Market Abuse and the Definition of Inside Information

The Upper Tribunal has considered the statutory meaning of "inside information" as well as the circumstances in which the "reasonable belief" defence may be relied upon.

The Upper Tribunal case of David Massey v. The Financial Services Authority (FIN/2009/0024) contains an interesting discussion of the definition of "inside information" for the purposes of the market abuse provisions of the Financial Services and Markets Act 2000 (FSMA) and a consideration of the statutory defence, available to someone who has otherwise committed market abuse, that he believed on "reasonable grounds" that his behaviour was not abusive.

1. THE FACTS OF THE CASE

Put briefly, Mr Massey made a short sale of 2.5 million shares in an AIM-listed company called Eicom Plc and almost immediately afterwards subscribed for 2.6 million new shares at a greatly discounted price. He used the new shares to meet his obligations under the short sale and made a net profit of just over £100,000. The FSA alleged that he made the short sale on the basis of the inside information that the issue of discounted shares was readily available to him. Mr Massey had been a former corporate finance adviser to Eicom and the company had privately made the offer of the discounted share issue to him.

The background was that Eicom had been urgently seeking new capital for some months and had made a number of (announced) discounted share issues – but it was known to at least some in the market that it was still seeking further funds. News of the previous discounted share issues had not had any effect on the share price, although the level of discount had not been as great in those cases as was given to Mr Massey.

Mr Massey contended that the market was aware that Eicom might well be making further discounted share issues to raise capital and, in the light of the fact that previous issues had not moved the share price, it was legitimate for him to trade on the basis of his knowledge that one such new discounted issue (to him) was imminent.
2. THE DEFINITION OF “INSIDE INFORMATION”

To judge whether market abuse had been committed, the Tribunal had to consider the meaning of “inside information” as defined in FSMA. Inside information, for the purposes of this case, was thus information that:

• was not generally available,
• was of a precise nature,
• was related to Eicom as an issuer of shares, and
• would, if generally available, have been likely to have a significant effect on the price of the shares.

These constituent elements of the definition are then broken down further in FSMA, as explained in the following paragraphs.

2.1 Information must be “not generally available”

The Tribunal held that, because of the private nature of the share issue to Mr Massey (it was not a part of the original programme of announced discounted issues of shares) and the much greater discount than had applied previously, there was a “substantial risk that the [share price] would fall when the discounted issue became known” and therefore the fact of the issue was potentially price sensitive.

Moreover, the Tribunal concluded that the knowledge of the private share issue possessed by Mr Massey was “not generally available”:

"this information about Eicom’s willingness to issue discounted shares was in line with, but not the same as, the information that was generally available concerning the likelihood that Eicom was still in need of working capital and would be willing to issue discounted shares in order to obtain it. The information known to [Mr Massey] was more specific, and the proposed discount was deeper than the discount which had been available through [the previous discounted programme]. The information known to him therefore satisfied the requirement that it be not generally available."

The Tribunal went on to consider the secondary definitions relevant to the primary definition of inside information described above.

2.2 Information must be “precise”

The statutory definition of “inside information” provides that information will only be precise if it:

“a. 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

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\(^2\) Section 118C FSMA.

\(^3\) Section 118C(5) FSMA.
b. 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 [relevant securities]."

The Tribunal had no difficulty in finding that element (a) was satisfied, but went on to say:

"Element (b) is less straightforward. We have not found the statutory wording easy to understand. The phrase “specific enough to enable a conclusion to be drawn” seems to introduce a strong note of definiteness, which is then effectively removed, or at least diluted, by the phrase “as to the possible effect… on the price”. We note that there is no requirement for a conclusion as to the actual or probable effect on the price, but only as to the possible effect. We also note that the statutory words contain no explicit guidance on how precise the conclusion needs to be. Is it enough that there may be a conclusion merely that the event, when it becomes known, may alter the price? A risk of alteration is a “possible effect”, even if it is not known whether the occurrence of an alteration is more probable than not, or whether, if it occurs it is more likely to be an increase or a decrease."

