King & Spalding

Client Alert

Financial Institutions Regulation Practice Group

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Asset managers' guide to the EU Market Abuse Regulation: will you be compliant on 3 July 2016?

The EU Market Abuse Regulation (596/2014) ("MAR") applies from 3 July 2016. This guide is intended as an aid to asset managers in assessing, in the weeks running up to 3 July but also on an ongoing basis, whether amendments to existing practices and procedures are needed to ensure compliance. We do not seek in this guide to provide a comprehensive overview of MAR but instead to focus on some practical implementation issues. For many EEA-based asset managers preparations for implementation will already be well advanced but there is still time to make additional changes and train staff ahead of the 3 July deadline. Asset managers based outside the EEA need to be aware of the extraterritorial reach of MAR, which can expose them to fines by national regulators in the EEA.

In its recent Market Watch newsletter (number 50) the UK Financial Conduct Authority ("FCA") stated that "*It is the responsibility of firms to ensure that they understand the new requirements and are fully compliant by 3 July 2016*". In practice it is impossible for firms to be fully compliant by 3 July 2016. MAR will not fully apply until MiFID II implementation (described below) on 3 January 2018, when MAR references to Organised Trading Facilities, SME growth markets, emission allowances and related auctioned products will begin to apply. Further, the approach of the European Securities and Markets Authority ("ESMA") and national regulators to interpreting MAR will inevitably develop with experience and as "Level 3" guidance, in particular through the ESMA Q&A process, is rolled out. Asset managers can only make best efforts towards compliance by 3 July 2016. They will need to keep their systems, procedures and policies for compliance with MAR under rolling review after 3 July 2016 to ensure that compliance is achieved and maintained.

Asset managers trading across Europe should also be aware of local laws implementing Directive 2014/57/EU on criminal sanctions for market abuse ("CSMAD"). CSMAD will not apply in the UK or Denmark, as the respective governments have exercised their rights to opt out. CSMAD is intended to cover the most serious cases of intentional market abuse. The controls that asset managers put in place to prevent breaches of MAR should be sufficient to protect against the risk of breaching CSMAD.

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Overview - widened scope

The civil "offences" under MAR are summarised in the graphics on pages 3 and 4 of this guide. The principal changes in scope of these offences as against the predecessor Market Abuse Directive ("MAD") are as follows:

- The "financial instruments" covered by the insider dealing and market manipulation offences will now extend to:
  - financial instruments admitted or requested to be admitted to trading on all EEA trading venues, including Multilateral Trading Facilities ("MTFs") and, from 3 January 2018, Organised Trading Facilities ("OTF");
  - financial instruments the price or value of which depends or has an effect upon the price or value of such financial instruments,

  whereas MAD covered only financial instruments traded on regulated markets and related investments.
- The market manipulation offences now extend to behaviour in relation to spot commodity contracts and auctioned products based on emission allowances.
- All types of behaviour that could result in market manipulation are now prohibited, this is no longer limited to entering into transactions or placing orders to trade.
- The insider dealing offence now includes using inside information to cancel or amend a pre-existing order.
- MAR makes explicit that a legal presumption applies with the effect that a person in possession of inside information who trades is deemed to have used the inside information and so has committed an insider dealing offence, unless one of the specific legitimate behaviours under Article 9 MAR applies. This presumption can be rebutted if evidence can be produced to show that the inside information was not used. [1]
- There is a specific offence covering transmitting false or misleading information or providing false or misleading inputs in relation to a benchmark or any other behaviour which manipulates the calculation of a benchmark. The MAR definition of "benchmark" is very wide.

