

A case study of the impact of the Market Abuse Regulation on structured finance products

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The Market Abuse Regulation (“**MAR**”) came into force on 3 July 2016. Given that it is a regulation rather than a directive, it is directly effective in all Member States of the EU without the need for any implementing measures on national level. This is also the case in the UK, whose immediate status as a Member State has not been affected by its vote to leave the EU. MAR replaces the previous civil market abuse framework under the Market Abuse Directive (“**MAD**”). As stated in the recitals, it is intended to “*establish a more uniform and stronger framework in order to preserve market integrity, to avoid potential regulatory arbitrage, to ensure accountability in the event of attempted manipulation, and to provide more legal certainty and less regulatory complexity for market participants*”. However, MAR has also led to substantial market uncertainty about its application and created potential issues for a wide range of transactions. This alert memorandum considers the issues created by MAR in the context of one particular example of transaction, as an illustration of the wider implications of the regulation. For a more general discussion of the new regime under MAR, please refer to our previous client alert “[*The new market abuse regime: the framework so far*](#)”.

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Scenario

This alert memorandum considers the application of MAR in the context of a refinancing of one tranche of collateralized loan obligations (“**CLOs**”). The CLOs are issued by a special purpose vehicle organized in the Cayman Islands and the class being refinanced (“**Refinanced Notes**”), as well as the other tranches of CLOs are listed on the Global Exchange Market of the Irish Stock Exchange (“**GEM**”). The refinancing will be funded through the issuance and sale of notes (“**Replacement Notes**”) that are identical to the Refinanced Notes save for the interest rate, which will be lower. It is expected that the Replacement Notes will be listed on GEM once issued.

Application of MAR to the scenario

1. Scope of MAR:

MAR applies to financial instruments admitted to trading on a regulated market, traded on a multilateral trading facility (“**MTF**”) or an organised trading facility (“**OTF**”), or for which a request for admission to trading on a regulated market or an MTF has been made, including to privately placed securities. Hence the scope of MAR is wider than that of MAD as not only regulated markets are covered but also MTFs and OTFs. While our scenario above would not have been within the scope of the previous regime under MAD, the GEM, which is an exchange regulated market and an MTF, is now subject to MAR.

There is no official guidance on how far advanced the process of requesting an admission to trading has to be for MAR to become applicable. However, market expectations are that probably nothing prior to submissions of the final application for admission to trading would fall within the scope of the regulation and that, for instance, the first submission of a prospectus to the regulator for review would not trigger this test.

Applying this to our scenario, the Replacement Notes are not yet admitted to trading on the GEM and, until the final application for admission to trading is made,

should not be subject to MAR. Nonetheless, the refinancing may fall within the scope of MAR due to the other tranches of the CLO which are and remain listed for trading on the GEM.

The scope of MAR extends beyond financial instruments admitted to trading on a regulated market or traded on an MTF or an OTF. It also covers financial instruments the price or value of which depends on, or has an effect on, the price or value of the instruments directly within the scope of the regulation. The refinancing of one CLO tranche is likely to have an impact on the price of at least some of the other tranches of the CLO. This brings the refinancing within the scope of MAR indirectly, through its effect on the other tranches which will remain outstanding after the refinancing.

2. Inside information

MAR defines inside information as follows:

“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 price of those financial instruments or on the price of related derivative financial instruments”. MAR further states that information is likely to have a “significant effect” on price if it is information that a “reasonable investor would be likely to use as part of the basis of his or her investment decisions”.

Application of MAR is hence very broad in scope. In our scenario, information relating to the potential refinancing of a tranche of notes is clearly “of a precise nature”. There is a general obligation to make inside information public as soon as possible where the related securities fall within the scope of MAR, which is the case where the securities are listed, including on the GEM. Information is classified as inside information in the time period before it is made public.

The question is, therefore, whether a reasonable investor would be likely to use this information as part of the basis of his investment decision. Importantly, the key here appears to be the relevance of the

information for the investor, rather than the significance of its possible effect. The fact of the refinancing, and the likely interest rate for the Replacement Notes, is information that a reasonable investor would take into account when making an investment decision and, therefore, the definition of “inside information” is met.

3. Market soundings

The European Securities and Markets Authority (“ESMA”) has introduced regulation in respect of market soundings in circumstances where inside information is shared on a confidential basis with a limited number of people, for instance certain investors, before it is made public. Such circumstances are likely to be relevant in the context of refinancing a tranche of a structured finance product.

The concept of “market soundings” under MAR deals with “*the 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*”. This includes such communications by both the issuer and the arranging bank in the scenario. The arranging bank would likely engage in market sounding in order to evaluate the market’s appetite for the Replacement Notes and assess on what terms the refinancing could occur.

MAR requires market participants to specifically consider, before engaging in a market sounding, whether such activity involves the disclosure of inside information. The relevant person, in our scenario likely to be the arranging bank, would have to make a written record of its conclusion and keep this record updated throughout the course of the market sounding. The relevant inside information for the purposes of the scenario would be the intention to refinance the relevant tranche, as this information constitutes inside information in relation to the other tranches of the structured product which are not refinanced.

