CONSULTATION PAPER NO. 63

05 OCTOBER 2009

CHANGES TO THE DIFC INSIDER DEALING REGIME

CONSULTATION PAPER NO 63

CHANGES TO THE DIFC INSIDER DEALING REGIME

Why are we issuing this paper?

1. The DFSA proposes certain changes to the Markets Law 2004 to bring our insider dealing regime into line with international best practices. The proposals would broaden the scope of "insiders" and add a number of defences to the insider dealing prohibition in the DIFC.

Who should read this paper?

2. The proposals in this paper would be of interest to:

   a. any Authorised Person or Recognised Persons who deals in Investments listed on a DIFC market;

   b. any other person who deals, whether directly or through another person, in Investments listed on a DIFC market;

   c. advisors to persons in a. and b. above; and

   d. other persons with an interest in insider dealing or market abuse.

How is this paper structured?

3. In this paper, we set out:

   a. a summary of our proposals (paragraphs 7 to 9);

   b. some background to the existing regime (paragraphs 10 to 16);

   c. why we are changing the current regime (paragraph 17 to 19),

   d. an outline of the key elements of our proposed insider dealing prohibition and defences (paragraphs 20 to 42); and

   e. other matters for consideration (paragraphs 43 to 47).

   The proposed changes to the Markets Law are in Appendix 1.

How to provide comments?

4. All comments should be in writing and sent to the person specified below. You may, if relevant, identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

What happens next?

5. The deadline for providing comments on the proposals is **4 November 2009**. Once we receive your comments, we will consider if any further refinements are required to these proposals. We will then proceed to recommend the proposed changes to the Markets Law 2004 to the President for enactment by the Ruler. You should not act on these proposals until the relevant changes to the Markets Law 2004 are made. We will issue a notice on our website telling you when this happens.

Comments to be addressed or emailed to:

Matthew Shanahan
Policy and Legal Services
DFSA
PO Box 75850
Dubai, UAE

e-mail: mshanahan@dfsa.ae

Terminology in this paper

6. In this paper, defined terms are identified throughout by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in the Glossary Module (GLO) or in the proposed amendments. Unless the context otherwise requires (for example the term is defined in the Markets Law 2004), where capitalisation of the initial letter is not used, the expression has its natural meaning.

Summary of proposed amendments

7. We are consulting stakeholders on proposed changes to the Markets Law 2004 to broaden the scope of the current insider dealing prohibition (the **insider dealing prohibition** or the **prohibition**) and to add three new defences. As currently drafted, Part 8 of the Markets Law, "*Prevention of Market Misconduct*" is limited in scope with respect to the insider dealing prohibition and does not contain a number of defences and exclusions found in other jurisdictions.

8. Our proposals are based on the EU's Market Abuse Directive (the **MAD**) and drafting is broadly in line with the UK's implementation of that directive in its Code of Market Conduct. The key change to the insider dealing prohibition is that a person will become an insider by possessing inside information, rather than by being connected to the issuer to which the inside information relates. This focuses the insider dealing prohibition on the risk that insider dealing poses to the integrity and confidence of the DIFC markets, rather than on the duty owed by officers or agents of a Reporting Entity. Liability for insider dealing would not be restricted to those who are connected or related to an issuer.

9. The proposals would bring the DFSA into line with the MAD, which is a tried and tested model with some associated jurisprudence. Our proposed changes with regard to defences should bring the DIFC into line with international best practice.

Background

10. The law on insider dealing in the DIFC is found in the Part 8, chapters 1 and 2 of the Markets Law 2004. The substantive insider dealing law is set out under Articles 42 to 45. Articles 48, 49 and 50 provide various defences.

11. Under Article 42 of the Markets Law the prohibition against insider dealing is limited to a Reporting Entity or those who are connected or related to the Reporting Entity. The list of potential "insiders" ("*persons in a special relationship*" with a Reporting Entity) is narrow when compared to for example the MAD or the Australian Corporations Act. The contravention of insider dealing attaches to the relationship with a Reporting Entity as opposed to the possession of inside information.

12. The current prohibition is drafted as follows:

> "*42. Insider dealing*
>
> *1) A Reporting Entity or person in a special relationship with a Reporting Entity shall not, in the DIFC or elsewhere, deal in*

Investments of or relating to the Reporting Entity if the person possesses material information that:

(a) is not generally available in the market; and

(b) has not been disclosed to the market in accordance with this Law or the Rules."