The Tribunal stated that:

- it had “doubts” over whether a literal interpretation of element (b) was the correct one; therefore
- it would “assume in Mr Massey’s favour, without deciding the point”, that the conclusion concerning price must relate to an "effect in a particular direction"; and
- while it was “uncertain” whether the announcement of the discount issue would have an effect on price…
- …such an effect was certainly “possible”; and
- if there were such an effect, it would be to reduce the price.

The Tribunal concluded, therefore, that the information in this case was “precise” as defined by FSMA.

2.3 Information must be “likely to have a significant effect on the price"

This is a further objective test which must be satisfied before information is deemed to be “inside information”\(^4\). The test has long been regarded as problematic because it requires that:

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

The critical legal question here is whether this additional test substitutes for the ordinary meaning of “significant effect on the price” or whether it is a condition on that ordinary meaning, so that an effect on price is only to be regarded as significant if it is an effect that would influence a “reasonable investor”.

Though Mr Massey preferred the latter interpretation, the Tribunal opted for the former:

"We would have considerable sympathy with [Mr Massey’s] view if the phrase “likely to have a significant effect on the price” had been used in the Act in its ordinary sense… [but] whether or not the information was (in the ordinary

\(^4\) Section 118C(6) FSMA.
sense) likely to have a significant effect on the price, we consider it is clear that the information was "of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions."

Comment
One could turn the tables on the Tribunal and observe that this interpretation renders the term “significant effect on the price” to be “almost empty of effect”, as the Tribunal said of the literal interpretation of the provisions relating to information being precise. The better view should be that the “reasonable investor” objective test is, in the context of FSMA, merely a restraint on the meaning of “significant effect on price” and not a replacement for that meaning.

Otherwise, the term would seem to be redundant – why not simply incorporate the objective test into the original definition, i.e. that the information would, if generally available, be likely to be material to a reasonable investor’s decision? This point does not appear to have been considered by the Tribunal.

3. "REASONABLE GROUNDS" FOR BELIEF THAT CONDUCT WAS NOT MARKET ABUSE?

The Tribunal accepted that Mr Massey “genuinely believed” that his knowledge of the possibility or probability of a further discounted share issue by Eicom was “generally available” and that the news of any actual issue would not move the price, based on historical evidence. But, in a salutary passage, the Tribunal went on:

“...[Mr Massey] persuaded himself that the circumstances were such that he was entitled to trade as he did. But wishful thinking is not the same as having a belief on reasonable grounds that his behaviour did not fall within the definition of market abuse.”

Based on the Tribunal’s findings of fact, especially the finding that a reasonable investor would be likely to use news of the discounted issue to Mr Massey as part of the basis of his investment decisions, and the finding of law that that alone was sufficient to make the news have a “significant effect on price”, the Tribunal concluded that:

“a reasonable market professional, even without having in mind the precise wording of the statutory test... would have appreciated that the transaction at least risked constituting such abuse, and would therefore have either drawn back from implementing it or sought appropriate advice to confirm that it was legitimate before proceedings.”

The statutory defence was therefore not available to Mr Massey.

Comment
Mr Massey’s argument on this point was again undermined by the Tribunal’s interpretation of the term "significant effect on the price". However, the Tribunal’s decision is a reminder that the defence has to rely on objective, reasonable, grounds for a belief. It is not good enough to show that a belief is at least understandable or not irrational.
THE KEY PRACTICAL IMPLICATIONS OF THE MASSEY CASE

• Information that is consistent with, or similar to, information concerning an issuer or a security which is already generally available may nevertheless be inside information if it is not in fact information which is known generally to the market.

• For non-public information to constitute inside information, it is probably necessary to know that it would, if made generally available, be likely to have a significant effect on price in "a particular direction", i.e. it may not be inside information if its effect on price is likely to be significant but it is genuinely not clear whether the effect would be positive or negative.

• In considering the statutory defence to market abuse, it is probably not sufficient for the firm or individual concerned simply to believe genuinely that a particular course of conduct does not constitute market abuse: there should be objectively reasonable grounds for that belief.