

## Pending issues in the review of the European market abuse rules

Carmine Di Noia

The proposed legislative package on market abuse comprises two documents: a draft regulation (COM 2011/651), which will largely replace the existing market abuse Directive (2003/6) (MAD) and the level 2 measures; and a new Directive (COM 2011/654) dealing with criminal sanctions.

Market abuse rules are needed to ensure market integrity and investor confidence, to allow companies to raise capital and contribute to economic growth, thereby increasing employment.

Rules in place are a necessary but not sufficient condition.

On the one hand, they need to be technically well-designed, proportionate and crystal-clear, avoiding uncertainties in the interpretation, especially when there are, correctly, tough sanctions. On the other side, regulation needs to be complemented by efficient supervision. In integrated financial markets, abuses should be regulated in a harmonised manner by member states and a timely cooperation is therefore necessary among national competent authorities, which has not always been the case.

The text will initially concentrate on the scope and definitions – in particular the definitions of insider information, insider dealing and market manipulation – and the listed companies' disclosure obligations, including the specific provisions for SMEs. Many proposals are rooted in the 2007 ESME report.<sup>1</sup>

<sup>1</sup> See report by the European Securities Markets Expert Group (ESME), "Market abuse EU legal framework and its implementation by Member States", 6 July 2007 (hereinafter ESME Report) ([http://ec.europa.eu/internal\\_market/securities/docs/esme/mad\\_070706\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/esme/mad_070706_en.pdf)). See also N. Moloney, *EC Securities Regulation*, Oxford: Oxford University Press, 2008; J.L. Hansen and D. Moalem, "The MAD Disclosure Regime and the Two-Fold Notion of Inside

As the ESME Report illustrated, the existing MAD framework has been implemented in many different ways in Europe, despite the Lamfalussy approach. This is undesirable even if it allowed member states and especially their competent authorities in the last decade to overcome the fatal flaws of the 2003/6 Directive.

### 1. The notion of inside information

In 2003, MAD not only regulated market abuse but also fair disclosure obligations for listed companies: in particular, it provided for the public disclosure of inside information as soon as possible by making the same kind of information (inside information) the basis both for the prohibition of insider trading and for the obligation to disclose. This coincidence of notions generated a lot of legal uncertainty, especially because market abuse was already the basis in many member states for criminal offences. The possibility for listed companies to delay disclosure has been severely limited by the condition that such delay should not be misleading. In order to solve that uncertainty, many member states simply did not apply the Directive or circumvented it with guidelines of their competent authorities, which proved to be valuable at a first glance but often worthless when dealing with criminal charges.

After ten years, the draft Regulation has the merit to recognise that a differentiation is needed and goes back in distinguishing the information that cannot be abused from the information that listed companies has to disclose.

But it does it in the wrong way: instead of clarifying the circumstances when listed companies have to disclose

Information – The Available Solution", *Capital Markets Law Journal*, 2009, p. 323 and C. Di Noia and M. Gargantini, "The Market abuse directive disclosure regime in practice: Some margins for future actions", in *Rivista delle società*, 4/2009.

\* Carmine Di Noia is Deputy Director General and Head of Capital Markets and Listed Companies at Assonime (the Association of the Italian Corporations).



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relevant facts that arise in their own sphere of activities or when delaying disclosure is possible, it enlarges the notion of inside information not to be abused, by introducing a new Article 6.1 (e), relevant only for abuse purposes.<sup>2</sup>

This novelty, never put out for consultation by the European Commission, introduces a new case of inside information which lacks two criteria hitherto applied to the notion of inside information: the requirement of being “precise” and price sensitivity.<sup>3</sup> While it is appropriate to consider market abuse as warranting criminal sanctions, the violation should be carefully described in detail, and not left to the excessive discretion of the courts, in order to allow citizens to understand easily when they commit an abuse or not.

The lack of certainty and the extension of the violation as a criminal sanction may lead financial intermediaries to limit sensibly their trades and reduce liquidity on European stocks. It may also reduce the corporate governance dialogue, often encouraged by European institutions, between companies and shareholders, if the latter feel restricted in their ability to trade. It may also severely limit the possibility for companies to act in general and operate on their shares (despite the provision of Art. 3) and to use variable compensation schemes for managers instead of granting only fixed compensation, irrespective of the results of the companies.<sup>4</sup>

Two major changes are therefore necessary. The new Art. 6.1, e) should be deleted. The disclosure obligation in Art. 12 should take into account the ‘old’ definition of inside information for disclosure duties of Directive 2001/34/EC;<sup>5</sup> in any case the requirement for a listed company of “not misleading the public” when delaying disclosure of an inside information – which is by definition impossible to comply with – should be modified in order to allow

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<sup>2</sup> Inside information also includes information not falling within the previous paragraphs relating to one or more issuers of financial instruments or to one or more financial instruments which is not generally available to the public but which, if it were available to a reasonable investor who regularly deals on the market and in the financial instrument or a related spot commodity contract concerned, would be regarded by that person as relevant when deciding the terms on which transactions in the financial instrument or a related spot commodity contract should be effected.