13. Therefore, the prohibition applies to:

a. Reporting Entities; and

b. "persons in a special relationship with a Reporting Entity".

14. A "*person in special relationship*" is defined under Article 45 as:

"(a) a person that is a director, officer, employee, affiliate, Associate or adviser of:

(i) the relevant Reporting Entity;

(ii) a person that is proposing to make a Takeover Offer under Part 7 for the shares of the Reporting Entity; or

(iii) a person that is proposing to be involved in a takeover with the Reporting Entity;

(b) a person that is engaging in or proposes to engage in any business or professional activity with or on behalf of the Reporting Entity or with or on behalf of a person described in Article 45(2)(a)(ii) or (iii);

(c) a person that is a director, officer or employee of the entity described in Article 45(2)(b);

(d) a person that learned of the material information with respect to the Reporting Entity while the person came within Article 45(2)(a), (b) or (c); or

(e) a person that learned of material information with respect to the Reporting Entity from any other person described in Article 45(2)(a), (b), (c) or (d) and knows or ought reasonably to have known that the other person is in such a relationship."

15. The effect of the current drafting is that the insider dealing prohibition attaches to persons connected to a Reporting Entity because they have a special relationship with the Reporting Entity. The definition of a "*person in special relationship*" restricts insiders to those persons meeting the criteria set out in limbs (a) to (e) of Article 45.

16. The current prohibition also focuses on how a person "learned" of the material information as opposed to the market detriment of a person having material information (no matter how it was acquired).

Why we are changing the insider dealing regime

17. Persons caught by limbs (a) to (e) of the definition of "*person in special relationship*" are insiders. However, as the prohibition is drafted, a person not falling in limbs (a) to (e) of the definition is not a "*person in special relationship*" and hence is not caught by the insider dealing prohibition. This regulatory gap means that insider dealing can be carried out by anyone who receives material information from person (e) in the definition of "*person in special relationship*" or from anyone or anywhere else, provided they do not themselves fall into limbs (a) to (e) of the definition.

18. This raises market abuse issues because a person not in a special relationship with a Reporting Entity may arguably engage in certain activities which are generally considered to be insider dealing without fear of sanction. While Article 43 of the Markets Law 2004 contains a prohibition on disclosure of inside information, this is merely a deterrent to insiders not to disclose to others and means that the DFSA can only act against the person disclosing the material information, not the recipient of the material information who uses the information.

19. Further to the above, a review of the insider dealing regimes in a number of other jurisdictions has highlighted some gaps in our regime in the area of defences. We are also taking this opportunity to tidy up some of our current drafting.

Outline of our proposed insider dealing regime

20. The details of our proposals can be found in Appendix 1. However, in summary the DFSA proposes a new insider dealing prohibition with the following characteristics:

Nature and scope of the proposed regime

21. Like the MAD, the proposed insider dealing provisions will be a civil regime, not a criminal one, and will be based on extracts from Chapter 1 of the FSA Code of Market Conduct. The prohibition will continue to apply to Authorised Persons and to those persons who are not regulated by the DFSA. The proposed scope will be wider in that the prohibition will apply to anyone possessing inside information, rather than to persons connected to the issuer.

22. The current geographical scope of the prohibition is wide, applying as it does to dealing "in the DIFC or elsewhere". The DFSA can take action against any person wherever they are located for a breach of the insider dealing prohibition, subject of course to the limitation in Article 44 which states:

> *"Articles 36 to 43 of this Part do not apply to conduct which occurs outside the jurisdiction unless the conduct affects the DIFC markets or users of the DIFC markets."*

23. However, the geographical scope of the prohibition is cut back by limiting the prohibition to behaviour in relation to dealing "*in Investments of or relating to the Reporting Entity*". The link to a Reporting Entity means that the behaviour would have to be in relation to, for example, an Investment listed or proposed to be listed in the DIFC. The dealing does not have to take place on-market in order to breach the prohibition so OTC transactions would be caught. We do not propose to change the current geographical scope of the prohibition.

Enforcement and sanctions

24. We propose to enforce the regime using the civil and administrative powers in Part 9 of the Markets Law 2004 as well as the enforcement powers provided in the Regulatory Law 2004 and associated Rules.

25. When taking enforcement action against a person for insider dealing, where a profit is made as a result of the insider dealing, we would expect, at a minimum, to seek disgorgement under Article 54(1)(l) of the Markets Law 2004. When acting against a person located outside of the DIFC the DFSA would, where appropriate, seek assistance from the relevant local regulator or other authority. This may include seeking enforcement of a DIFC Court judgment in the relevant local court.

