ISDA Safe, Efficient Markets

FIA

29 November 2019

Final ISDA and FIA response to ESMA Consultation on MAR Review

EXECUTIVE SUMMARY

- ISDA and FIA welcome the opportunity to respond to the consultation launched by ESMA on the review of the Market Abuse Regulation (MAR) in the view of the future technical advice that ESMA will have to submit to the European Commission. MAR has been applicable for approximately two years and a half and ISDA and FIA consider that it has generally proved appropriate.
- EU legislators introduced a specific regime to tackle insider dealing in commodity derivatives (and spot commodity) markets. ISDA and FIA support this regime established in 2014 and consider that it is still appropriate. ISDA and FIA therefore do not see a need to change this framework.
- ISDA and FIA understand that ESMA may seek simplification of the regime and contemplate further alignment between the regime applicable to securities markets and that for commodity derivatives markets. However, we strongly believe that such alignment is not appropriate and that the reasons for separate definitions of inside information are still valid.
- ISDA and FIA do support the current regime applicable to front running and strongly believe that firms should continue to be able to implement their own plans and strategies for trading, production and hedging.
- ISDA and FIA agree with ESMA that any changes to MAR in relation to benchmarks should be coordinated with the outcome of the review of the European Benchmarks Regulation and only be proposed following completion of the review. This is not to say, however, that the scope of MAR and the scope of the BMR should be aligned. In light of the different policy objectives (prevention and enforcement relating to market abuse on the one hand and the administrative and governance standards applicable to administrators, contributors and users of benchmarks on the other) it is reasonable for their scope to diverge significantly.

SPECIFIC COMMENTS

Section 3.1 – Spot FX contracts

Q1: Do you consider necessary to extend the scope of MAR to spot FX contracts? Please explain the reasons why the scope should or should not be extended, and whether the same goals could be achieved by changing any other piece of the EU regulatory framework.

ISDA and FIA members support GFXD's response to this question.

Q2: Do you agree with ESMA's preliminary view about the structural changes that would be necessary to apply MAR to spot FX contracts? Please elaborate and indicate if you would consider necessary introducing additional regulatory changes.

ISDA and FIA members support GFXD's response to this question.

Section 3.2 – Scope of application of the benchmarks provisions

Q3: Do you agree with ESMA's analysis on the scope of the two definitions of benchmark in MAR and BMR? Do you think that the difference between the MAR and BMR definitions raises any market abuse risks and if so what changes might be necessary?

Subject to later comments regarding the potential advantages of allowing the two definitions of benchmark to diverge, we agree with ESMA's view that any possible change in MAR in relation to benchmarks should be coordinated and coherent with the outcome of the BMR review. In this light, we believe it would be most appropriate to await the outcome of the BMR review consultation before introducing any BMR-related changes to MAR.

This is not to say, however, that the definition of benchmark in MAR needs to mirror the definition of benchmark in the BMR. As described by ESMA, the two pieces of legislation are complementary but they cover different activities. Whereas MAR prohibits manipulation or provision of false or misleading data in respect of a benchmark, BMR governs the administrative and governance obligations of administrators, contributors and users. It may be, therefore, that the definition of benchmarks that are brought into scope in relation to each piece of legislation should be allowed to diverge significantly in order to reflect overarching policy objectives. This may be particularly important given the desire of many stakeholders to significantly refine the scope of the BMR during the course of the BMR Review.

- It is also imperative that the definition of a benchmark for the purposes of MAR (breach of which may lead to criminal sanction) is as objective and clear as possible in order to promote compliance with MAR, monitoring an enforcement activities. It is ISDA and FIA's view that the definition of 'benchmark' in the BMR is vague and subjective. For example: **'Systematic Internaliser'.** The definition of financial instrument in BMR also refers to financial instruments "traded via a systematic internaliser" ("SI"). Generally, ISDA and FIA are of the view that the definition of financial instrument in Art 3(1)(16) is so expansive and vague that it is difficult to know what could be out of the BMR scope and whether this could vary over time. This causes significant difficulties to firms from an organisational perspective.