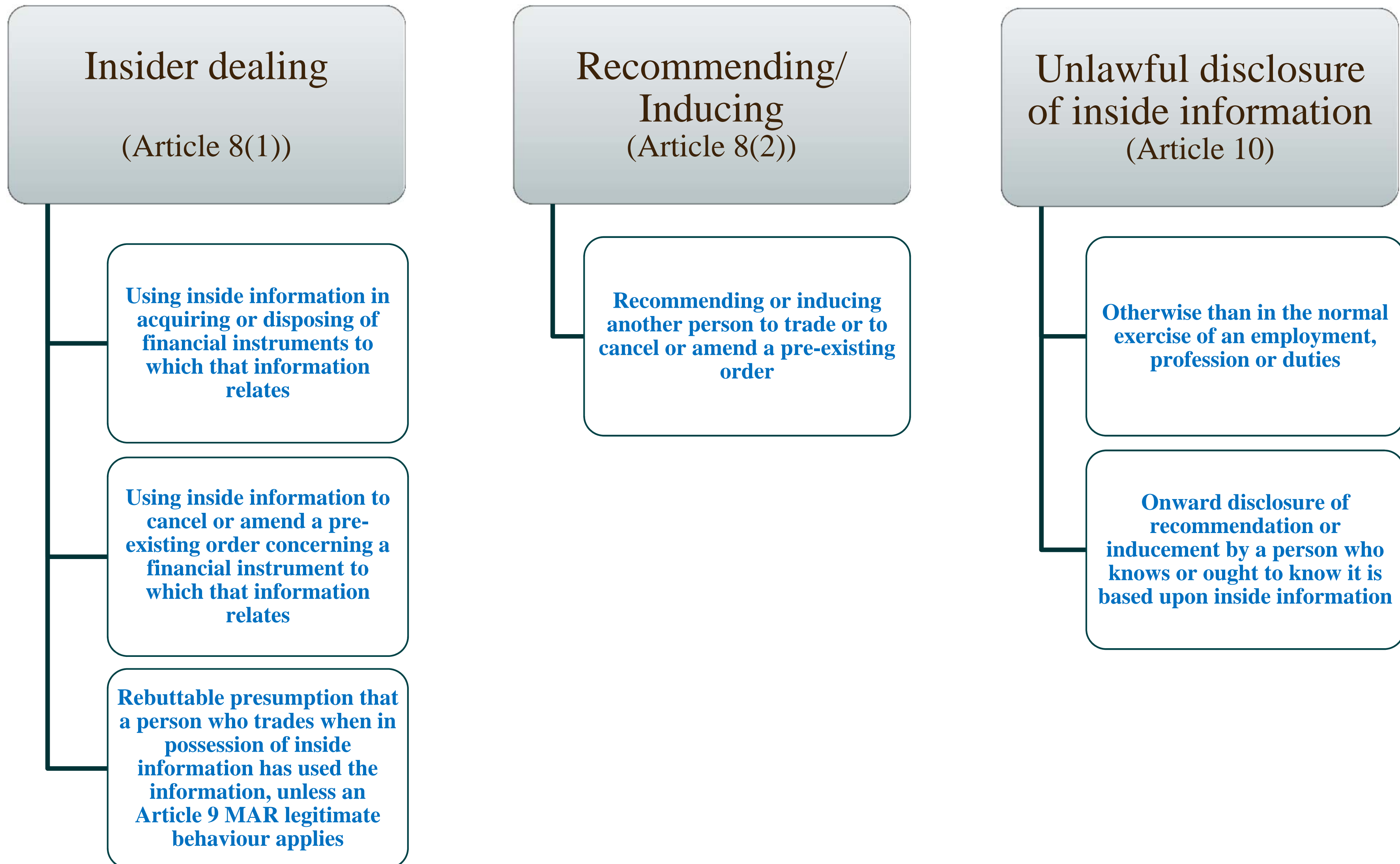
Practical implementation issues

1. Extraterritorial reach

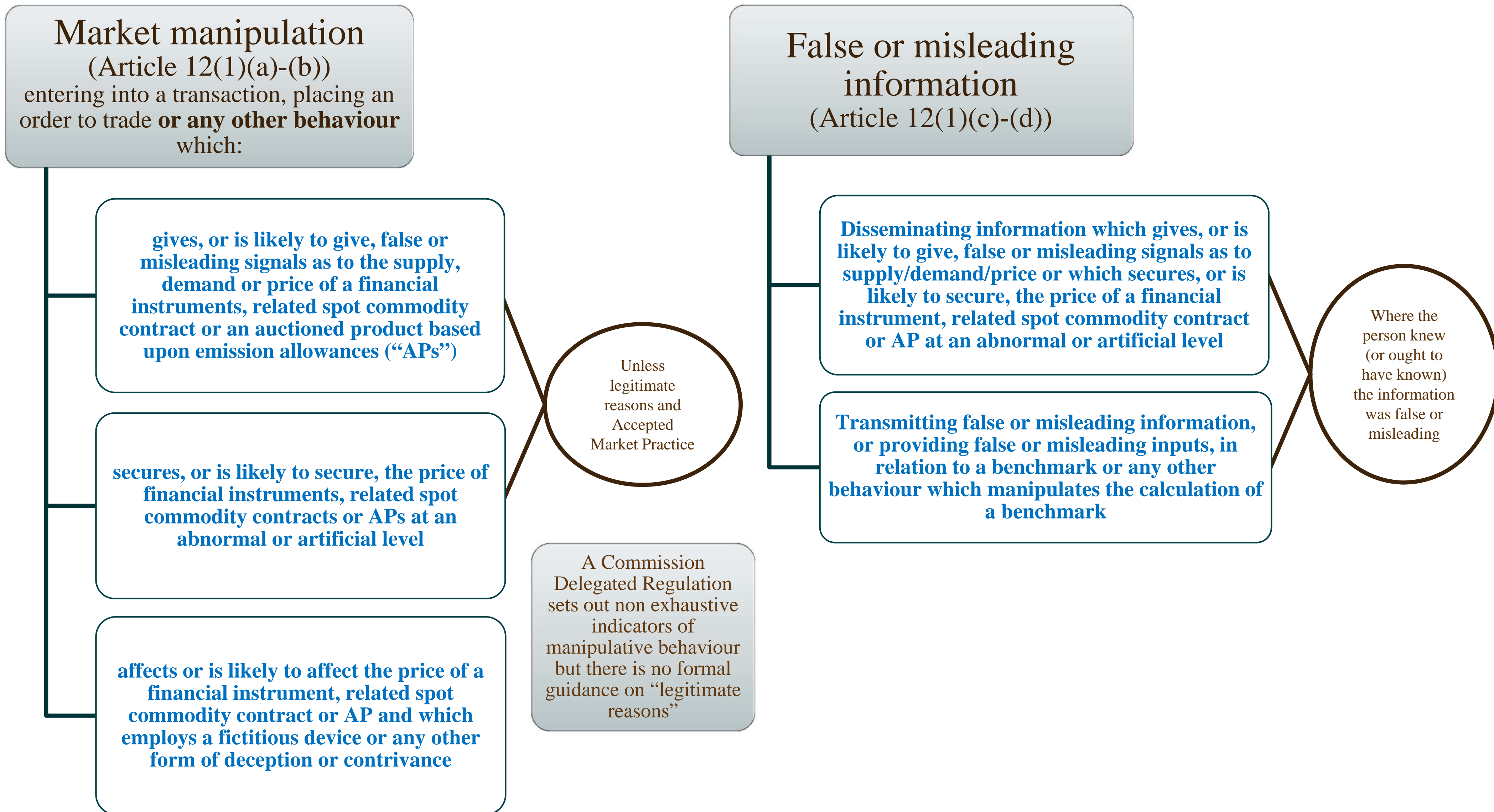
Where a financial instrument is in scope of MAR (because it is admitted to trading on an EEA trading venue), then behaviour anywhere in the world concerning that financial instrument can constitute an offence under MAR, whether on or off a trading venue. This means that a US based manager of a non EEA fund who trades shares with a primary listing on NASDAQ using inside information can be guilty of the insider dealing offence under MAR if those shares or related financial instruments are admitted to a trading venue in the EEA.