The prohibition

26. We propose to bring the DFSA into line with the MAD and impose a blanket ban on insider dealing. Our proposals would prohibit dealing in a Reporting Entity's shares, bonds or related investments by anyone in possession of inside information in relation to the Reporting Entity subject to certain safeharbours and defences. The prohibition in Article 42 would be drafted as follows:

> "*A person who is an insider shall not, in the DIFC or elsewhere, directly or indirectly, deal, or attempt to deal, in an Investment of a Reporting Entity, or in a related investment, on the basis of inside information*."

27. This model follows the UK model which prohibits dealing "*on the basis of*" inside information thus incorporating a mental element to the contravention of insider dealing. The inclusion of a condition that the dealing in question must be based on the inside information places the burden of proof on the DFSA to show on the balance of probabilities that the dealing was undertaken using the relevant inside information. However, the DFSA need only meet the burden of proof to the civil standard. This provides a degree of balance for the parties in civil market abuse cases.

28. The inclusion of a mental element to the prohibition is found in EU Member States' implementations of the MAD and "*on the basis of*" is also the test used in the U.S. The UK's Financial Services and Markets Tribunal (FSMT) has held that for dealing to be "*based on*" inside information the information concerned must have a "*material influence*" on the decision to engage in the dealing. The FSMT has also held that the information concerned must be one of the reasons for the dealing, but need not be the only reason. We consider this to be the correct test.

29. Because the insider dealing prohibition would apply to "*related investments*" as well as Investments, it captures dealing in derivatives, other Investments and even other Reporting Entities' shares. Therefore, a person possessing inside information regarding one Reporting Entity could be caught by the prohibition if he were to deal in shares of another Reporting Entity if there were a causal link between the inside information on the first Reporting Entity and the change in price of another Reporting Entity.

Issue for consideration

Do you have any concerns or comments about our proposed insider dealing prohibition in Article 42 of the Markets Law 2004?

Is the DFSA correct to add a mental element or test of intent to the insider dealing prohibition?

Do the proposed changes create any unintended consequences?

Definition of inside information

30. Inside Information is defined in Article 45(1) of the Markets Law 2004. We propose to define it along the lines of the UK model as being information of a precise nature which:

(i) is not generally available,

(ii) relates, directly or indirectly, to one or more Reporting Entities of the Investments concerned or to one or more of the Investments, and

(iii) would, if generally available, be likely to have a significant effect on the price of the Investments or on the price of related investments.

31. The definition of "*precise*" (in relation to information) is proposed to be set out in Article 45(2). Information is precise if it:

(i) indicates circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur; and

(ii) is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of Investments or related investments.

32. Information would be likely to have a "*significant effect on price*" if and only if it is information of the kind which a reasonable investor would be likely to use as part of the basis of his investment decisions.

33. The concept of information not being generally available is akin to it being unpublished or non-public. For example, the DFSA considers that a rumour may not amount to information being generally available but also that it need not have been published through a Regulatory Information Service (RIS) for it to become generally available. The DFSA considers that it will be a matter of assessing the weight of evidence when considered as a whole in deciding if on balance information has become "*generally available*".

Insiders

34. Our proposed changes would introduce the concept of an "*insider*". An insider is to be defined in Article 45(6) as:

> "*A person who has inside information:*
>
> *(a) as a result of his membership of the administrative, management or supervisory bodies of a relevant Reporting Entity;*
>
> *(b) as a result of his holding in the capital of the relevant Reporting Entity;*
>
> *(c) as a result of having access to the information through the exercise of his employment, profession or duties;*
>
> *(d) as a result of his criminal activities; or*
>
> *(e) which he has obtained by other means and which he knows, or could reasonably be expected to know, is inside information."*

35. The definition differentiates between persons connected to the Reporting Entity, persons obtaining information via their employment or criminal activities, and "other" insiders. Only the "other" insiders would be protected by an objective test of knowledge of whether information is inside information. For insiders who are connected to the Reporting Entity and persons obtaining information via their employment or criminal activities knowledge is irrelevant.

Pending orders

36. The proposed amendments to Article 45(4) of the Markets Law 2004 provide that the definition of inside information would include information on pending orders, which is not currently caught. This provision is derived from the MAD and brings what is commonly known as "front-running" into the insider dealing prohibition. Knowledge of pending orders in the market can be very valuable information and dealing on the basis of this information gives a person an advantage over other market users as well as "spoiling" the market.

