceptable level of uncertainty around the ability of market participants to carry out legitimate and essential trading and risk management activities (see paras 2.2.3 to 2.2.6).

1.1.5 The FOA believes that:

(a) the "legitimate business" exclusions in a number of key exemptions in the original MAD, as reflected in Recitals 18 (Market Makers and Principal Traders), 29 (Takeovers), 30 (Dealing on Own Intentions) and 31 (Research) should be reinstated in the new legislation; and

(b) because of the cross-market reach of the regulation, its requirements should, where relevant and appropriate, be closely approximated to REMIT (particularly Recital 12), and the defences accommodated within REMIT (see para 2.2.5).

1.1.6 The FOA believes that proof of wrongful intent should apply in all cases of market abuse and welcomes the fact that it will play a significant role as an element that will have to be proved in the context of criminal proceedings and assumes that this will apply equally (and it should be expressly stated therefore) to the new offences of attempt, incitement and aiding and abetting and the position regarding orders (see paras 2.2.8, 3.3.3 and 3.3.5).

1.1.7 The FOA accepts the need for an extra-territorial element to market abuse to prevent cross-border misbehaviours, but remains concerned over consequential problems for financial

service providers and consumers in managing conflicts of laws, compliance complexity and potential regulatory confusion insofar as not all jurisdictions will deem the same set of behaviours to be abusive.

1.1.8 Obligations to prevent or mitigate suspicious dealings or orders whether in the context of market infrastructure operators or financial services firms must be realistic (recognising that neither firms nor markets will always have all the information necessary to determine whether or not an order or transaction is suspicious), and applied and interpreted therefore on an "all reasonable steps" basis (see further paras 2.1.3 and 2.2.11).

1.1.9 With regard to Article 2, the FOA remains unclear as to why the extension to physical contracts covers only spot dealings and not physical forward dealings (see para 2.2.1).

1.1.10 In terms of the extension of market abuse to include orders, the FOA believes that Recital 22 which refers simply to the placing of orders "which may not be executed" is incorrect and should accord more closely with Article 8 which refers to no intention to trade (see para 2.2.10). This is particularly important given the potentially very wide definition of 'algorithmic trading' in Article 5.

1.1.11 With regard to the less burdensome regime for SME markets and issuers, the FOA recognises the need for costs imposed on small firms and markets to be proportionate, but this should not involve any compromise in the underlying core principles of sustaining market integrity and investor protection (see para 2.2.12).

1.1.12 The FOA remains concerned over the impracticality of the approach adopted towards the maintenance and upkeep of insider lists (see para 2.2.13). This concern is particularly noteworthy in the context of commodity derivatives where the list of potential insiders could extend to staff involved in the physical operations of producers and suppliers of commodities.

1.1.13 The FOA notes the requirement that measures and sanctions should be both "proportionate and dissuasive", but remains unclear as to how they can be both e.g. is the acceptable level of dissuasive sanctioning subject to the overriding requirement that it should be fair and proportionate to the offence? (see paras 2.2.17 to 2.2.18).

1.1.14 There are a number of terms in the regulation (eg reporting of "continuous data" (para 3.4.4.1 of the Explanatory Memorandum) and direct access to trading systems (Article 17.2 c of MIFIR) which are unclear and which could benefit from more detail, particularly in the context of the cost-benefit of required processes and procedures.

2 MARKET ABUSE REGULATION

2.1 Miscellaneous Comments on Recitals

2.1.1 The observation in Recital 7 that "Market abuse is the concept that encompasses all unlawful behaviour in the financial markets" is not entirely correct. There are other forms of criminal activity that can take place in those markets which would not be covered by market abuse e.g. fraud, theft. Presumably, the Recital intends to cover "all unlawful *abusive* behaviours"?

2.1.2 The FOA supports the observation in Recital 12 that assumptions drawn about the price sensitivity of information after the event will not be "used to take actions against persons who drew reasonable conclusions from ex ante information available to them". In this regard the FOA would urge the Commission to consider providing guidance on the issues raised by the so-called 'expert networks' and the 'mosaic theory' of investing that have been an issue in recent high profile cases in the US.

2.1.3 The FOA acknowledges the current intention to classify emissions allowances as financial instruments as part of the review of the Markets in Financial Instruments Directive, and understands the subsequent need to address emissions allowances under MAR per Recital 16. Nevertheless, the FOA has questioned the justification for classifying allowances as financial instruments in its response to the MiFID review and, by extension, the need to include many of the specific clauses in MAR pertaining to the treatment of emissions allowances.