Given the difference in scope of behaviour caught by the MAR market abuse offences compared with US laws it is possible that a US manager could conduct trading that is lawful in the US but that is prohibited under MAR. The same could be true in other non EEA jurisdictions.

Insider dealing civil offences



Market manipulation civil offences



1. Extraterritorial reach (continued)

MAD already has such an extraterritorial effect in respect of the narrower scope of financial instruments caught but given the multiplicity of smaller EEA trading venues that will be within the scope of MAR and the relative ease and speed of admission to some of these, the risk of non EEA managers unwittingly coming within the scope of MAR is that much greater. Non EEA managers who will or may trade EEA financial instruments, or financial instruments that may have cross or multiple trading venues that could include EEA trading venues (or financial instrument related to them), need to ensure that they are fully aware of and respect the relevant restrictions under MAR.

2. Identifying in scope financial instruments

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 or which are traded for the first time on a regulated market, MTF or OTF in the EEA. This list will enable market participants to identify in scope financial instruments. In scope financial instruments are all financial instruments on this list as well as any financial instrument the price or value of which depends or has an effect upon the price or value of a financial instrument on ESMA's list. As was widely anticipated, on 7 June 2016, the European Parliament provisionally adopted a text which will delay the requirement for ESMA to publish the Article 4 list until MiFID II goes live in January 2018.[2] Even when the list does become available, Recital 9 of MAR makes it clear that firms will not be able to use the fact that a relevant financial instrument is not on the ESMA "golden list" as a defence to market abuse if a relevant financial instrument is in fact admitted to an EEA trading venue. However, it is hard to see how else asset managers can find an authoritative source to keep track of in scope financial instruments, notwithstanding that the ESMA list is unlikely to be updated quickly enough to be fully accurate on a real time basis.

The bigger issue is what firms should do between 3 July 2016 and January 2018 to ensure that they understand which financial instruments are in scope. Some data vendors who are also Approved Reporting Mechanisms may consider that they have the necessary information to compile their own golden lists, so it may be that these can become available to market participants in the near future. Alternatively, asset managers may well consider that their market abuse controls should simply cover all financial instruments and only seek to check whether an instrument is in scope of MAR if circumstances arise where a suspicious transaction or order report may be necessary.

3. Identifying inside information

Even for equities listed on existing regulated markets, where concepts of inside information and controls around it are well developed, MAR is likely to increase the number of situations where the need for careful analysis and difficult judgment calls will arise in the course of determining whether particular information is inside information. This is because the shift to a presumption of use of inside information comes together with:

- the much wider, and sometimes hard to apply, interpretation of the perimeter of inside information from European Court of Justice decisions like *Geltl v Daimler* (ECLI:EU:C:2012:397) and *Lafonta* (ECLI:EU:C:2014:2472) and the UK Upper Tribunal in the *Hannam* case ([2014] UKUT 0233);
- a dearth of statutory "safe harbours" – Article 9 of MAR provides a limited list of behaviours that prima facie will be deemed to be legitimate;
- the absence of an explicit defence for persons who had reasonable grounds to believe that the behaviour was not an offence or took all reasonable precautions or exercised all due diligence to avoid committing an

offence (which was previously available in the UK under Section 118 Financial Services and Markets Act 2000 ("FSMA"));

- the dearth of useful guidance, whether by ESMA or by national regulators, on behaviours that will or will not be considered to be an insider dealing offence and factors that will be taken into account in determining whether behaviour may be insider dealing. This leaves great uncertainty as to how EEA national regulators will apply MAR unless and until useful ESMA guidance in the form of Q&As develops.

The level of confidence that inside information has been correctly identified can only be lower for those instruments and markets where disclosure standards and requirements are less well developed.

In the UK, the FCA's Code of Market Conduct ("the Code") has to date been extremely useful to internal and external legal and compliance advisers in determining whether particular trades or behaviour can be permitted. Though the FCA will issue a revised version of the Code in the form of guidance, this will be stripped of much material that advisers have found useful. This will be removed because the FCA considers that the material may conflict with the proper interpretation of MAR. For example, much of the guidance on whether behaviour is conducted "on the basis of " inside information (in other words, whether inside information has been *used*) including the much relied upon evidential provision in MAR 1.3.3 ("*the decision to deal or attempt to deal was made before the person possessed the inside information"*) will be gone.

To mitigate the risks arising from the difficulty, in some cases, of identifying whether inside information has been received, it will be vital to have a culture, within asset managers, whereby staff are ready to consult with the compliance function in cases of doubt. To encourage such a culture there must be an ability for compliance staff to be available to respond quickly to requests for guidance and to make prompt decisions. Front office staff should also receive training to make them aware of the risks faced by their firm in light of the difficulties associated with identifying inside information.

4. Recording evidence to rebut the presumption of use of inside information

We recommend that asset managers now build into their practices and procedures the routine recording of the evidence that they may need to rely upon in the future to rebut a presumption that they have used inside information. This means that documenting reasons for an individual trading decision will sometimes be appropriate or prudent. Though many investment teams may regard it as impractical to record a reason for each and every trade, asset managers can identify situations where trades may be at greater risk of a challenge that they were based on inside information and ensure that the reasons for those trades are recorded: for example, trading decisions that are made by an equity investor soon after a meeting with the relevant company's management, or trading decisions made soon after an asset manager has refused to participate in a market sounding related to the relevant issuer or financial instruments. Because of the difficulties there can be in identifying whether inside information has been received, it would also be wise to build in a "cooling off" or "sleep on it" period in such circumstances before a trade in the relevant instruments will occur. For example, a rule that after a meeting with company representatives a manager will not trade in the relevant stock until the next business day at the earliest. The compliance team should, of course, also be consulted in all cases where there is a risk that inside information has been received.

