Overview of the EU market abuse regime under the Market Abuse Directive ("MAD I")

1. MAD I: Background

1.1 MAD I was adopted by the European Parliament and the European Council in January 2003. It replaced the Insider Dealing Directive (Directive 89/592/EEC), which had a limited remit. MAD I aimed to introduce a common EU legal framework for the prevention and detection of both insider dealing and market manipulation, reducing the number of different rules and standards across the EU.

1.2 MAD I was introduced under the Lamfalussy process. (Further details and illustrative diagrams of this legislative process can be found at the RegZone by clicking here.) The process involves the European Commission, the European Parliament, the Council of Ministers, the Advisory Committee for Securities and the European Securities and Markets Authority (ESMA). Further details of EU institutions can be found at the RegZone. Click here to see a chart of the current position and here for a chart of the proposed system.

2. MAD I: Structure (EU legislation and CESR guidance)

2.1 Level 1: Market Abuse Directive 2003/6/EC

The main framework legislation takes the form of a directive, which defines and prohibits:

- insider dealing; and
- market manipulation

It also imposes related regulatory requirements on financial institutions, such as suspicious transaction reporting, and requires issuers to disclose price sensitive information.

2.2 Level 2: Implementing directives and regulation

At Level 2, three directives and a regulation implement the Level 1 provisions. They cover the following:

- definition and public disclosure of inside information and the definition of market manipulation;\(^2\)
- fair presentation of investment recommendations and the disclosure of conflicts of interest;\(^3\)
- accepted market practices; the definition of inside information in relation to derivatives on commodities; drawing up lists of insiders; notification of managers’ transactions; and notification of suspicious transactions;\(^4\) and
- exemptions for buy-back programs and stabilisation of financial instruments.\(^5\)

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\(^1\) The predominance of directives (which allow Member States some discretion) over regulations in Level 2 has been stated to contribute to the lack of harmonisation under MAD - Di Noia’s speech at 2008 Conference on MAD
\(^2\) Level 2 Directive 2003-124-EC
\(^3\) Level 2 Directive 2003-125-EC
\(^4\) Level 2 Directive 2004-72-EC
\(^5\) Level 2 Regulation (EC) 2273-2003
2.3 Level 3: CESR guidance

CESR (ESMA’s predecessor) produced guidance on the following:

- accepted market practices; practices which should be considered as market manipulation; and a common format for reporting suspicious transactions;

- the concept of inside information; legitimate reasons for delaying publication; when information relating to a client’s pending orders constitutes inside information; and the procedure for insider lists in the case of issuers subject to the jurisdiction of more than one EU or EEA Member State; and

- the harmonisation of requirements for insider lists; Suspicious Transaction Reporting (STR); the Stabilisation and Buy-back regimes; and the concept of inside information.

3. MAD I: Implementation

MAD I took effect in 2005 and was implemented in the UK on 1 July 2005. It required Member States to meet certain minimum regulatory standards, and provided a baseline for national prohibitions on market abuse. MAD I therefore imposes basic requirements for each Member State’s administrative (rather than criminal) system of regulation. However:

- this has been treated as minimum harmonisation so that and Member States were free to impose additional obligations or prohibitions. There are also specific additional discretions within the Directive;

- Member States can limit the scope of the Directive by designating certain practices as ‘Accepted Market Practices.’ These are ‘practices that are reasonably expected in one or more financial markets and are accepted by the competent authorities.’ These are by no means safe harbours. In the absence of legitimate purpose, there is no AMP defence; and

- the Directive does not in any way harmonise the criminal law relating to Market Abuse, requiring they impose administrative measures and sanctions ‘without prejudice to the right of Member States to impose criminal sanctions.’ Criminal regulation therefore remains an entirely un-harmonised area, which will differ from country to country and from MAD I, and indeed from administrative regime in the country concerned.

4. MAD I: Scope of prohibited activities

The prohibition on market manipulation contained within MAD I is of general application and is not limited to financial institutions and their employees.

4.1 Insiders

The main prohibitions relating to insider dealing (MAD I, Articles 2 and 3) apply to insiders and to any other ‘person who possesses inside information while that person knows, or ought to have known, that it is inside information.’ The prohibitions apply to companies and to individuals (both in relation to personal dealings and to their activities for their employer).