2.1.4 The FOA notes in Recital 22, the obligation on persons who arrange or execute transactions to have systems in place "to detect and report suspicious transactions" and to report suspicious orders and transactions that take place outside a trading venue. The FOA would emphasise the importance of adopting a proportionate approach in setting these obligations, recognising that such persons may not always be able to see all the circumstances and that, in reality, this should be no more than "all reasonable steps" obligation. The FOA believes that this should be stated in terms and, further, that systems that are deployed for these purposes should be ones that are *"are designed to detect and report suspicious transactions"*. (See also para 2.2.11)

With regard to Recital 32, the FOA agrees that ESMA should be informed where there is a cross-border element to an alleged abusive activity, but – and this does appear to be recognised in the Recital – national competent authorities are and must continue to be frontline supervisors, even in the context of cross-border EU abusive activities.

2.2 Comments on Articles

2.2.1 The FOA broadly agrees with the scope provisions set out in **Article 2**, but:

(a) is unclear as to why paragraphs 3(b) and (c) are limited to spot commodity contracts and do not cover also forward physical dealings; and

(b) assumes that the reference to commodities is intended to include non-commodity "exotic" products (para C 10 in Annex 1 of MiFID), but questions how the inclusion of

the underlying is going to be addressed, because the latter is not necessarily a spot "commodity" contracts;

(c) would question why the regulation applies to financial instruments traded on a regulated market, MTF or an OTF without reference to the venue being located in the EU on the basis that it is surely not the intention to apply the Regulation to financial instruments traded on venues outside the EU;

(d) notes that there is no requirement to draw up a list of MTFs or OTFs (as there is in relation to Regulated Markets) and, as such, it will be very difficult to ascertain whether a particular instrument is traded on an MTF or OTF and therefore within scope of the market abuse regime;

(e) assumes that references to "issuers of financial instruments" would not apply to, for example, commodities, which are not "issued" and are not subject to the same type of information-disclosure obligations as, for example, cash equities – a confusion that applies to a number of the provisions in Article 6.

2.2.2 With regard to **Article 3**, the FOA notes that the exemption to Articles 9 and 10 is limited to trading in "own shares" in buy-back programmes or for stabilisation purposes. The FOA believes that this is unduly restrictive, and that the Article should facilitate stabilisation of all financial instruments. Recital 9 makes this point by emphasising that "Stabilisation of financial instruments or trading in own shares in buy-back programmes can be legitimate… and should not, therefore, in themselves be regarded as market abuse". The FOA believes that this Article should be brought into line with the definition of scope set out in Recital 9.

2.2.3 The FOA supports a closer approximation in the definition of inside information in **Article 6** as it applies to both financial instruments, derivatives on commodities and emissions allowances, but has a number of concerns over the high degree of uncertainty as to what and when information will be classified as inside information e.g.:

(a) In relation to para 1(b), the FOA agrees that the definition should be aligned with individual market rules and requirements, but the word "notably" injects a high degree of uncertainty as to precisely what would constitute inside information in relation to commodities in 1(b) i.e. what other category of information which would not be a market required disclosure is sought to be caught by paragraph 1(b) *that is not caught by the other subsections in para 1.*

(b) With regard to para 1(e), the inclusion of information merely on the ground that it is regarded by a reasonable investor as "relevant" (to deciding the terms on which a transaction should be effected), is extraordinarily wide and could cover any form of commercially-sensitive information. The FOA believes that this test should be deleted for the reasons set out in para 2.2.4, the severe risk of unintended consequences for legitimate market dealings and because this test is, in any event, in conflict with and circular to the terms of Article 6, para 3.

(c) All forms of inside information should be precise and price-sensitive, in breach of acceptable market practices and not founded just on the vague test of "relevance".

2.2.4 Commodity houses, including commodity miners, producers, growers, refiners, farmers, transporters, merchants and suppliers are engaged, essentially, in commerce and trade (and

not the provision of investment or banking services) and will all hold information which is relevant to existing or anticipated production, quality, storage and supply levels and will use that information in order to determine their trading and risk management needs and fulfil their delivery commitments.