- **'Financial Instrument',** The BMR definition of financial instrument cross-references the systematic internaliser (SI) definition in MiFID 2, point (20) of Article 4(1). Certain OTC derivatives may fall under the scope of the BMR only under limb (iii) (i.e. traded via an SI) of Art 3.1. (16) that defines what is a financial instrument. However, scoping OTC derivatives into the BMR appears to be in contradiction with Recital 9 of the BMR that states "This regulation should therefore cover benchmarks which are used to price financial instruments listed or traded on regulated venues." In September 2018, ESMA published the BMR Q.A 5.8, which further defines when financial instruments traded on a SI are in scope of the BMR. Nonetheless, this Q&A created additional confusion in the industry instead of clarifying the intent of the Regulation given that its limb (b) appears to scope in financial instruments not traded on trading venues (ToTV) i.e. *"all other instruments that are actually traded on a systematic internaliser,* regardless of any requirement of the systematic internaliser to provide reference data".

  ESMA's recently updated market transparency Q&A 11 seems to acknowledge that "*it might be challenging for investment firms to access reliable and comprehensive sources of EU wide information preventing de facto the systematic internaliser test to be carried out*". This statement appears to recognise that it may in fact be impossible for firms always to know whether or not they have become an SI in particular non-TOTV instruments or classes of instruments. This has the unfortunate result under the BMR that firms cannot know which OTC derivatives are 'financial instruments' in scope of the BMR and therefore equally cannot be sure that they are complying with their obligations with respect to the use of benchmarks except by assuming that all OTC derivatives are in scope.

  Additionally, the reference to SIs is problematic over the lifecycle of a derivatives contract given that the BMR does not distinguish between the mandatory and voluntary SI regimes. Financial market participants are thus facing a problem of lacking visibility regarding their counterparties' SI status since a counterparty could have a) passed or fallen below a threshold for financial instruments or b) could have voluntarily opted-in or opted-out as an SI for a class of financial instruments.

  Given that this does not seem to be a natural conclusion, ISDA and FIA are suggesting a removal of the SI reference from the scope of the BMR in the context of the BMR review.

  We are also of the view that the test to determine whether a benchmark is used in a financial instrument should be undertaken only at the time of entry into a derivative contract to avoid a situation in which contracts which are out of scope when traded come into scope because of some subsequent event outside the control of the parties.

Made available to the public. Guidance provided to the market has suggested that if the level of an index can be reverse engineered by observing the amount of coupon payable on a financial instrument, then the index will have been 'made available to the public' (one of the key elements of whether it falls in scope of BMR or not). This makes the scope of BMR almost impossible to determine (in that it is difficult to say beyond reasonable doubt what is not in scope).

Based on the above, we do not consider that the definition of a 'benchmark' in the BMR constitutes the sound basis for the definition of a 'benchmark' for the purposes of MAR.

Q4: Do you agree that the Article 30 of MAR "Administrative sanctions and other administrative measures" should also make reference to administrators of benchmarks and supervised contributors?

The associations feel this question is very difficult to answer without seeing the wording that is proposed. For example, is the intention to ban those who have manipulated benchmarks from holding regulated senior management roles in supervised entities? In which case, this would seem to be already covered by the existing text. Or would it be to ban them from holding (unsupervised) senior management roles in unsupervised administrators or contributors? Or any other role in such entities?

In general, the associations do not disagree that administrators and contributors should be made subject to MARs administrative measures but more detail is required in order to provide informed feedback.

It is worth considering the extra-territoriality of any such provision, given that administrators and contributors to benchmarks may be from jurisdictions outside the European Union. This may cause issues for NCAs to monitor and enforce.

The associations agree that potential overlap between the two enforcement regimes under MAR and BMR should be considered to remove the prospect of confusion and duplicative punishments.

Q5: Do you agree that the Article 23 of MAR "Powers of competent authorities" point (g) should also make reference to administrators of benchmarks and supervised contributors? Do you think that is there any other provision in Article 23 that should be amended to tackle (attempted) manipulation of benchmarks?

