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Market Soundings: Practical issues under the new regime

[Updated on 5 August 2016 to reflect Level 2 measures; this briefing was initially published on 30 April 2016.]

Market Soundings: Practical issues under the new regime

The Market Abuse Regulation ("MAR")[1] which came into force on 3rd July 2016 sets out a new set of rules to govern the conduct of market soundings. It is a highly prescriptive regime which introduces obligations on those carrying out soundings as well as on those who are sounded out. It heralds a significant change from the current position where the act of "wall-crossing" a potential investor (by communicating inside information to him) was largely a matter left to individual national regulators and market practice, without any harmonised EU-wide rules.

MAR sets out certain high level obligations and requirements and these have been substantially fleshed out in Level 2 measures[2]. The new regime adds significantly to the compliance burden on both "disclosers" and "recipients", which gives rise to some practical issues, but also introduces new questions of interpretation.

Level 2 measures affecting recipients of soundings raise some particular issues. Several European 'buy-side' participants and industry organisations have expressed concern that the new regime is unduly burdensome and disproportionate and will lead to unwillingness to receive market soundings, particularly amongst smaller firms or those which only infrequently receive soundings. There is also a question as to what will or should happen with recipients in third countries outside the EU who are not bound by the regime. Despite these reservations, the majority, although not all, of the original ESMA proposals on obligations for recipients have been retained and are part of ESMA's Final Guidelines which were issued on 13 July 2016.

There is one advantage of the new regime which is that compliance with it by disclosers effectively creates a "safe harbour" from any improper disclosure of inside information. This is useful in circumstances where issuers/offerors and their advisors or brokers are gauging investor interest in a potential capital markets transaction (such as IPOs, rights issues, debt issuances or secondary market sales of equity or debt).

What is a 'market sounding'?

The definition is important because there are occasions when, even though no inside information is being disclosed, a prescribed disclosure procedure must still be followed.

Article 11 MAR describes a "market sounding" as:

"a communication of information, 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, to one or more potential investors by:

(a) an issuer

(b) a secondary offeror of a financial instrument in such a quantity or value that the transaction is distinct from ordinary trading and involves a selling method based on the prior assessment of potential interest from potential investors; or

(c) an emission allowance market participant; or

(d) a third party acting on behalf or on the account of a person referred to in point (a), (b), or (c)".

It is important to note that the new regime is limited to issuers/ offerors and those acting on their behalf. Where a discloser seeks to gauge investor interest on his own initiative, for example with the intention of subsequently pitching a fundraising to the issuer, it would not be considered to be a "market sounding", and the discloser would have to consider whether what he is doing involves any disclosure of inside information. If a recipient who is sounded out further seeks to sound out his own clients (for example, an asset manager sounding out his own segregated account clients), he would not benefit from the protections under the new regime, and the manager would have to consider how he could sound out his clients without it amounting to market abuse. Soundings that fall outside the "safe harbour" created by the new regime would not amount to market abuse if conducted in the normal exercise of business, particularly if all the policies and safeguards around disclosure are adopted.

In addition, the distinction drawn with "ordinary trading" is helpful in making clear that execution activities would not involve a sounding, and this is the case even where there is discussion with a counterparty as to price or size of a potential trade. That said, the distinction with "ordinary trading" is not wholly clear in all circumstances, in particular carrying out a block trade may involve a sounding. Block trading is discussed further below.

Equally importantly, a "market sounding" need not involve inside information for it to trigger the new regime, although soundings will commonly involve the disclosure of inside information. "Inside information" in this context is:

[1] Regulation on Market Abuse 596/2014/EU.

[2] (a) Delegated Regulation supplementing MAR with regard to regulatory technical standards (RTS) for the appropriate arrangements, systems and procedures for disclosing market participants conducting market soundings (EU) 2016/960, applied from 3 July 2016;

(b) Implementing Regulation laying down ITS for market soundings with regard to the systems and notification templates to be used by DMPs and the format of the records in accordance with MAR (EU) 2016/959, applied from 3 July 2016;

(c) ESMA: Final Report: Draft technical standards on the Market Abuse Regulation, 28th September 2015 (ESMA/2015/1455); and

(d) ESMA: Final Report: Guidelines on the Market Abuse Regulation – market soundings and delay of disclosure of inside information, 13 July 2016 (ESMA/2016/1130).