Front office staff can also increase their level of protection by more recording of their trading strategies and ideas, the analysis they perform on investment targets, and how these develop through time. Order management policies and practices should also be recorded. Doing this will arm asset managers with the evidence needed to respond readily to enquiries by a regulator and assist in rebutting a presumption that inside information has been used.

5. How to trade legitimately when in possession of inside information

A typical liquidity trade highlights some of the practical difficulties arising from MAR. Where an asset manager needs to meet subscriptions or redemptions in an equity fund the manager will normally want to trade proportionately across positions held in the equity portfolio but can the manager do so in respect of a relevant stock which is on the restricted list?

Prior to MAR this could be legal for a UK based manager, after appropriate consultation with internal compliance and/or legal functions, because if the trade in the restricted stock was for purposes of meeting liquidity and was not motivated by the inside information then inside information was not used and the trade did not breach Section 118 FSMA. In contrast, under MAR there is the legal presumption that an asset manager who trades when in possession of inside information has used that inside information. Does that mean that in these circumstances under MAR a manager must exclude the affected stock from the liquidity trades? To do so could be damaging for investors.

Such a trade will not prima facie fall within the legitimate behaviour at Article 9(3) of MAR (which states that "*a transaction in discharge of an obligation that has become due in good faith….and (a) results from an order placed or an agreement concluded before the person possessed the inside information; or (b) the transaction is carried out to satisfy a legal or regulatory obligation that arose before the person possessed the inside information*"). In principle, discretionary asset managers could arrange for the clients they serve to issue standing legally binding instructions to their asset managers covering such liquidity trades (though allowing for appropriate execution discretion), which could bring such trades within Article 9(3), in which case the presumption of use would not apply. Without such an existing legal obligation being in place, the asset manager who decides to trade in such circumstances is relying upon being able to produce, in response to any challenge by a regulator, persuasive evidence that the inside information was not used. As a minimum, a clear contemporaneous record of the reasons for the trade and the permission for the trade given by the compliance function should be kept.

There are other types of routine trades that asset managers will wish to carry out that may include restricted stock but that will not involve using inside information. If it is impractical to arrange standing legal instructions that would fall within Article 9(3) to cover such trades, instead asset managers could document their policy as regards such trades, which will increase the manager's level of protection by providing some evidence to rebut the presumption that inside information has been used. However, even with such a policy in place, prior permission should always be obtained from the compliance team before trading a stock on a restricted list. The most risk averse approach would be simply never to trade in a restricted stock.

Asset managers may also wish to review their approach to the use of Chinese walls and consider whether setting up additional Chinese walls could be a solution to some problems posed by the presumption of use. For example, could having a centralised dealing desk walled off from the investment teams partially solve the issues discussed in paragraph 6 below, regarding working large trades over time? Under Article 9(1) there will not be a presumption of use of inside information where a legal person maintains internal arrangements that effectively ensure that neither the natural person who made the trading decision to which the information relates nor another natural person who may have had influence on that decision was in possession of the inside information.

6. Order management – cancelling and modifying orders

MAR's extension of the insider dealing offence to cover using inside information in decisions to cancel or amend an order can have difficult practical implications for asset managers that could potentially inhibit the ability to ensure that best execution is achieved. The obligations under MAR can also potentially clash with different obligations in another relevant jurisdiction, for example we understand that there is at least one non EEA jurisdiction where there

is a requirement to cancel pending orders if a firm subsequently comes into possession of inside information related to that financial instrument.

This issue is highlighted in the scenario of a manager with a large order in a particular financial instrument that needs to be worked in tranches over time because of issues like limited liquidity, the desire to obtain the right price and to avoid disrupting the market. If the manager comes into possession of inside information at a time when the order is still only part executed what is the correct course of conduct?

- To the extent that the order or tranches of it have been placed with an external broker or on a trading venue, then in our view the trade should not be cancelled and should be allowed to complete. However, if the broker has to revert to the manager for guidance on execution parameters, there is a risk that these further instructions could be deemed to amount to placing or amending an order, which would mean the presumption of use would apply. And, in giving the broker further guidance, the manager may use the inside information and so would find it hard to rebut the presumption. In these circumstances the correct approach may be context dependent.

- Where tranches of the "order" have not yet been placed externally, for example because they are still with traders on an in house central dealing desk, must these remaining tranches be cancelled? If the central dealing desk is separated from the managers and from the relevant inside information by an effective Chinese wall then cancellation may not be necessary, unless the dealer would need to refer back to the manager for guidance.

Should managers always cancel orders that they have placed in an order management system or with a central dealing desk (but which have not yet been sent outside the firm) if the manager then comes into possession of relevant inside information? Such orders are not yet an instruction that is legally binding on the firm (so we would argue are not yet "orders" within the meaning of the cancelling orders offence under MAR) so in principle could be cancelled and doing so will not impact the market, yet in deciding to cancel such an order a manager may well be using inside information to his benefit. On the other hand, the fact that the order is in the order management system or has been placed with the central dealing desk already, is surely good evidence to rebut the presumption that the individual manager has used the inside information in deciding to trade (this assumes that the firm's systems will retain records of this internal activity after an order has been executed). Unless the central dealing desk would need to revert back to the manager for guidance before trading, we are inclined to the view that it can be appropriate not to cancel or modify pending orders that are still in an order management system or with the central dealing desk but the firm will need to retain the necessary records to prove to a regulator that inside information has not been used.

It would be helpful to have guidance from ESMA or the FCA on how a firm should treat orders that have already been placed in an order management system or with a central dealing desk before relevant inside information is received. However, asset managers cannot wait to see if such guidance will appear. They should be deciding now on their policy and procedures to deal with these types of order management issues.