Please see our response to Q4 above (including in relation to questions of extra-terrioriality).

Q6: Do you agree that Article 30 of MAR points (e), (f) and (g) should also make reference to submitters within supervised contributors and assessors within administrators of commodity benchmarks?

As a general comment, we would like to note that the purpose of Article 30(2) powers in relation to persons discharging managerial responsibilities is to prohibit people with management power over the entity from continuing to manage similar entities if they breach MAR. It is questionable whether a submitter or assessor who is not part of the senior management regime should be dealt with here. As is the case for Question 5 and Question 6, further information is required to provide informed feedback.

Section 5 – Article 7 of MAR – definition of inside information

Q13: Have market participants experienced any difficulties with identifying what information is inside information and the moment in which information becomes inside information under the current MAR definition?

Our response focuses on the definition of inside information applicable to commodity derivatives in Article 7(1)(b) MAR and under this definition, there were no material issues identifying inside information and the moment in which information becomes inside information. ISDA and FIA members consider that the definition of inside information applicable to commodity derivatives is appropriate as it recognises the structural difference between information on an issuer of securities and a commodity derivative contract or the underlying commodity to this contract.

We understand that ESMA assesses the difference between the definition of inside information for commodity derivatives (which requires the information to be expected or required to be disclosed) and the definition applicable to financial instruments and asks whether this distinction is appropriate or necessary. We however question the statement made by ESMA in paragraph 91 of the consultation paper: "*The different bar set for the inside information concerning commodity derivatives and financial instruments may lead to the following: a non-listed commodity producer may be able to disclose to other parties information that, if the same firm was listed, would be treated as inside information. Those other parties receiving the information from the non-listed firm may be able to trade on that information, which would be considered as insider dealing if the same information was received from a listed firm*".

This statement does not take into account that there is information that a non-listed commodity producer would have to disclose as inside information (in relation to commodity derivatives) which a listed firm would not have to disclose (in relation to bonds / shares), simply because the information is not relating to the commodity producer but to the commodity derivative.

In relation to commodity derivatives, a person would have to disclose information that, if public, *"would be likely to have a significant effect on the prices of such derivatives or related spot commodity contracts"*. As a result, this person is not just disclosing information about the issuer that might have an effect on the price of securities issued by that issuer, but is also disclosing information about the underlying commodities. Such information could include information about global trading, political situations in relevant countries, key refinery outages, as well as information on the firm's own trading strategy. Since the scope of inside information in relation to commodity derivatives is potentially so much wider, it is appropriate to limit it to information that can reasonably be expected to be monitored and disclosed.

Regarding the definition of inside information in relation to emission allowances (Article 7.(1)(c) of MAR), ISDA and FIA members note that it is unclear what would constitute 'inside information' under MAR, which is not already covered by the definition of inside information under Article 2 (1) of the Regulation on Energy Markets Integrity and Transparency (REMIT) in conjunction with the definition of wholesale energy products (Article 2 (4) REMIT). In the emission market, prices are mainly influenced by macro-economic information and EU Member States' policy decisions (e.g. EU Emissions Trading System (ETS) revision, nuclear phase out, amount of certified emission reductions (CERs) that could be taken into account in the EU). Usually industrial emitters hold little non-public information that would be relevant in relation to the price developments of emission allowances and their derivatives. Most it not all of the planned and unplanned shutdowns of production, storage,

transmission and other facilities do not have a significant effect on price formation in emission markets, as very few industrial installations are large enough to impact the wider market. In any case these outages are already covered by the REMIT definition of inside information and consequential disclosure obligations.

In practice, all relevant inside information concerning emission allowances markets is sufficiently covered and published under REMIT. Also, the REMIT publication is sufficient for the purpose of the MAR disclosure of inside information as Article 2 (2) of Implementing Regulation (EU) 2016/1055 recognises it also for the purpose of compliance with the disclosure obligation under Article 17 (2) of MAR.