"*information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.*" (Article 7(1)(a) MAR)

"*Financial Instruments*" comprise of instruments traded on an EU regulated market, multilateral trading facility (MTF), organised trading facility (OTF) or instruments whose value depends or has an effect on the price of an instrument traded on a regulated market, MTF or OTF. (Article 2(1) MAR)

What are the new requirements on (a) disclosers and (b) recipients in a market sounding?

(a) Obligations on the discloser

Prior to the market sounding

The discloser must consider whether inside information is involved

The discloser should decide in advance what information it is necessary to disclose, and whether indeed it constitutes inside information. At the same time, the discloser should determine, to the extent possible, the estimated time when it will cease to be inside information (see 'Cleansing' below). The discloser needs to keep a written record for five years of its conclusion and the reasons for it. It may be asked to provide this record to the regulator at a later time.

Conducting the sounding

Soundings can take place in writing, phone, email or other medium. If by phone, recorded lines should be used where possible, subject to the recipient consenting to the recording.

Process where inside information is to be disclosed

A script or list of talking points should be used (if inside information is disclosed) setting out a standard set of points for each investor in the following sequence:

- a statement that the communication is for the purposes of a market sounding
- if on a recorded telephone line, a statement that the conversation is being recorded and obtaining consent to recording the conversation
- confirmation that the individual is the person entrusted by the recipient institution to receive the sounding
- clarifying that if the person agrees to receive the sounding (i) that inside information will be disclosed, and (ii) the recipient has to separately consider for himself whether it is inside information
- if possible, an estimation of when the information will cease to be inside information, the factors that affect that estimation and how the recipient will be informed of any change
- informing the recipient of his obligation to keep the information confidential and not to trade on the basis of it
- obtaining the recipient's consent to receiving inside information
- if he consents, identifying the information that is inside information.

Process where no inside information is to be disclosed

Despite there being, in the opinion of the discloser, no inside information, a prescribed process must still be followed in the following sequence:

- a statement that the communication is for the purposes of a market sounding
- if on a recorded telephone line, a statement that the conversation is being recorded and obtaining consent to recording the conversation
- confirmation that the individual is the person entrusted by the recipient institution to receive the sounding
- a statement that the recipient will receive information which the discloser considers not to be inside information
- the recipient agreeing to receive the market sounding.

It is possible that recipients are sounded out in relation to transactions that are already public knowledge. Certain details of the transaction may nonetheless amount to inside information. Care must be taken by the discloser in such circumstances and a cautious approach would instead suggest following the procedure required for when inside information is disclosed.

'Cleansing' - when information ceases to be inside information

When the discloser determines that the information that was disclosed in the market sounding has ceased to be inside information, the discloser should provide the recipient, in accordance with a special ESMA template, with the identity of the disclosing participant, the transaction, the date/time of the initial sounding, the fact that information has ceased to be inside information and the date when that occurred.

Record keeping

Records need to be maintained electronically and kept for five years of the following:

- the list of all persons receiving information, date/time of sounding and any follow-up and contact details
- the list of any potential investors refusing to receive any soundings
- the facts relevant to the assessment that inside information ceased to be such.

Other documentation which needs to be kept includes:

- the discloser's written procedures on market soundings, including scripts
- all communications with recipients including documents provided to them (i.e. audio/video recordings, copies of correspondence)
- if conversations are not recorded, then minutes are required, drawn up by discloser in accordance with an ESMA template and which include the date/time, identity of parties, information and materials disclosed, and the consents obtained. If minutes are not agreed within five business days after the sounding, then records of both the discloser's and recipient's versions of the minutes must be retained.

All records must be made available to the regulator on request.

(b) Obligations on the recipient

Communicating the wish not to receive market soundings

After being addressed by a discloser, the recipient should notify it whether they wish not to receive future market soundings in relation to either (i) all potential transactions, or (ii) particular types of potential transactions.