7. Participating in market soundings

Most asset managers for which market soundings are relevant will already have wall crossing procedures. These need to be reviewed and where appropriate modified to bring them into line with the expectations under MAR regarding market soundings.

Article 11 of MAR defines a market sounding as the communication of information to one or more potential investors, prior to the announcement of a transaction, in order to gauge the interest of potential investors in a possible transaction and the conditions relating to it such as its potential size or pricing. The Commission has adopted a Delegated Regulation (C(2016) 2859) which prescribes great detail regarding how issuers and their advisers should conduct and record the market sounding process, both for soundings in which inside information

will be disclosed and those where no inside information will be passed. Though issuers and their advisers are not required to conduct market soundings in accordance with Article 11, if they do so the individuals making the disclosure on behalf of the disclosing market participant ("DMP") gain the protection that the disclosure of inside information pursuant to the sounding is deemed to be in the normal exercise of their employment, profession or duties.[3] In practice we expect that sell side firms will be trying to follow Article 11 market sounding procedures in respect of all market soundings going forward.

Article 11(7) of MAR requires a person receiving such a market sounding (Market Sounding Recipient – "MSR") to assess for itself whether it is in possession of inside information as a result of the sounding and when inside information received as a result of a market sounding ceases to be inside information.

MAR requires ESMA to issue guidelines for MSRs. ESMA's draft Guidelines for MSRs (ESMA/2016/162 – these are not expected to be published in final form until Q3 2016 at the earliest) go much further than existing good practice promulgated by the FCA in its thematic review report TR 15/1 of February 2015. Consequently all FCA regulated asset managers should review their practices related to receiving market soundings and amend them as appropriate. Notwithstanding that the designation "Guidelines" may suggest that the contents are not obligatory, a prudent asset manager will ensure that they are followed because national regulators are likely to come to regard the Guidelines as minimum best practice.

The box at pages 16 and 17 summarise the main points of the draft Guidelines. In particular note:

- Guidelines 1, 2, 5 and 6 cover all market soundings, not just those market soundings that will involve inside information being received. So the controls on internal dissemination of information received, including the "need to know" restriction, and the obligation to draw up a list of persons in possession of information received in a market sounding, apply equally to information received in a market sounding that is not inside information. A firm's pre-MAR controls may well not seek to control the internal dissemination of such non inside information.

- Designating a specific individual or contact point to receive third party communications regarding market soundings will be particularly effective to demonstrate to regulators that the knowledge of information received in a market sounding is closely controlled, especially if that person or contact point is within the compliance function, so that it is clear to regulators that the investment team are protected from the risk of leakage of inside information even in the initial approach by a third party enquiring whether the firm is willing to participate in a market sounding. In its thematic review report of February 2015 (TR15/1) the FCA regarded it as good practice to have an initial point of contact for soundings independent of the fund managers. In some cases this enabled soundings to be rejected without sharing any information with fund managers. In other cases where the fund manager was consulted but declined to participate in a sounding, it enabled an independent assessment of the information that had been received in the initial approach to verify that it did not constitute inside information.

- Even in cases where the DMP states that inside information will be disclosed in the market sounding and the MSR agrees to receive the information on that basis, the obligation in Guideline 3(1) prima facie still applies such that the MSR must conduct an independent assessment as to whether the information is inside information, taking into consideration "all the information available to them, including information obtained from sources other than the DMP". Theoretically there could be instances where the MSR disagrees with the DMP that information is inside information, for example where the MSR believes that the DMP has been unduly cautious in its assessment of whether information is inside

information. However, the mechanism in Guideline 4 for the MSR to notify that it disagrees with the designation given by the DMP only applies where the DMP has stated that no inside information is disclosed. Unless a DMP was prepared, following a challenge by an MSR, expressly to change its view and agree that information it had originally designated as inside information was not in fact inside information, it would be very risky for an MSR that disagreed not to restrict itself from trading.

- Note that the persons intended to be on the list required by draft Guideline 6 are those persons "in possession of information communicated in the course of market soundings". This does not mean that all persons who know that a stock is restricted should be on the list, as mere knowledge that there is a restriction does not necessitate that the person knows the information that has been communicated in the market sounding and which has led to the restriction. Many managers operate a "restrict all" approach, taking the view that this is effective to prevent insider trading when staff share an open plan environment where it would be hard to ensure that knowledge of inside information does not inadvertently spread (notwithstanding having a "need to know" policy). The question has been raised whether such managers should put all staff on the Guideline 6 list on the basis that they could come into possession of inside information, even though they may not actually do so. We believe that ESMA and national regulators are likely to take the view that firms should attempt to track and only list persons they believe have actually come into possession/knowledge of the information received in the market sounding and that "need to know" policies should be more strongly enforced by asset managers under MAR than has been the case under the pre MAR regime. For example, see the FCA's comments on best practice regarding controlling access to inside information and managing the risk of improper disclosure in its February

8. Market Manipulation

Extensive but non-exhaustive lists of types of behaviour that will or may be market manipulation are given in Article 12(2) and Annex I of MAR and Commission Delegated Regulation EU/2016/522.

Behaviour falling under Article 12(1)(a) of MAR will not be an offence if a person can establish that the behaviour has been carried out "*for legitimate reasons, and conform with an accepted market practice as established in accordance with Article 13*". Similar wording occurs in MAD ("*his reasons for doing so are legitimate… and conform to accepted market practices on the regulated market concerned*") and was implemented in Section 118 FSMA as "*otherwise than for legitimate reasons and in conformity with accepted market practices on the relevant market*".