If the arranging bank concludes that the market sounding will include the communication of inside

information, it will have to comply with the requirements of MAR governing such communications and the detailed procedures developed by ESMA. Market participants may take the view that the procedures are applicable even where no inside information is concerned based on one possible reading of the rules. The most important of the requirements for the arranging bank are discussed below, but a full breakdown of the obligations on both the arranging bank and the receiving investor is set out at Annex 1 below.

When engaging in a market sounding involving inside information, the arranging bank must (i) obtain the consent of the person receiving the market sounding to receive inside information; (ii) inform the recipient that he is prohibited from using that information by acquiring or disposing of the financial instruments to which the inside information relates (i.e. the tranches which are not refinanced) or cancelling or amending an order which has already been placed and (iii) inform the recipient that by agreeing to receive the relevant information he is obliged to keep it confidential. The new rules do not envisage that every market sounding will include inside information, and some soundings may be so general as to fall outside of the definition of inside information.¹ However, as discussed above, the arranging bank must consider whether a particular market sounding involves the disclosure of inside information, and keep a written record of its conclusion for a period of at least five years.

The arranging bank must also maintain a record of all information given to recipients of the market sounding and the identity of the potential investors to whom the information has been disclosed. The arranging bank and the recipient must agree this record between them, and this record must be kept for five years.

¹ See ESMA’s Final Report on MAR Guidelines, 16 July 2016 paragraph 6: “*The MAR regime is intended to regulate the way market soundings are conducted, including the transmission of inside information in the course of such soundings. However, in practical terms, not all market soundings involve the disclosure of inside information.*”

Finally, the arranging bank is required to inform the recipient as soon as possible once the information disclosed within the market sounding ceases to constitute inside information.

4. Practical implications

These regulations place a heavy burden on both the arranging bank and the investors with which it carries out the market sounding. In particular, the requirement to notify all recipients as soon as the information disclosed ceases to be inside information adds an extra layer of complexity. Where the refinancing goes ahead, this will likely be around the time at which the deal is announced via notice posted by the ISE, or possibly when the listing particulars are published. However, for deals which do not go ahead after market soundings have taken place, the analysis is more difficult; at what point does the information eventually become so stale that it is no longer likely to have a significant effect on the price of the instruments?

For further detail with respect to the respective duties of the discloser, i.e. the arranging bank, and the recipient, i.e. the potential investor, please refer to *Annex I* below.

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ANNEX 1

Duties of the Discloser (Arranging bank)	Duties of the Recipient (Potential investor)
<ul style="list-style-type: none"> Assess whether the market sounding will involve the disclosure of inside information and make a written note of reasons for the determination 	<ul style="list-style-type: none"> Put in place procedures to communicate wishes not to receive market soundings, whether this wish relates to specific transactions or transactions in general. Ensure that those in charge of receiving inside information are properly trained Establish, implement and maintain internal procedures ensuring the flow of information is managed and controlled on a confidential basis
<ul style="list-style-type: none"> Inform Recipient of the determination on whether the disclosure will include inside information and the consequent restrictions and confidentiality obligations. Obtain Recipient's consent to receiving the information 	<ul style="list-style-type: none"> Designate a person or contact point who will receive the market sounding Keep a list of all staff who are in possession of the information communicated in the course of market soundings (whether or not the information constitutes inside information)
<ul style="list-style-type: none"> Provide Recipient with a certain set of information, including a statement that a market sounding is being conducted and clarifying whether the Discloser believes inside information will be disclosed or not 	<ul style="list-style-type: none"> Make an independent assessment of whether the disclosure included inside information and, if so, when this might cease to be the case. Where this assessment indicates that inside information has been disclosed, identify all the issuers and financial instruments to which the information relates
<ul style="list-style-type: none"> Maintain a detailed record of all of these requirements, including to whom the information is disclosed and what information was disclosed (even if the Discloser has determined that no inside information was disclosed). Maintain these records for at least five years 	<ul style="list-style-type: none"> Maintain a detailed record of all of these requirements, including notifications to Disclosers of the wish not to receive market soundings and disagreements between Discloser and Recipient on the classification of information. Maintain these records for at least five years
Procedures	
<ul style="list-style-type: none"> If the Discloser has access to recorded telephone lines, they should use them (if the Recipient consents). If the Discloser does not have access to recorded lines (or the Recipient does not consent), written minutes or notes should be drawn up, agreed and signed by both parties. If the parties do not agree the record within five working days after the market sounding, the Discloser should keep two versions, each signed by one party. If the Recipient does not provide signed written minutes or notes, the Discloser should retain its own signed copy. Disclosers will be required to give Recipients an estimate of when information will cease to be inside information, if applicable (for example, when it is estimated that information will be publicly announced or when it is expected to become stale) as well as the factors that could affect that estimate and the manner in which changes to that estimate will be communicated to the Recipient. Disclosers will also be required to monitor the status of information disclosed to Recipients – if it has ceased to be inside information, Disclosers should inform Recipients as soon as possible. 	