<sup>3</sup> Although price sensitivity seems to have been supplanted by reasonable investor test (Art. 6.2). The proposed extension is an adaptation of the UK concept of RINGA (Relevant Information Not Generally Available), but without other limits (for example, that the information is considered relevant if it would be ordinarily the subject of an announcement required by law or made by convention – see section 1.5, FSA Code of Market Conduct).

<sup>4</sup> Managers may find it impossible to execute share options or even sell stock grants of their company.

<sup>5</sup> “The company must inform the public as soon as possible of any major new developments in its sphere of activity which are not public knowledge and which may, by virtue of their effect on its assets and liabilities or financial position or on the general course of its business, lead to substantial movements in the prices of its shares” (Art. 68).

companies to disclose negotiations only when they have a sufficient degree of certainty, avoiding market manipulation.<sup>6</sup>

## 2. Inside information, takeover and buying shares

The draft Regulation eliminates, without any consultation by the European Commission, the “Whereas 29 and 30” of the MAD.<sup>7</sup>

“Whereas 29” provides protection to merger and acquisition operations by excluding that communication of inside information from the potential target to the potential bidder represents a breach of confidentiality that triggers a disclosure duty. “Whereas 30”, which has been deemed applicable to takeover bids by the ECJ, excludes that the bidder has to disclose inside information regarding the purpose of launching a takeover.<sup>8</sup> If this was not the case, no takeover activity could indeed survive since, once the intention of launching a bid was disseminated, the target’s market price would immediately increase to a level matching the consideration of the bid, thus making the acquisition impossible. The combination of “Whereas 29 and 30” therefore excludes that information concerning the intention to launch a bid falls within the disclosure obligations of the bidder.

Both “Whereas” should be reintroduced in the Regulation, possibly in Art. 6.

## 3. The treatment of rumours and the definition of market manipulation

Issuers rarely face, in practice, cases involving information that can be classified in a clear-cut manner as “inside information to be published”, while a decision to publish is required in a very short timeframe. In many cases, before (the issuer realises that) an obligation to disclose an inside information has arisen, rumours<sup>9</sup> spread in the market, in some cases causing sudden price variations.

There is no clear rule either in the existing MAD framework or in the proposed framework on how issuers should behave

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<sup>6</sup> See the ESME report for more detailed solutions dealing with the concept of precision; another possible option could be to limit the precision of Art. 6.2 in Art. 12, making reference only to the existing set of circumstances or events.

<sup>7</sup> Whereas 29 stated that “having access to inside information relating to another company and using it in the context of a public takeover bid for the purpose of gaining control of that company or proposing a merger with that company should not in itself be deemed to constitute insider dealing”. Whereas 30 stated that “since the acquisition or disposal of financial instruments necessarily involves a prior decision to acquire or dispose taken by the person who undertakes one or other of these operations, the carrying out of this acquisition or disposal should not be deemed in itself to constitute the use of inside information”.

<sup>8</sup> See Moloney, *op. cit.*, pp. 959-960.

<sup>9</sup> Rumours harm market confidence and increase volatility, regardless of whether they are true or false.

when rumours addressing their securities are spreading.<sup>10</sup> Member states adopt different approaches: in some countries there are “no comment” provisions; in others, there is an obligation to comment only if rumours create abnormal movement in prices or quantities; in others, only ‘true’ rumours must be commented upon.

Uncertainty arises, especially because a sudden obligation to comment may result in the disclosure of incomplete or misleading information by listed companies. In fact, sending (or even attempting to send) “misleading signals” may result in a criminal violation.<sup>11</sup> The paradox is that, for an issuer, it’s better not to disclose information than to risk disclosure of misleading information: the net effect of the proposed MAD framework could result in less information available to investors, with implications for an efficient price formation.

Given that listed companies are traded on many different European platforms and market manipulation rules are applicable to them, a common European framework would be welcomed.

Listed companies should be obliged to comment only if two conditions obtain: the rumor is true and there are abnormal movements in prices or quantities. Otherwise, “no comment” policies should be clearly allowed.