Article 13 contains a power for national competent authorities to establish formally an accepted market practice ("Accepted Market Practice") where specified criteria in Article 13(2) can be satisfied and following notice to ESMA and other competent authorities. The similar mechanism available under MAD has to date has been used by competent authorities under relatively limited circumstances, so there are few formally adopted Accepted Market Practices under the current regime and they are narrowly focussed. The UK does not currently have any Accepted Market Practice.

In the course of enforcement proceedings the FCA (we intend here to refer also to the regulator under its previous name, the Financial Services Authority) has on occasion in the past half heartedly sought to argue that there is no defence of "legitimate reasons" where behaviour has had the effect of manipulating a market unless there is a

relevant Accepted Market Practice and the behaviour also conforms with it. It would be unfortunate if ESMA or other national regulators take a similar line in respect of MAR enforcement. The FCA's argument was never pursued with vigour, not least because it has always been easy to point out that the FCA's own Code of Market Conduct contains guidance on legitimate reasons that is not linked to an Accepted Market Practice also being available.

MAR does not require ESMA to produce formal guidance on the important concept of "legitimate reasons" and it has not done so. This leaves uncertainty whether some behaviours that currently are understood to be legitimate could, under MAR, come to be regarded as proscribed. Interestingly the FCA guidance that is to replace the Code of Market Conduct retains its paragraphs containing factors indicating that behaviour is for legitimate reasons. These include the following paragraph (as amended) that has been much relied upon by UK firms to defend particular trading strategies (including in the context of algorithmic trading and high speed trading):

"*It is unlikely that the behaviour of trading venue users when dealing at times and in sizes most beneficial to them (whether for the purpose of long term investment objectives, risk management or short term speculation) and seeking the maximum profit from their dealings will of itself amount to manipulation. Such behaviour, generally speaking, improves the liquidity and efficiency of trading venues.*"

Unless and until useful Level 3 guidance develops on "legitimate reasons", MAR increases the challenge for firms in determining whether particular trading and order management behaviours can be permitted.

9. Monitoring and reporting suspicious transactions and orders

For many asset managers, particularly where a broad range of different types of financial instruments are traded, most attention and effort to date in preparing for implementation of MAR will have focussed on how to establish proactive monitoring systems across the wide range of financial instruments in scope, whether traded on or outside a trading venue, and behaviour in relation to spot commodities and benchmarks.

The basic obligation

Article 16(2) of MAR requires "persons professionally arranging or executing transactions" to establish and maintain effective arrangements, systems and procedures to detect and report suspicious orders and transactions. Where such a person has a reasonable suspicion that a transaction or order could have constituted actual or attempted market abuse, they must make a notification to the regulator in the Member State where they are registered or have their head office. The report must be made without delay once the reasonable suspicion is formed.

ESMA has recently confirmed (in its first published MAR Q&A dated 30 May 2016) that it construes "persons professionally arranging or executing transactions" broadly and to include buy side firms, such as investment management firms as well as firms professionally engaged in trading on own account. In response to earlier ESMA consultations it has been argued, quite properly, that MAR itself defines "arranging" as "the reception and transmission of orders", which discretionary asset managers do not do. It is possible that this legal argument may eventually prevail. However, hitherto, discretionary managers have generally regarded themselves as within the existing suspicious transaction reporting obligation pursuant to MAD and many are already doing some level of proactive monitoring, so it is hard to see a strong policy case to support this legal argument.

The detailed requirements

The detailed requirements are set out in a Commission Delegated Regulation (C(2016) 1402) containing regulatory technical standards. The question of whether there should be a requirement for automated systems for detecting abusive transactions was raised in ESMA's prior consultation on the standards, where a large number of respondents considered that this would be disproportionate. Nevertheless Recital 1 to the Delegated Regulation states "The whole process is likely to require some level of automation", and ESMA has expressed the view that in the large majority of cases some level of automated surveillance will be needed. Just how much automation is the right amount is a critical issue with which asset managers are now grappling. The national regulator can ask a firm to demonstrate the appropriateness of its systems including as to the level of automation. This is almost certainly an issue the FCA will address in due course in thematic reviews.

The monitoring and detection systems and procedures must:

- cover all orders received and transmitted and all transactions executed, whether on or outside a trading venue;
- allow for the analysis individually and comparatively of each and every transaction executed and order placed, modified, cancelled or rejected whether on a trading venue or outside a trading venue;
- be capable of producing alerts in accordance with predefined parameters indicating activities requiring further analysis;
- cover the full range of trading activities undertaken;
- take account of the elements of the offences as well as the non-exhaustive indicators of market abuse in Annex I of MAR and Commission Delegated Regulation EU/2016/522;
- use an appropriate level of human analysis;
- provide for effective and comprehensive training of the staff involved in the monitoring, detection and identification of orders and transactions that could constitute market abuse or attempted market abuse, including the staff involved in the processing of orders and transactions;
- be fully documented in writing; and
- at a minimum be audited and reviewed annually.

Fortunately there is a proportionality concept. The systems and procedures should be appropriate and proportionate in relation to the scale, size and nature of the business activity.

Open questions impacting implementation

There are many open questions, including on some fundamental questions of legal interpretation regarding the scope of the obligations. In order to progress now on implementation of monitoring systems, asset managers have no choice at this time but to make a judgment calls and take what they consider to be a reasonable approach. To fortify arguments that those judgment calls are reasonable asset managers may wish to take advice from external experts. Asset managers should also inform themselves what solutions are available from financial services specialist information technology vendors, of which there are many currently marketing monitoring products, but should not feel obliged to buy into such off the shelf solutions as they may simply not be appropriate for a given asset manager's scale and mix of business.

These levels of uncertainty also mean that asset managers will need to keep systems and procedures under rolling review to keep track of developments in the industry's experience of MAR and as regulator guidance develops.