Nevertheless, wholesale energy market participants (as defined in REMIT) have to comply with the MAR definition at the same time although the latter does not cover additional, price relevant inside information. Therefore, we believe that the current definition of 'inside information' in relation to emission allowances in MAR creates an unnecessary additional layer of complexity and legal insecurity for wholesale energy market participants and this without any obvious benefits.

Therefore, we propose to introduce a reference to the REMIT definition of inside information into the definition in Art. 7(1)(c) MAR to avoid these adverse consequences for wholesale energy market participants. This would mean that wholesale energy market participants would have to comply exclusively with the REMIT definition of insider information with regard to emission allowances and derivatives thereof. This approach would substantially reduce complexity without diminishing the effectiveness of the regime.

Furthermore, we believe that this complexity is exaggerated by the defined thresholds under Article 7 (4) and 17 (2) of MAR, which determine which emission allowance market participants (EAMP) are subject to the insider regime under MAR. The set thresholds for EAMP, defined as per Art. 5 of Regulation (EU) No 2016/522, are set at a rather low level. Especially with the threshold for the rated thermal input, it is rather easy to exceed the threshold, even though a market participant may have only a mix of CCGTs that run rather clean or some power plants might even be quite small. Also, this threshold approach would not be necessary if the above-mentioned reference to the REMIT definition is introduced as in this case all relevant inside information is covered and disclosed by wholesale energy market participants. Alternatively, we would recommend thresholds for single power plants /resp. facilities. As long as the overall threshold and the single facility threshold are not exceeded cumulatively, firms could be out of scope of the EAMP definition.

Q14: Do market participants consider that the definition of inside information is sufficient for combatting market abuse?

Yes, ISDA and FIA members believe that the current language in Article 7 (1) MAR appropriately defines impermissible inside information and are not aware of any case since the full application of the regime that would prove it insufficient.

Q15: In particular, have market participants identified information that they would consider as inside information, but which is not covered by the current definition of inside information?

No, ISDA and FIA members have not identified any such information under any of the definitions of inside information under Article 7 (1) MAR.

We consider that the provision is drafted in a sufficiently broad manner to ensure that the definition of inside information is wide enough to capture the information necessary to combat market abuse. Our members consider that, if the definition of inside information is reassessed, the focus should be on the extent to which existing national legislation, rules and guidance are consistent with the intended Level 1 definition and therefore whether Level 3 guidance should be provided to ensure pan-European consistency in the interpretation and application of the definition.

Q16: Have market participants identified inside information on commodity derivatives which is not included in the current definition of Article 7(1)(b) of MAR?

No, ISDA and FIA members we have not identified information that should be covered by the current definition of inside information relating to commodity derivatives but is not.

However, as mentioned above under Q13, in practice all relevant insider information concerning emission allowances markets is already sufficiently covered and published under REMIT. We believe that the current MAR definition of 'inside information' in relation to emission allowances creates an unnecessary additional layer of complexity and legal uncertainty for wholesale energy market participants subject to REMIT and this without any obvious benefits. Therefore, we propose to introduce a reference to the definition of inside information of REMIT into the definition of Art. 7 (1) (c) MAR to avoid these adverse consequences for wholesale energy market participants. This would mean that wholesale energy market participants would have to comply exclusively with the REMIT definition of insider information with regard to emission allowances markets and derivatives thereof This approach substantially reduces complexity for the real economy.

Q17: What is an appropriate balance between the scope of inside information relating to commodity derivatives and allowing commodity producers to undertake hedging transactions on the basis of that information, to enable them to carry out their commercial activities and to support the effective functioning of the market?

ISDA and FIA members strongly recommend that the fourth element of the definition of inside information in relation to commodity derivatives, namely that relevant information must be disclosable, is retained.

During the legislative process leading to MAR, EU legislators agreed for specific reasons to retain the additional condition already mentioned in the previous MAD that in order for proprietary information to be considered inside information, it has to be reasonably expected to be disclosed or required to be disclosed in accordance with legal or regulatory provisions at the Union or national level, market rules, contract, practice or custom, on the relevant commodity derivatives markets or spot markets (hereinafter "the disclosability criterion"). These specific reasons are still valid.