Defences

37. We propose to add three new defences to the insider dealing prohibition which are not currently available to market users in the DIFC but which are common in other jurisdictions. We are also taking the opportunity to tidy up some of the existing defences. We believe that in the interests of legal certainty and efficient markets the regime ought to incorporate sufficient and effective safe harbours to protect market users acting in good faith who might otherwise breach the prohibition because technically they fall within its scope.

38. We propose to split the general defences in Article 48(2) between those for Article 42 (insider dealing) and Article 43 (disclosure and procuring) because they do not all apply equally to both offences. We are removing 48(2)(c), which deals with disclosure of information in the course of business, because it is already incorporated in the Article 43(1) contravention.

39. We are also proposing to add to Article 45 a safe harbour for investment research, which in many cases falls into the definition of insider dealing because *inter alia* the contents of the research can have a significant effect on the price of the Investments.

40. We propose to re-draft the Article 49 Chinese Wall defence. The existing drafting is somewhat complex. This proposal does not change the general policy regarding information barriers but it does remove this defence for Article 43 contraventions. We have done this because this defence is for "dealing in Investments" so it has no application to Article 43. We are also proposing to delete the Article 50 defence which deals with unsolicited orders to deal on behalf of another person. We propose to replace this with a re-drafted defence for dealing on the basis of unsolicited client orders in Article 48(2)(f). The proposed new defences will deal specifically with market-making (Article 42(2)(e), mergers and acquisitions activity (Article 42(2)(g)) and buy-back programmes (Article 42(2)(h)).

41. The new defence for market-making is designed to protect persons acting in good faith in the ordinary course of market making. The new defence for mergers and acquisitions activity is designed as a safe harbour for persons acting in good faith in the course of corporate finance activities, where they may on occasion be required to deal in circumstances where they are invariably insiders. We have included a new defence for a Reporting Entity acquiring its own shares as part of a buy-back programme because, while a Reporting Entity could reasonably argue that dealing as part of a buy-back programme was not done "*on the basis of*" inside information, we consider that a specific safe harbour is preferable in the interests of legal certainty.

42. Finally, the defences in Article 48(2)(b), (c), and (d) have been amended by including a test that the relevant dealing must be legitimate in order for a person to rely on the defence. As currently drafted these defences are potentially too wide.

Issues for consideration

Do you have any concerns or comments about our proposed deletion/redrafting of defences and the new defences on market-making, mergers and acquisitions activity and buy-back programmes ?

Are there any other defences that could be added to protect legitimate users of the markets in the DIFC?

Other matters

Commodity derivatives

43. We propose to update Article 42(2), which excludes commodity options and futures from the insider dealing regime, to reflect the recent changes to the definition of Investments. We propose to replace the present exclusion as drafted with an exclusion for "commodity derivatives".

Terminology

44. The new definition of Inside Information adds to the DFSA legislative framework an additional concept which deals with non-public price sensitive information. The other related concepts are:

    a. Material Information in Article 23(2)(b) of the Markets Law and OSR Chapter 8.2 (continuous disclosure); and

    b. related to a. above, Price Sensitive Information (**PSI**) in OSR A2.1, 2.3 and 2.4 and the guidance in App7.

45. We consider that the proposed definition of Inside Information encompasses both Material Information and PSI. From a policy and a user's perspective it may not be desirable to have three separate definitions in the Rulebook when one (Inside Information) is broad enough to capture the other two. Three definitions may also cause confusion for market users as it may create a perception that the concepts are somehow different when in fact they are not.

46. Article 6 of the MAD, which covers issuers' duties to disclose non-public price sensitive information, makes no distinction between inside information for the purposes of market disclosure and inside information for the purposes of the insider dealing prohibition. This is reflected in Member States' implementing measures, where for example, the UK, Germany, Belgium, Italy, Netherlands and France all use the same terminology for their disclosure and insider dealing regimes. We consider that Inside information as a concept is not incompatible with a disclosure regime.

47. Therefore, in order to reduce the number of unnecessary definitions in the Rulebook, we propose to review the current terminology used in our disclosure regime with a view to replacing Material Information and PSI with Inside Information. We hope to consult on this rationalisation in the first quarter of 2010.

Issue for consideration

Do you have any concerns or comments about the use of the concept of Inside Information in a disclosure regime?