4.2 The protection of ‘regulated markets’

MAD I is concerned with protecting the major European exchanges and markets. It therefore applies only to financial instruments admitted to trading on a regulated market (in at least one Member State). These markets must all meet the highest market standards in MiFID, which relate to secondary market activity and are more

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6 CESR 04-505b
7 CESR/06- 562b
8 CESR/09-219
9 MAD art. 14
10 But note the issue which arose in the Group NV & CBFA litigation (Spector Photo)
11 Further detail on establishing Accepted Market Practices can be found in the level 2 Directive 2004/72/EC and the Level 3 first set of guidance (CESR 04-505b).
12 Level 2 Directive 2004/72/EC
13 CESR 04-505b
14 MAD art. 14
15 Defined in MAD art. 2
16 MAD art. 2(4)
17 This includes financial instruments for which a request for admission to trading on such a market has been made. The Commission is required to publish a list of regulated markets notified to it on a yearly basis in the Official Journal of the European Union. See List of regulated markets.
stringent than the requirements for MTFs. Some are subject to primary market requirements under the listing regime\(^\text{18}\).

It does, however, apply \textit{irrespective} of whether or not the transaction itself takes place on such a market. It therefore applies to OTC transactions and those executed at a venue which is not a regulated market (such as an alternative trading platform or MTF), provided the instrument concerned is traded on a regulated market. So it applies, for example, to a transaction on Chi-X Europe in CAC, DAX or FTSE100 stock.

The insider dealing prohibitions, but not the prohibition on market manipulation, also apply to any financial instrument ‘whose value depends on a financial instrument as defined above’ \(^\text{19}\) (i.e. ‘related instruments’). So, for example, they would apply to a transaction in a derivative such as a CFD whose value depends on the share price of a CAC, DAX or FTSE100 equity. Such a transaction might be a bespoke OTC transaction with a bank, through a spread-bet or CFD firm, or a transaction on an alternative platform such as an MTF.

4.3 Geographical Scope

The Directive applies to all Member States of the EEA. It requires each Member State to apply prohibitions on two geographical bases\(^\text{20}\).

First, there must be a prohibition in each state relating to instruments traded in regulated markets operating in that state. This prohibition must apply irrespective of where an activity takes place; so it would be an offence in France to carry out insider dealing in CAC stocks in another Member State (e.g. Germany), or even outside the EEA (e.g. in the USA). Each state’s prohibitions therefore have global reach. The Directive does not, however, require Member States to make it an offence in their country to conduct activities there which are a ‘super-equivalent’ offence in another Member State (e.g. one which has applied the market abuse regime to MTFs) or an offence in a non-EEA state, such as a breach of SEC requirements in the US.

Second, each state must prohibit activities within its jurisdiction in relation to instruments that are traded on any regulated market anywhere in the EEA. So it would be an offence in France to release false information in Paris which would manipulate the DAX market in Germany. (This would also be an offence in Germany under the first requirement above).

5. MAD I: Definition of ‘inside information’\(^21\)

‘Inside information’ is defined as information of a precise nature which has not been made public, relating, directly or indirectly, to one or more issuers of financial instruments 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 on the price of related derivative financial instruments.

In relation to derivatives on commodities\(^22\), ‘inside information’ is defined as information of a precise nature which has not been made public, relating, directly or indirectly, to one or more such derivatives and which users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets.\(^23\)

6. MAD I: Prohibitions

6.1 Insider dealing

Under MAD I, insiders are prohibited from:

(a) \textbf{Insider dealing}

i.e. using inside information by dealing (for a person’s own account or for the account of a third party) financial instruments to which that information relates.\(^24\)

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\(^{18}\) In addition to the MiFID requirements for regulated markets, Listing Authority functions impose primary market requirements in relation to the listing of instruments and securities traded on Regulated Markets including the harmonised EU regime under the Disclosure and Transparency and Listing directives. For example, in the UK the FSA, acting as the UK’s listing authority, reviews and approves prospectuses and circulars, determines eligibility for listing and maintains the Official List. The FSA polices the ongoing compliance of issuers and major shareholders with the disclosures required under directives. It also authorises sponsors (specialist firms which assist premium issuers with drawing up listing documents, are responsible for the content and act as the key interface between the UKLA and issuers) and monitors their performance.