Just some of the open questions that we see raised by asset managers about the scope of monitoring and reporting procedures are as follows:

- What is an order? Should an expression of interest or request for a price/quote be treated as an order and so be covered by the same level of proactive monitoring?

- How can firms effectively capture and record orders and amendments to orders made through voice broking or media such as Bloomberg messaging? Should traders be trained to express their communications to brokers in a particular way, so that it is clearer to the receiving broker whether this is an instruction to trade, rather than a preliminary step?

- What is an attempt at insider dealing or market manipulation? Is an attempt simply an order that is cancelled or not executed or a quote that is withdrawn or is not taken up, alternatively does it also cover attempts to place an order or make a quote? If the latter, is only behaviour that is externalised from the manager (i.e. capable of being seen by the market) subject to the proactive monitoring and reporting obligation? Alternatively does the need to monitor for attempts mean that all amendments and cancellations in a firm's internal order management system are in scope of proactive monitoring, regardless that this activity has not been externalized to the market and so cannot impact price? If your order management system does not save logs of all such amendments and cancellations must it now be changed to ensure that those logs are kept?

- How to take into account the indicators of market manipulation in designing monitoring? The meaning/scope of some of these indicators is rather unclear, for example in relation to "phishing" and "smoking". Asset managers will not necessarily have access to all of the information that would be needed to assess whether some of these indicators are triggered, indeed some types of data will only be available to trading venues. Asset managers should consider whether additional sources of data are available that should be accessed and built into monitoring systems. Does a long/short equity manager that may only occasionally trade in derivatives need to have the full derivative monitoring capability that a business focused on derivatives trading would have?

- What is proportionate? What is correct calibration of checks? For example, how far back in time/in volume of transactions should rolling routine checks be run that are seeking to identify patterns of behaviour that may indicate market manipulation or attempted market manipulation?

- At what point during the analysis of an alert generated by the monitoring system will relevant individuals in the firm have formed a reasonable suspicion that market abuse or attempted market abuse has occurred, so that the reporting obligation is triggered?

- Must all of the analysis on every alert generated from the monitoring system be saved and recorded, including where no suspicious transaction and order report ("STOR") has been submitted, in order to fulfil the obligation in Article 3(8) of the Commission Delegated Regulation? Artcle 3(8) provides that firms "*shall maintain for a period of five years the information documenting the analysis carried out with regard to the orders and transactions that could constitute market abuse or attempted market abuse which have been examined and the reasons for submitting or not submitting a STOR*". How does one effectively record the human analysis?

There may be differences of view between asset managers on the correct response to such questions. Indeed, what is appropriate and proportionate will be dependent on the specific nature of an asset manager's business.

In our view the correct *legal* interpretation of the scope of the monitoring and reporting obligation arising from MAR is a narrow one. The monitoring obligation in Article 2(1)(a) of the Delegated Regulation is restricted to "all orders received and transmitted and all transactions executed" by the firm that may constitute market abuse or attempted market abuse, as is the reporting obligation. The legal definition of "order" in the Delegated Regulation covers "each and every order, including each and every quote, irrespective of whether its purpose is initial submission, modification, update or cancellation". It would be helpful to have explicit ESMA guidance that order or quote means something capable of being legally binding, which we believe is the correct legal interpretation. It would also be helpful to have guidance to the effect that attempted market abuse would only cover behaviour that is externalised from the asset manager, again which we believe is the correct interpretation.

Plainly however, a very wide range of behaviour beyond orders and transactions can constitute market abuse and it would be wrong for firms to use the direct effect of MAR to argue that wider monitoring and reporting can never be necessary or appropriate for their business. The FCA already expects firms' anti market abuse controls to cover the much wider range of behaviour that can constitute market abuse. UK regulated firms are bound by general obligations not to allow their business to be used for the purposes of financial crime. We would recommend that asset managers assess, in designing their proportionate monitoring and reporting systems and procedures, the intelligence value of all information available to them in their normal business systems, including internal order management systems.

As regards when the reporting obligation is triggered, note that in the FCA's recent Market Watch newsletter (number 50) the FCA commented that some firms have "potentially set too high a bar for the reasonable suspicion test, these have included instances where firms appear to have sought a level of evidence amounting to proof that market abuse has taken place, as opposed to reasonable suspicion that it may have done". There have also been examples where the FCA believed firms focussed their efforts on closing alerts, rather than undertaking an appropriate, balanced review. The FCA warns that firms should "be cautious of seeking reasons not to submit". The FCA believes that even on the current narrower regime, there is a general under-reporting across most asset classes.

10. Practical guidance summary

We set out below a summary of the practical steps discussed above:

1. Non EEA firms should also consider the risks which MAR presents to their business. What is regarded as legitimate trading under non EEA insider dealing laws may, owing to the wide application of MAR, result in a breach of MAR's requirements, even where the relevant securities have a primary listing on a non EEA trading venue.

2. ESMA's "golden list" of financial instruments admitted to EEA trading venues is not expected to be available prior to 2018 (and even then this will not be definitive), so firms need to consider how they will identify financial instruments in scope of MAR.

3. Identifying when a firm is in possession of inside information may, in some cases, require careful analysis and difficult decisions. In order to encourage adequate and timely reporting of potential issues or edge cases by staff members, the compliance team must be available and ready to make prompt decisions and support front office staff.

4. MAR introduces a presumption that inside information possessed by a firm has been used and there are few safe harbours from this. In order to rebut the presumption effectively, it is vital that contemporaneous evidence is available to demonstrate that the inside information was not used. This may mean documenting reasons for individual trading decisions. In addition, it may be prudent to have written policies in respect of routine trades, such as liquidity trades. We recommend that asset managers also have written policies to deal with scenarios in which they come into possession of inside information whilst an order is waiting to be executed, taking account the different types of order routing used.