#### 4. Managers’ transactions

With regard to managers’ transactions, the proposed higher threshold for disclosure obligation will significantly reduce trades without signalling value. However, it should be clarified that every time the threshold is reached, the

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<sup>10</sup> The third set of CESR Level 3 guidance, with non-binding value, states only that when the rumour relates to a piece of information that is inside information within the issuer, the latter is expected to react and respond to the relevant publication or rumour, as that piece of information is sufficiently precise to indicate that a leak of information has occurred (p. 9). This is the simplest case: the issuer has an obligation to comment on (true) rumours to the extent that their precision shows a leakage of inside information has occurred: *rectius* the issuers has to disclose the inside information which he was possibly delaying because confidentiality is broken. On the contrary, “in general, other than in exceptional circumstances or unless requested to comment by the competent regulator pursuant to Art. 6(7) of MAD, issuers are under no obligation to respond to speculation or market rumours which are without substance”. Thus, issuers are also under no obligation to respond to false rumours. CESR considers that this should also apply to publications, e.g. articles published in the press or internet postings, which are not result of the issuer’s initiative in relation to its disclosure obligations. The problem is that issuers often face true rumours which are not related to a complete inside information but rather relate to a confidential information or to a circumstance (not “a set of”) which is true (i.e. true rumours not necessarily stemming from a breach of confidentiality).

<sup>11</sup> In fact, even if Art. 5 of the proposed Directive excludes Art. 4.1 d) which deals with “dissemination of information which gives misleading signals”, the reference to 4.a) (“giving misleading signals”) may be taken into account by courts.

calculation of the threshold should restart from zero until the limit has been reached again, to avoid insignificant notifications to the regulator. Such notification should be sent by the relevant people or the companies to the competent authorities only, which should decide the rules for public access. This would allow for the centralisation of information.<sup>12</sup>

The deadline for the communication has been shortened (from 5 business days to 2 business days). This may create difficulties, in particular: i) if the duty of communication to the public also concerns transactions made by persons closely associated with managers and to which are be notified to the public by the latter; and ii) also considering that in many cases issuers notify transactions on behalf of managers.

Maximum harmonisation is in any case necessary.

#### 5. Insiders’ lists

With regard to insiders’ lists, their effective utility, at least with respect to listed companies, has been questioned. Furthermore, an extension of the notion of inside information may lead companies to incur relevant costs of compliance, especially in multinational listed companies.

While the Commission, in the consultation paper, reflected on the possibility to re-examine the rules in order to alleviate these burdens for issuers, it now proposes only to exempt issuers on SME growth markets.

Simplification of insiders’ lists should be applied to listed companies or at least to all SMEs, wherever traded (regulated markets or MTFs).

#### 6. The extension of disclosure obligation to MTFs

It is not appropriate to extend disclosure obligations to issuers whose shares are traded on demand only on “listing” MTFs. The simplifications foreseen in the proposed market abuse (and MiFID) framework are not so relevant.

Companies choose listing MTFs because there are less costly rules with respect to regulated markets. Intermediaries and investors know it and behave accordingly. While it is possible to extend market abuse rules in this case, imposing disclosure obligations would limit the possibility for SMEs to raise capital. In any case, a possible extension of the disclosure obligation regime should be left to member states, with a voluntary application by MTFs. This would be easier in case a different notion of information (Art. 12) is used. Any different solution could be detrimental for raising capital and could raise the costs of compliance for companies.<sup>13</sup>

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<sup>12</sup> A similar approach was taken in the draft Regulation on short selling.

<sup>13</sup> A scenario for the financial markets that would be compatible with the set of Community rules would be a system of three steps: i) regulated market “Basic”, dedicated to all listed companies with requirements in line with EU directives,

## 7. Accepted market practices

The draft Regulation removes the accepted market practices (AMPs), which shall remain applicable 12 months after entry into application of the Regulation itself.

The proposed removal of these AMPs, which will imply losing benefits of operating in these kinds of “safe harbours”, should be reconsidered; many member states recognised some AMPs<sup>14</sup> (and some of them have many similarities). The European Commission, in its consultation paper of 2009, seemed to consider the opportunity to have greater convergence in this field, instead of a removal. It would be appropriate to keep them and, if necessary, to strengthen the ESMA coordination role in order to solve the problem of financial instruments traded in more than one jurisdiction.<sup>15</sup>

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with a simplified regime governing related party transactions and the voluntary adoption of a code of corporate governance; ii) a regulated market “Plus” for voluntary membership by all companies, large or small, even SMEs, characterised by a very strict discipline, even in terms of governance; and iii) an MTF for companies not listed on a regulated market, not accessible to the retail market and open only to professional investors (institutional and private equity), with basic requirements of transparency.

<sup>14</sup> Ten AMPs have been published on the ESMA website.

<sup>15</sup> As envisaged by the Commission in the Impact Assessment (option 5.5.2, p. 175).

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[www.eurocapitalmarkets.org](http://www.eurocapitalmarkets.org) | [info@eurocapitalmarkets.org](mailto:info@eurocapitalmarkets.org)

Place du Congrès 1 | 1000 Brussels | Tel: + 32 2 229 39 11 | Fax: + 32 2 219 41 51