The main reason is that there are structural differences between commodity derivatives and securities markets that justify different approaches to the regulation of (mis)use of proprietary information. The main difference is that commodity market participants must be able to hedge their production and consumption needs and commodity price risks.

It is not conceivable that any such obligation could be imposed, given the variety of possible underlying commodities and the global nature of the markets. Commodities firms, including energy utilities, oil and gas producers, farmers, etc., are all engaged in commerce and trade, which essentially involves holding information which is relevant to existing or anticipated production, and to quality, storage and supply levels, and these parties will use that information in order to determine their trading and risk

management needs and to fulfil their deliveries. It is therefore critical, that no general disclosure obligation (i.e., requiring the disclosure of all inside information relating to commodity markets irrespective of the disclosability criterion) be in place. In particular, the disclosability criterion prevents any general disclosure obligation that requires making public all inside information.

Otherwise, such a general disclosure obligation would restrict the ability of physical market participants and liquidity providers to hedge, other than from a distressed position, and this in turn would lead to increased overall costs of trading and production for those participants and therefore increased costs for consumers.

Please also see our response to Question 19.

Q18: As of today, does the current definition of Article 7(1)(b) of MAR allow commodity producers to hedge their commercial activities? In this respect, please provide information on hedging difficulties encountered.

ISDA and FIA members do not see material hedging difficulties and from that perspective do not see a need to change the current definition of Article 7(1)(b) of MAR.

Q19: Please provide your views on whether the general definition of inside information of Article 7(1)(a) of MAR could be used for commodity derivatives. In such case, would safeguards enabling commodity producers to undertake hedging transactions based on proprietary inside information related to their commercial activities be needed? Which types of safeguards would you envisage?

As stated above under question 13 and 17, ISDA and FIA members consider that there are structural differences between securities markets and commodity derivatives markets that justify the specific definition of inside information for commodity derivatives. EU legislators decided to have separate definitions of inside information for those reasons, which are still valid. As a result, we strongly believe that the general definition of inside information of Article 7(1)(a) of MAR should not be used for commodity derivatives.

Since the Market Abuse Directive (2003/6/EC), separate definitions were used for inside information for issuers of financial instruments and for commodity derivatives. Art. 1 of MAD established, that inside information for commodities would need to be information that "users of markets on which such derivatives are traded would expect to receive in accordance with accepted market practices on those markets". During the ESMA public hearing on the MAR Review on 5 November 2019, ESMA acknowledged that one of the biggest challenges in relation to the definition of inside information under Article 7(1)(a) of MAR, is to ascertain the point in time when inside information comes into existence. Market participants raised concerns that the definition in Article 7(1)(a) may be too wide or vague, and that safeguards are required to avoid information being identified as potentially being inside information very early on in a transaction, thus unnecessarily blocking or restricting capital market transactions, which has a detrimental effect on market participants and liquidity.

The definition of inside information for commodities in Article 7(1)(b) avoids such risk by being more prescriptive, allowing market participants to better assess what constitutes inside information. The removal of the fourth leg of the definition would expand the scope of information falling under this definition significantly and lead to the definition becoming unmanageable for commodity derivatives, given that it includes information that relates to either the commodity derivatives themselves, directly or indirectly, or directly to related spot commodity markets.

Unless there is an obligation to disclose or market expectation of disclosure of a certain type of information, there may be no specific forum or timeline for disclosure and so often no way for market participants to check if what may amount to inside information has become "public" enough to remove the risk of being an insider. Also, if information is of a type that is disclosable to the rest of the market, market participants would expect to be able to price trades based on that information, making information of that type more obviously likely to have an effect on price - so having access to it ahead of the market in those circumstances would amount to an advantage.