Recipient'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

Whilst taking into account the discloser's assessment, recipients should independently assess whether they are in possession of inside information as a result of the market sounding, taking into consideration all the information available to them, including the information obtained from sources other than the discloser.

Similarly, whilst taking into account the discloser's notification that the information disclosed in the course of the market sounding is no longer inside information, recipients 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 discloser.

Discrepancies of opinion between discloser and recipient

In the case of market soundings where, according to the discloser, no inside information is disclosed, but the recipient considers it is in possession of inside information, it was initially proposed by ESMA that the recipient should either (i) refrain from informing the discloser of the discrepancy of opinion, if the different assessment is due to the fact that the recipient is in possession of other information than that received from the discloser; or (ii) inform the discloser of the discrepancy of opinion, if the different assessment is based exclusively upon the information that the recipient received from the discloser. These proposals were subject to considerable criticism on various grounds that they risk further disclosure of inside information between the parties, serve no useful purpose, are unduly complex and burdensome, or rest on the false assumption that the recipient is in a better position than the discloser to assess whether information disclosed to it is inside information. In light of this, ESMA has deleted its guidance requiring the recipient to communicate its disagreement to the discloser as to whether information (i) is inside information or (ii) has ceased to be inside information.

Internal procedures and staff training

The recipient should establish internal procedures that are appropriate to the scale, size and nature of its business activity to (i) ensure that where the recipient of the market sounding designates a specific person or a contact point (e.g. an "info@" email address) to receive market soundings, that information is made available to the discloser; (ii) 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; (iii) ensure that the function or body entrusted to assess whether the recipient is in possession of inside information as a result of the market sounding is clearly identified and composed of staff properly trained for that purpose; and (iv) control the flow of inside information arising from the market sounding within the recipient institution and its staff. The recipient should ensure that the staff receiving and processing the information in the course of the market sounding is properly trained on the relevant internal procedures and on the prohibitions arising from being in possession of inside information.

List of recipient's staff who are in possession of the information communicated in the course of market soundings

For each market sounding, recipients should draw up a list of the persons working for them or otherwise performing tasks through which they have access to the information communicated in the course of market soundings.

Assessment of related financial instruments

Where the recipient has assessed that it is in possession of inside information as a result of a market sounding, the recipient should identify all the issuers and financial instruments to which that inside information relates.
During the consultation the concern was expressed that many recipients would not be capable, especially in a short time frame, of compiling a complete list as the process may require further inquiry and perhaps legal advice. The Final Guidelines soften the requirement somewhat: the recipient is now only required to identify those issuers and instruments to which it believes the inside information relates, with the level of detail of the assessment being linked to the complexity of the recipient's trading activity (i.e. there is now a degree of proportionality to the obligation).

Written minutes or notes

Where the discloser has drawn up written minutes or notes of any unrecorded meetings or unrecorded telephone conversations, the recipient should either: (i) sign these minutes or notes where it agrees upon their content; or (ii) provide the discloser with its 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 discloser.

Record keeping

Recipients are required to maintain records of (i) any notification given to a discloser of its wish not to receive future market soundings; (ii) a reasoned assessment as to whether a sounding disclosed inside information and as to whether it continues to contain inside information notwithstanding the discloser having informed the recipient that information previously disclosed no longer amounts to inside information; (iii) any discrepancy of opinion with the discloser as to status of any information; (iv) internal procedures; (v) lists of persons receiving information conveyed in market soundings; and (vi) the assessment of affected issuers and financial instruments.

There is clearly a need for both disclosers and recipients to consider a more formal and structured process for soundings than is currently likely to be the case and set matters out in written procedures, a process which inevitably focusses the mind on the details as to how the new requirements can be satisfied. Certain recipients, particularly those that may not have the size to justify the additional compliance burden, may consider the new regime to be unduly onerous and may decline to receive any market soundings at all.

Particular issues:

(a) When does a general conversation become a 'market sounding'?