It is critical therefore that they are able to exercise legitimate commercial trading discretions, hedge their underlying risks, manage changes in supply and demand, meet their contractual delivery obligations and keep commercially sensitive information relevant to their assets confidential. In the absence of qualification and specific defences to ensure proportionality, the combined vagueness in 1(b) and the breadth of 1(e) will have a serious "chilling" effect on dealing activities essential to the process of securing supply, stabilising commodity prices (which flow through to consumers) and managing cash flows.

Para 1 (e) would also make it near impossible for directors and other senior managers to exercise share options, as much information that may be 'relevant' would not fall within a disclosure requirement and so such directors and senior managers could never be 'cleansed' of such information.

2.2.5 For these reasons, the FOA would urge the Commission to apply this definition only to precise and price sensitive information concerning events outside the normal operational activities of firms and, while the FOA understands that the technical standards and thresholds supporting REMIT have yet to be drafted, consider including those provisions and protections in REMIT which pay due regard to preserving the ability of firms to enter into legitimate commercial and risk management trading activities and that this will of necessity involve the use of commercially confidential (to the firm) information to meet those needs, namely:

(a) that information on a market participant's own plans and strategies for trading should not be considered as inside information;

(b) that dealings necessary to cover loss from unplanned outages or act under national emergency rules (e.g. confidential data, such as marginal cost information, on individual power plants, should be exempted insofar as it is information that no market participant could reasonably expect to receive). While this is relevant to producers and operators of storage and transport facilities, it is equally important for other market participants (and the FOA believes that the adoption of a narrower and more appropriate definition of inside information will mean that any exemption of this nature would not be a license to trade on inside information);

(c) that the original proposed defence of "legitimate reasons" should be reinstated providing they accord with market rules and practices (as reflected in para 1(b) of Article 2).

2.2.6 The broad definition of inside information under **Article 6** para 1(d) as it applies to persons executing orders on behalf of clients, gives rise to the concern that, taken literally, the Regulation prohibits brokerage business as the instructions given by a client to a broker could reasonably constitute information which, if made public, would be taken into account by other investors. While the FOA accepts that the intent of this paragraph is to prevent "front running" and/or dissuade brokers from executing client orders while in pursuit of other inside information, the definitions need to be sufficiently precise, or else client instructions spelled out as an exception.

2.2.7 With regard to **Article 6** (para 2), the FOA believes that amending "may reasonably be" in the second line to read "is reasonably" would create a higher degree of certainty of outcome, without detracting from the purpose of the provision.

The FOA also believes that the word 'possible' should be deleted from line 5 of para 2 following the case of David Massey vs the FSA (FIN/2009/0024) which highlighted the uncertainty introduced into the definition of 'inside information' by the use of the word 'possible'.

2.2.8 With regard to **Article 7**, the FOA would argue:

(a) that the addition of the words "or had any contact with those involved in the decision whereby the information could have been transmitted or its existence could have been indicated" adds nothing to the purpose of the paragraph, but actually detracts from it in a way to add significant uncertainty insofar as it is quite conceivable that the legal person could be in casual contact with anyone involved in the transaction decision for personal reasons or for necessary business reasons that are nothing to do with the decision in question;

(b) the exemption in paragraph 8 should be extended to cover situations (e.g. trading programmes) where there is no strict legal or regulatory obligation to act.

More generally, Article 7 appears to be couched in wholly objective terms in that there is no requirement for authorities to discern any *intention* to commit market abuse, or even recklessness. As such, the considerable uncertainty introduces in this regard by the Spector Photo case remains unresolved. The FOA urges the Commission to consider specifying clearly that a person will not be guilty of market abuse unless he intended to commit market abuse.

2.2.9 The behaviours identified in **Article 8** (para 3), which could constitute market manipulation or attempts to engage in market manipulation include both intent-based and effects-based behaviours – other than in sub-paragraphs (a) and (e), which are purely effects-based contraventions. However, should they not include the alternative of wrongful intent, bearing in mind that the institution of criminal proceedings for market manipulation is dependent upon proving wrongful intent?

2.2.10 With regard to **Article 8** (para 3(c)), the FOA welcomes the inclusion of the words "without any intention to trade", which establishes wrongful intent – unlike the related Recital 22, which refers simply to the placing of orders "which may not be executed". This interpretation in the Recital completely disregards the fact that there may be a genuine intention to execute the order when it is placed in which case there is no manipulation or attempted manipulation of the market. In other words, the FOA believes that this provision is directed at "spoofing" where bids and offers are made with the specific intent of cancelling the bid or offer before execution at the time the bid or offer is made in order to, for example, delay the execution of trades by another market participant or create an appearance of false market liquidity.