5. MAR imposes obligations on recipients of market soundings and the relevant guidelines published by ESMA cover all market soundings, not just ones involving inside information being received. This will require asset managers to review their practices related to receiving market soundings and amend them as appropriate.

6. The obligation to monitor and report suspicious transactions and orders raises a number of currently unanswered questions. The correct approach will vary from firm to firm. In designing monitoring and reporting systems and procedures, asset managers should assess the intelligence value of all information available to them in their normal business systems, including internal order management systems and consider the extent to which additional data sources are necessary and appropriate.

7. Prior to 3 July, firms should make every effort to ensure that all relevant staff, including all front office staff have been given training covering the wider scope of MAR and tailored to the firm's particular strategies and asset classes.

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This alert provides a general summary of recent legal developments. It is not intended to be and should not be relied upon as legal advice. In some jurisdictions, this may be considered "Attorney Advertising."

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[1] The European Court of Justice in the *Spector Photo* case ruled that such a rebuttable presumption was also intended to apply under MAD. UK national legislation implementing MAD (Section 118 FSMA) has not contained such a presumption and in practice neither the FCA nor its predecessor, the Financial Services Authority, has applied such a presumption in enforcing the current domestic market abuse regime. This will change from 3 July 2016 when MAR has direct effect in the UK.

[2] The "MiFID II" Directive (2014/65/EU) together with the Markets in Financial Instruments Regulation (Regulation 600/2014) will repeal and recast the original Markets in Financial Instruments Directive (2004/39/EC) ("MiFID"). MiFID II, like MiFID before it, forms the legal framework governing the requirements applicable to investment firms, trading venues, data reporting service providers and third-country firms providing investment services or activities in the EU. MiFID II implementation has been delayed until 3 January 2018.

[3] Although MAR only legislates this protection for market soundings where the DMP will be warning the recipient that inside information will be disclosed, not for market soundings where there will be no disclosure of inside information

Guidelines for Market Sounding Recipients

1. Designated persons or contact point within the MSR entitled to receive market soundings

Where the person receiving the market sounding ("MSR") designates a specific person or a contact point to receive market soundings, the MSR should ensure that that information is made available to the disclosing market participants ("DMP").

2. Communicating the wish not to receive the market soundings

After being addressed by a DMP, the MSR should notify it whether they wish not to receive future market soundings in relation to either all potential transactions or particular types of potential transactions.

3. MSR's assessment as to whether they are in possession of inside information as a result of the market sounding and as to when they cease to be in possession of inside information

(a) While taking into account the DMP's assessment, MSRs should independently assess whether they are in possession of inside information as a result of the market sounding taking into consideration as a relevant factor all the information available to them, including the information obtained from sources other than the DMP.

(b) While taking into account the DMP's notification that the information disclosed in the course of the market sounding is no longer inside information, MSRs should independently assess whether they are still in possession of inside information taking into consideration all the information available to them, including the information obtained from other sources than the DMP.

4. Discrepancies of opinion between DMP and MSR

(a) In the case of market soundings where according to the DMP no inside information is disclosed, where the MSR assesses on the contrary they are in possession of inside information they should:

i. refrain from informing the DMP of the discrepancy of opinion if the different assessment is due to the fact that the MSR is in possession of other information than that received from the DMP; or

ii. inform the DMP of the discrepancy of opinion if the different assessment is based exclusively upon the information that the MSR received from the DMP.

(b) In the case of market soundings where according to the DMP inside information has been disclosed, where the MSR receives the DMP's notification informing that the information communicated in the course of the market sounding ceased to be inside information and disagrees with the DMP's conclusion, the MSR should:

i. refrain from informing the DMP of the discrepancy of opinion if the different assessment is due to the fact that the MSR is in possession of other information than that received from the DMP; or

ii. inform the DMP of the discrepancy of opinion if the different assessment is based exclusively upon the information that the MSR received from the DMP.

5. Internal procedures and staff training

(a) The MSR should establish, implement and maintain internal procedures to:

i. ensure that the information received in the course of the market sounding is internally communicated only through pre-determined reporting lines and on a need-to-know basis;

ii. ensure that the function or body entrusted to assess whether the MSR is in possession of inside information as a result of the market sounding are clearly identified and composed of staff properly trained to that purpose;

iii. manage and control the flow of inside information arising from the market sounding within the MSR and its staff, in order for the MSR and its staff to comply with Articles 8 and 10 of MAR.

(b) The MSR should ensure that the staff receiving and processing the information in the course of the market sounding are properly trained on the relevant internal procedures and on the prohibitions, under Articles 8 and 10 of MAR, arising from being in possession of inside information.

6. List of MSR's staff that are in possession of the information communicated in the course of market soundings

For each market sounding, MSRs should draw up a list of the persons working for them that are in possession of the information communicated in the course of the market soundings.

7. Assessment of related financial instruments

Where the MSR has assessed that it is in possession of inside information as a result of a market sounding, the MSR should identify all the issuers and financial instruments to which that inside information relates.

8. Written minutes or notes

Where in accordance with [Article 6(2)(d) of Delegated Regulation (EU) …/… [RTS on Market soundings]] the DMP has drawn up written minutes or notes of the unrecorded meetings or unrecorded telephone conversation, the MSR should:

(a) sign these minutes or notes where they agree upon their content; or

(b) provide the DMP with their own version of the minutes or notes duly signed within five working days after the market sounding where they do not agree upon the content of the minutes or notes drawn up by the DMP.

9. Record keeping

MSRs should keep records in a durable medium that ensures accessibility and readability for a period of five years of:

a) the notifications referred to in guideline 2;

b) the assessments referred to in guideline 3 and the reasons therefor;

c) the discrepancy of opinion referred to in guideline 4;

d) the procedures referred to in guideline 5;

e) the lists referred to in guideline 6; and

f) the assessment of related instruments referred to in guideline 7.