There is no official guidance on this, but we suggest the following pointers that it is not a market sounding:

- the disclosure does not mention the specific transaction, or no specific details are discussed such as the name(s) of the potential parties, the nature of the transaction, timing, price or other specifics;

- similarly in relation to communications with an investor that are not premised, either expressly or implicitly, on a specific transaction. Non-deal roadshows, for example, should not typically involve any market sounding. Certain communications designed to gauge appetite in a potential capital-raising may be too speculative or hypothetical as to a specific transaction to fall within the market soundings regime but are nonetheless close to the boundaries of the regime where greater care needs to be taken.

- the person making the enquiry is no better informed than any other market observer, and does not act on behalf of any party likely to be involved in the potential transaction.

(b) Block trading

ESMA's view is that "undertaking a block trade can be compared to (and may amount to) a placing"[4], and given that the block of securities may be offered at a discount to the prevailing market price it may be necessary to sound out investors in advance communicating information as to the size, volume or in some circumstances the identity of the seller. Any such information could individually or collectively amount to inside information if the block of securities is of a sufficient size or value that the transaction is distinct from ordinary trading and involves a selling method based on the prior assessment of potential interest from potential investors; if so, the soundings regime would apply. Note that the regime would not extend to cases where the broker is not acting on behalf of the owner of securities and this includes instances where the broker is attempting to gauge investor appetite prior to proposing a transaction to an owner of securities in the hope of being mandated by the owner.

(c) Should an invitation for someone to be wall-crossed refer to the name of the company, or offer multiple names?

If the name of the company is divulged prior to the recipient agreeing to be wall-crossed, there is the risk that the recipient will be aware of other information which will enable him to construct a fuller picture such that he may end up being in receipt of inside information. Accordingly, this approach is not recommended unless there is a substantial degree of confidence that the disclosure of the company's name would not risk disclosing inside information to the recipient.

In order to avoid disclosing inside information, another option

[4]See paragraphs 68 to 70 of the Final Report of 28 September 2015 setting out Draft Technical Standards (ESMA/2015/1455).

sometimes used is a multiple names approach (where the market sounding refers to a number of named companies, one of which is the relevant company). The risk here is that it still might be possible to deduce which company is involved, particularly where there is sufficient information in the market to enable the recipient to assess the impact of a potential transaction on the company's securities. For these reasons, it is not recommended. More generally, consideration should always be given as to the risk that any disclosure could impart sufficient information which might enable the recipient to deduce the identity of the relevant company.

(d) What happens if a transaction does not proceed?

On the buy-side, a wall-crossed recipient will cease to be an insider once an announcement is made which discloses the proposed transaction. At that stage, the restrictions imposed upon the recipient fall away.

Article 6 of MAR imposes on the disclosing party the obligation to inform the receiving party as soon as possible after inside information that is disclosed as part of a market sounding ceases to be inside information. It was not generally market practice for issuers to make cleansing announcements if a proposed transaction was no longer going ahead and instead reliance was placed on the information turning stale through the passage of time or being superseded by other events. Also, care must be taken when informing recipients that a transaction is not being pursued, particularly where a reason is given, because this information may itself constitute inside information.

Defences

It is worth bearing in mind that there are some common misconceptions about defences. The following are not defences, and this will continue to be so under MAR:

The information was already known by the recipient. This is not a defence because information can be "disclosed" to an individual who already knows about it; if the disclosure reinforces the existing knowledge of the recipient, it might nonetheless constitute disclosure of inside information.

Information cannot be inside information if it contains inaccuracies. Where a particular piece of information indicates some circumstances or events which actually exist or have occurred or which may reasonably be expected to come about or occur, it may still be inside information even if it contains inaccuracies.

No financial gain was made or loss avoided. Whether or not a profit is made or loss avoided, if inside information is improperly disclosed this amounts to market abuse.

The disclosure of inside information was received inadvertently. Although firms should already have in place policies for when inside information is received (as recommended by the FCA in its February 2015 Thematic Review (TR15/1) of market abuse issues in the asset management sector), notifying a discloser of a wish not to receive market soundings would not release a recipient from its obligations, if it has in fact received inside information.

If you have any further questions regarding this briefing or on this topic generally, please do not hesitate to contact the authors or your usual Fieldfisher contact.

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