2.2.11 With regard to **Article 11** (para 2), the FOA believes that the second line should read "Instruments shall have systems in placed *designed* to detect and report orders and transactions". It is important to bear in mind also that operators of trading venues should, rightly, have effective arrangements and procedures in place that are aimed at preventing

and detecting market abuse, but they may not always have all the information down the transaction chain that would enable them to reasonably suspect that market manipulative or insider dealings behaviours are taking place. This approach would be entirely in line with para 1 in Article 11 which refers to persons adopting and maintaining effective arrangements and procedures "aimed" at preventing and detecting market abuse, although the FOA would add that prevention is significantly more difficult than detection and this should be taken fully into account in setting proportional and reasonable expectations on financial organisations and market operators.

2.2.12 With regard to the proposed exemption threshold for emissions allowance market participants in **Article 12.2 subparagraph two**, the FOA notes that prior year emissions levels are not necessarily a reasonable measure of current year output. In practice, a threshold measure which incorporates some forward looking element may be more appropriate. Moreover, even relatively low current year outputs do not preclude the possibility that the removal of disclosure obligations could provide an advantage to a market participant, depending on the level at which the threshold is set.

2.2.13 With regard to the proposals for a less onerous regime for SME markets and issuers, as set out in **Article 12.7 and 13.2**, the FOA understands the need to avoid imposing unnecessary costs on SMEs – although it would add that the imposition of unnecessary costs is a concern for all regulated institutions – but would urge the Commission, if it decides to develop this alternative regime, to pay full regard to the "red lines" set out elsewhere in this Regulation, namely:

(a) in para 3.3.3 in the Explanatory Memorandum, that, in developing such a framework, there should be no prejudice "to the objectives of preserving the integrity and transparency of financial markets and of protecting investors";

(b) the qualification in Recital 26 that

any such regime should not undermine the policy objective that "prompt disclosure of inside information is essential to ensure investor confidence in those issuers"; and

compliance with any requirements must not result in "compromising investor protection".

In this context, it is perhaps worth bearing in mind that markets specialising in SMEs can give rise to significant regulatory concerns because of their very nature.

2.2.14 With regard to **Article 13** (and Recital 27), the FOA agrees that national differences relating to the maintenance of insider lists can create unnecessary administrative burdens, and supports the idea of a uniform approach. However, the FOA would emphasise the importance of not hard-coding unnecessary or unrealistic administrative burdens into any harmonised approach and to take into full account the need for requirements of this nature to be practical and sustainable (and is particularly important in the development of new requirements to address dealings in commodities). The FOA recognises that some increase in cost is inevitable in developing a more exacting and harmonised approach to market abuse, but would urge the Commission to develop new requirements in as cost-efficient way as possible.

2.2.15 With regard to **Article 17** (para 2(e)), the FOA strongly supports the requirement that a competent authority must obtain prior authorisation from the relevant judicial authority before entering private premises in order to seize documents, but questions whether or not this power should be restricted to circumstances where it is believed a criminal offence may have taken place, i.e. that the behaviour may have been committed with wrongful intent.

2.2.16 The FOA agrees with the proposals set out in **Chapter 4 (Articles 16-23)**, which sets out proposals for improving information flows and co-operative procedures between individual member state competent authorities and between them and ESMA, as regards the prevention, detection, investigation, prosecution and sanctioning of market abuse.

2.2.17 In relation to the provision of information under **Article 20**, the FOA would emphasise that careful consideration should be given to confidentiality issues that may arise when information is shared among competent authorities in different member states or with third country regulators. More particularly:

- access in certain sensitive areas needs to be accompanied by a full statement of reasons from the requesting authority;

- commercial confidentiality needs to be respected in practice, as well as in principle;

- information providers need to be wary of "fishing expeditions", requests for information made on behalf of departments or authorities that have no rights of access to the information and onward use of the information for purposes outside of the scope of the right of access;

- information requests from countries with questionable human rights or legal processes will need to be treated with caution.