\(^{19}\) MAD art. 9

\(^{20}\) MAD art. 10 requires countries to extend the Directive prohibitions: first, to actions carried out on its territory or abroad concerning financial instruments that are admitted to trading on a regulated market situated or operating within its territory or for which a request for admission to trading on such market has been made; and, second, to actions carried out on its territory concerning financial instruments that are admitted to trading on a regulated market in a Member State or for which a request for admission to trading on such market has been made.

\(^{21}\) For further clarification of the definition of inside information see Level 2 Directive 2003-154-EC and the Level 3 guidance CESR/06-562b.

\(^{22}\) More detail is found in Level 2 Directive 2004-72-EC.

\(^{23}\) MAD art. 1

\(^{24}\) MAD art. 2: A recent ECU ruling in the Spector photo case dealt with the interpretation of Article 2(1) of MAD (Spector Photo Group NV v Commissie voor het Bank, Financie-en Assurantiewezen, C-45/06.). The court ruled that a person in possession of inside information who deals in financial instruments to which this information relates can be assumed to have ‘used’
Disclosure of inside information
i.e. disclosing inside information to any person unless such disclosure is made in the
normal course of the exercise of a person’s employment, profession or duties.25

Tipping off
i.e. recommending or inducing another person, on the basis of inside information, to
acquire or dispose of financial instruments to which that information relates.26

6.2 Market manipulation27
This is prohibited under MAD I in the following forms:
– Transactions or orders to trade involving false or misleading signals as to the supply of, demand for
or price of financial instruments, or which secure the price of a financial instrument at an abnormal
level - unless they conform to accepted market practices;
– Transactions or orders to trade which employ fictitious devices, deception or contrivances; and
– Dissemination of information through the media which gives or is likely to give, false or misleading
signals as to financial instruments.

A non-exhaustive list of examples of types of practice which would constitute market manipulation can be found
in CESR’s Level 3 Guidance28

6.3 Safe harbours29
Behaviour which falls into the following categories (or “safe harbours”) will not amount to market abuse:
– Trading in own shares in “buy-back” programmes
– Stabilisation of a financial instrument.

To qualify for safe harbour status, buy-back programmes and stabilisation activities have to conform to the
requirements set out in the implementing regulation30.

7. MAD I: Obligations

7.1 Obligations on issuers
MAD I imposes a number of positive obligations31 on issuers of financial instruments (although these are limited
where the issuer has not requested or approved the admission to trading on a regulated market). These are as
follows:
– Obligation to publish inside information; i.e. to inform the market;
– Obligation to maintain insider lists; and
– Notification and publication of transactions by managers of issuers.

7.2 Regulatory requirements for financial and other institutions
such information. This assumption is rebuttable. There has been widespread criticism of this decision, especially in Germany, as it can be seen to reverse the burden of proof, thereby failing to
comply with the European Convention of Human Rights which stipulates that a person charged with a criminal offence is innocent until proven guilty.

25 MAD art. 3(a)
26 MAD art. 3(b)
27 MAD art. 5
28 CESR 04-505b
29 The exact scope of these is outlined in the Level 2 Regulation (EC) 2273-2003 and the CESR/09-219
30 Level 2 Regulation (EC) 2273-2003
31 MAD art. 6 imposes certain positive obligations on issuers of financial instruments. These relate to:
- the publication of inside information (MAD art. 6 (1-3)): information which directly concerns an issuer must be publicly disclosed “as soon as possible.” Delayed publication is permitted where
disclosure may prejudice the issuer’s legitimate interests, provided that such an omission would not be likely to mislead the public. Where inside information has been disclosed by the issuer or
anyone acting on his behalf to any third party, the issuer must make a complete and effective public disclosure, simultaneously where disclosure was intentional and promptly where disclosure
was unintentional;
- insider lists (MAD art. 6 (3)): issuers or persons acting on their behalf are required to draw up a list of persons working for them who have access to inside information. They must regularly
update this list and send it to the competent authority on demand;
- manager’s transactions (MAD art. 6 (4)): persons discharging managerial responsibilities within an issuer of financial instruments and, where applicable, persons closely associated with them,
shall, at least, notify to the competent authority the existence of transactions conducted on their own account relating to shares of the issuer, derivatives or other linked financial instruments.
This information must be made available to the public as soon as possible. There is a EUR 5,000 threshold.
(a) Suspicious transaction reporting