One key difference between commodity markets and securities markets is that in securities markets, information relating to an issuer of security is private information available to people by virtue of their relationship with that issuer (as officers, employees) and that information is material to the price of the security. There is no issuer of a commodity and it is market participants rather than "issuers" that enter into commodity derivatives transactions. Commodity prices are based on global market demand and supply, weather, geopolitical factors and a range of other factors and proprietary information relating to one market participant is unlikely to have a similar impact on the price of a commodity that information on an issuer may have on its share price.

Further and as set out in our response to Question 17, commodity market participants must be able to hedge their risks relation to the production and prices of commodities. Hedging by commodity producers and other market participants is a commercially prudent strategy that reduces risk in the real economy, and we believe regulators do not want to disincentivise this by imposing a general disclosure obligation (i.e. by categorising all proprietary information as inside information) and as a result increasing the risk for those who have interests in the underlying commodities or commodity infrastructure. The current definition in Article 7(1)(b) of MAR takes those differences into account and strikes a good balance between market participants reasonably expecting certain information to be disclosed and being able to use proprietary information available to them as consequence of being involved in commercial production and trade for the purposes of fulfilling their hedging and risk management requirements.

Q20: What changes could be made to include other cases of front running?

ISDA and FIA members understand that ESMA suggests clarifying that knowledge of pending orders should be inside information not just for persons charged with the execution of orders (as is the framework today) but also for other categories of persons (including directors of an issuer, the issuer itself, institutional investors etc.).

We consider that the current scope is aimed at the knowledge of other market participants' orders. A person charged with execution of orders is highly likely to have knowledge of other market participants' trading intentions, and so their ability to trade on this information should be limited. A director of an issuer would not come into possession of knowledge about other market participants' trading intentions regarding the issuer as a result of his role as director.

We therefore do not see any need to change the scope of the current framework.

Q21: Do you consider that specific conditions should be added in MAR to cover front running on financial instruments which have an illiquid market?

Q22: What market abuse and/or conduct risks could arise from pre-hedging behaviours and what systems and controls do firms have in place to address those risks? What measures could be used in MAR or other legislation to address those risks?

ESMA suggests that pre-hedging may constitute insider dealing, and that it may be appropriate to impose conduct rules on brokers, requiring them to provide transparency and disclose any pre-hedging arrangements. Particularly, ESMA is considering making a wider (and less defined) range of information potentially "inside information" in relation to commodities and commodity derivatives.

ISDA and FIA members strongly believe that the reasons for having a specialised definition of inside information in relation to commodity derivatives under MAR are still valid and unchanged, and that no specific misbehaviour in the market occurred that would justify such changes. As stated under questions 13, 17 and 19, alignment between the general definition of inside information (Article 7(1)(a)) and the specific definition of inside information for commodity derivatives (Article 7(1)(b)) would not be appropriate as there are structural differences between securities markets and commodity derivatives markets that justify separate definitions.

Pre-hedging activities of commodity firms should not be prohibited under MAR. Market participants should be able to implement their own plans and strategies for trading, production and hedging. Like under REMIT[1], information regarding the market participant's own plans and strategies for trading should not be considered as inside information.

For example, energy producers must be able to implement their own plans and strategies for their power production and for this purpose to procure all necessary commodities and emission allowances at any point in time to run their power plants and to sell the power (to be) produced and this on any (spot and future) commodity markets.

Q23: What benefits do pre-hedging behaviours provide to firms, clients and to the functioning of the market?

See our response to Q22.

[1] REMIT, recital 12: *The use or attempted use of inside information to trade either on one's own account or on the account of a third party should be clearly prohibited. Use of inside information can also consist in trading in wholesale energy products by persons who know, or ought to know, that the information they possess is inside information. Information regarding the market participant's own plans and strategies for trading should not be considered as inside information. Information which is required to be made public in accordance with Regulation (EC) No 714/2009 or (EC) No 715/2009, including guidelines and network codes adopted pursuant to those Regulations, may serve, if it is price-sensitive information, as the basis of market participants' decisions to enter into transactions in wholesale energy products and therefore could constitute inside information until it has been made public.*