2.2.18 With regard to **Article 24** (para 1), the FOA believes that there is an inherent conflict in the requirement that measures and sanctions should be both "proportionate and dissuasive" that needs to be managed (e.g. is the "cap" on the level of dissuasive sanctioning the fact that it must be fair and proportionate?). Furthermore, **Articles 25 and 26** state that a person who operates a trading venue is subject to sanctions if he fails to adopt and maintain effective arrangements and procedures aimed at preventing and detecting market manipulation practices. Those sanctions include public censure (Article 26(1)(d)) and a right for the competent authority to impose a fine of up to 10% of the annual turnover of the market operator's corporate group (Article 26(1)(m)). Elsewhere in MAR, such sanctions are reserved for the **perpetrators** of market abuse. The proposed powers over the operators of trading venues are excessive and are not justified by any demonstrable failure in existing regulatory practices. Trading venues have a close and continuous relationship with their regulators, who maintain ongoing scrutiny over the systems and controls employed by such trading venues to prevent and detect market abuse.

2.2.19 With regard to **Article 27**, the FOA agrees the list of factors to be taken into account in determining the appropriateness of a particular administrative measure or sanction, but it omits (and should include) any mitigating actions taken by the responsible person – particularly relevant in the case of inadvertent or purely effects-based breaches – and not just the level of cooperation of that person with the competent authority. The FOA notes that "additional factors" may be taken into account by competent authorities, but believes

that this factor is sufficiently important that it should be **expressly** applied to all competent authorities.

2.2.20 With regard to **Article 29**, the FOA believes that the financial incentives referred to in para 2 are permissible, but should not be such as to generate false accusations or entrapment, i.e. they should not be at such a level as to induce wrongful behaviours on the part of the whistleblower for pecuniary gain. The FOA believes that the same concerns that arise in connection with inducements apply in this context, and that it is important, therefore, that Article 29 states expressly that any financial incentives must be proportionate. .

3 MARKET ABUSE DIRECTIVE

3.1 General Observations

3.1.1 The FOA recognises the observation in the Explanatory Memorandum that "criminal convictions for market abuse offences, which often result in widespread media coverage, help to improve deterrence", but notes and supports also the observation that "criminal sanctions may not be appropriate for all types of violations and in all cases".

3.2 Miscellaneous Comments on Recitals

3.2.1 The FOA notes the observation in Recital 3 that "there should also be equal, strong and deterrent sanction regimes against all financial crimes", but believes that it would be consistent to use the same wording that appears in the Regulation and the Explanatory Memorandum to the Directive, namely, that sanctions should be "effective, proportionate and dissuasive".

3.3 Comments on Articles

3.3.1 With regard to **Article 1.2**, the FOA believes that non-EU governments and central banks should be – but are not - exempted in the same way as comparable EU bodies, particularly where they are trading for comparable purposes in similar circumstances.

3.3.2 The FOA supports the mandated application of criminal offences as regards insider dealing and market manipulation in **Articles 3 and 4**, but very much on the basis:

(a) that only the more serious misbehaviours will require to be the subject of criminal process;

(b) that, as envisaged, the burden of proof will be on the prosecution to prove wrongful intent; and

(c) that competent authorities are afforded some degree of enforcement discretion, particularly in the case of minor misbehaviours (whether intended or not).

The FOA's original response to the Commission's public consultation on revising the Market Abuse Directive emphasised that serious forms of misconduct are never usually dependent on one offence, but are covered by several different offences designed to fit different circumstances and the seriousness (or otherwise) of the alleged misconduct. The FOA welcomes the proposed differentiation between criminal and civil in that it goes some way to achieving that objective.

3.3.3 The FOA supports the introduction of the new criminal offences of inciting, aiding and abetting, and attempts to commit market manipulation (**Article 5**), but believes that, for the avoidance of doubt, it should be expressly stated that wrongful intent is a necessary ingredient for the purpose of proving these new offences (notwithstanding that it can be assumed to apply in most cases).

3.3.4 With regard to the offence of “attempt”, the FOA would point out that a failed attempt to manipulate a market can still have disorderly adverse side effects; and also that an intended attempt to manipulate a market could be a more serious offence than an inadvertent manipulation of a market, which did not involve wrongful intent.

3.3.5 With regard to **Article 7**, while the FOA understands the purpose behind establishing what amounts to vicarious liability of firms for the actions of their senior employees, the FOA believes strongly that this should only apply where there is demonstrable fault, e.g. a failure in systems and controls. It seems disproportionate not to (a) incorporate a “reasonable systems and controls” defence or (b) require proof of wrongful intent or recklessness on the part of an employing firm.