Any person professionally arranging transactions in financial instruments who reasonably suspects that a transaction might constitute insider dealing or market manipulation is obliged under MAD I to notify the competent authority without delay. MAD I clarifies in Recital 9 that STRs require ‘sufficient indications’ and emphasises that ‘certain transaction by themselves may seem completely void of anything suspicious, but might deliver such indications of possible market abuse, when seen in perspective with other transactions, certain behaviour or other information.’ CESR’s first level 3 guidance outlines possible signals of insider dealing and market manipulation.

(b) Research and analysis

Persons who produce or disseminate research concerning financial instruments or issuers of financial instruments and persons who produce or disseminate other information recommending or suggesting investment strategy, intended to be made public must, under MAD I, take reasonable care to ensure that information is fairly presented, and disclose their interests or indicate conflicts of interest concerning the financial instruments to which that information relates.

(c) Chinese walls and other preventative measures

MAD I also specifies further measures which ‘could’ be included to enhance market security including ‘grey lists, the application of ‘window trading’ to sensitive categories of personnel, the application of internal codes of conduct and the establishment of ‘Chinese walls.’

It specifies in Article 6 (6) that ‘Member States shall ensure that market operators adopt structural provisions aimed at preventing and detecting market manipulation practices.’

8 Powers and sanctions

MAD I imposes minimum standards for investigation and enforcement powers. Taking into account the experience of the US and the UK, the Directive requires sanctions based on administrative laws in order to avoid the difficulties of securing criminal convictions.

Each Member State is obliged to designate a single administrative authority competent. The competent authority must have the necessary supervisory and investigatory powers.

MAD I requires that administrative measures may be taken or administrative sanctions imposed on contravention of the Directive. These sanctions should be sufficiently dissuasive and proportionate to the gravity of the infringement and to the gains realised, and should be consistently applied.

8.1 Double jeopardy and multiple investigations

MAD I does not give exclusive powers to the competent authority of one Member State (as in the home/host system under the single passport). Instead, it requires that the geographical scope of national prohibitions under the Directive overlap. Super-equivalent prohibitions may add further to this overlap. Trading scenarios which require investigation could therefore fall within the competency of the authorities of several states; for example, the state in which the relevant regulated market is located; the state in which the execution venue used is located; and the state in which the trader is located.

MAD I provides that other Member States may not investigate and prosecute persons who are already the subject of judicial proceedings or a final judgement on the same facts (see Art. 16(2)). This does not, however, preclude (nor do the vague MAD I obligations on authorities to ‘cooperate in investigation activities’) multiple investigations by different authorities at the same time or a series of investigations into the same facts by different authorities (where the initial investigations do not lead to judicial proceedings).

8.2 Mutual assistance and cooperation

MAD I contains certain provisions designed to assist investigations by competent authorities. These include:

32 More detail can be found Level 2 Directive 2004-72-EC and CESR 04-505b
33 MAD art. 6(9)
34 CESR 04-505b
35 MAD art. 6(5)
36 MAD (24)
37 MAD art. 11
38 These powers can be held directly, collaboratively, by delegation or by application to the competent judicial authorities. For the minimum requirements, see MAD art. 12.
39 MAD (38)
40 MAD art. 16
obligations on authorities to notify other authorities who may wish to investigate evidence;
- power for an authority to request information from a foreign authority; and
- power for an authority to request a foreign authority to carry out an investigation in the foreign country.\(^{41}\)

\(^{41}\) MAD art. 16(4). This provision also permits a country to request that representatives of its own competent authority accompany the investigation. The investigation will, however, be subject throughout to the overall control of the Member State on whose territory it is conducted. The Commission is of the view that CESR/ESMA should be informed of such a request.