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While we await the outcome of the European Commission’s review of the Market Abuse Directive, in this second edition of our Market Abuse Update we highlight the most interesting developments in the market abuse and issuer disclosure regimes from 2010.

1. THE FSA’S RESPONSE TO SPECTOR PHOTO: A MENTAL ELEMENT FOR INSIDER DEALING?

The market abuse provisions of FSMA now largely, but not entirely, reflect and implement the requirements of the Market Abuse Directive (MAD)\(^1\).

So far as insider dealing is concerned, MAD requires that Member States prohibit certain persons who possess inside information from using that inside information to deal or encourage others to deal.

When implementing MAD into FSMA, the UK translated the notion of using inside information into a concept of dealing “on the basis of” inside information.

The case of Spector Photo, heard by the European Court of Justice, was discussed in the first edition of our Market Abuse Update (Feb 2010). In that case, the ECJ determined that there is a presumption that an insider who deals

\(^1\) There are also additional market abuse provisions in FSMA which predated and extend beyond the scope of MAD, but were nevertheless retained when MAD was implemented to provide a broader and, for some cases, more flexible framework for supervising market conduct. These retained pre-MAD provisions employ the standards of the “regular user” for identifying market abuse.
while in possession of inside information intended to use that information for the purpose of the dealing, and therefore ostensibly commits insider dealing. Although not going as far as to make insider dealing in effect a strict liability offence, the ECJ thus certainly rendered the mental element of insider dealing less flexible.

The ECJ qualified this apparently harsh initial presumption by stating that it could be rebutted, and that the scope of the insider dealing prohibition is limited to conduct that places other market participants at a disadvantage. Thus, certain categories of conduct that do not disadvantage other market participants, described by the court as being cases of “legitimate use”, will not constitute insider dealing even if the dealing party possesses inside information at the relevant time. The ECJ commented that it is explicitly acknowledged in MAD, for example, that the legitimate activities of market makers would not fall into the category of prohibited conduct.

In our first Market Abuse Update, we noted that the *Spector* decision would probably require a response by the UK to bring our existing approach to the MAD-derived insider dealing prohibition into line with European law as construed by the ECJ. We noted that this would need to be achieved by amendments either to FSMA or to the FSA’s Code of Market Conduct (CMC), or to both.

The FSA set out its response in its Quarterly Consultation Paper of October 2010 (CP10/22). In summary, the FSA’s view as explained in that CP is that:

- FSMA does not need to be amended; but

- one evidential provision in the CMC, MAR 1.3.4E, which addresses the (pre-*Spector*) mental element of the insider dealing offence – in particular indicating that for an offence to be committed inside information must be “the reason for, or a material influence” on, a decision to deal – should be deleted.

(MAR 1.3.4E is a general statement concerning the mental element of insider dealing. However, as discussed below, there are other more specific and helpful related provisions that also address the mental element, and that would appear to derive their rationale from this general provision.)

The consultation period for this change to the CMC closed in December but the FSA has not yet confirmed its final position.

The FSA’s position as regards amending FSMA is defensible, although equally one might have concluded that an ordinary reading of the phrase used in FSMA – “on the basis of” – suggests that an element of intention is required (indeed, that is the reading which informs the existing CMC). As a matter of law, however, UK statutes must be interpreted in accordance with the underlying EU provisions which they implement, and it is therefore certainly possible to construe the existing wording of FSMA in a manner which allows for the ECJ’s gloss as articulated in *Spector*.

In our view, however, the suggested amendment to the CMC is by no means sufficient to incorporate the *Spector* decision properly and fully. As mentioned above, the section of the CMC that provides guidance on the concept of the phrase “on the basis of”, from which the FSA is proposing to delete only one provision, was written by the FSA to explain its view of the pre-*Spector* element of intention in the FSMA offence. To give an example, one significant provision in this section of the CMC, on which many firms rely, refers to the existence of an effective Chinese wall, behind which inside information is held away from those deciding whether to deal. According to the CMC “that indicates that the decision to deal by an organisation is not ‘on the basis of’ inside information”.

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But the Spector decision suggests that, *prima facie*, such measures will not neutralise the possession of inside information within the firm.

In other words: though the CMC currently provides that use of a Chinese wall to protect information is a special case of information not being a reason for, or a material influence on, the decision to deal (and thus capable of neutralising insider dealing risk), Spector appears to hold that as soon as a firm possesses inside information any dealing in securities that are price-affected by that information is prohibited unless the firm can produce sufficient evidence to rebut the presumption of use of that information, or show that the dealing falls outside the intended scope of the prohibition.

The difficulty which the FSA appears not to have recognised is that if the general statement in MAR 1.3.4E needs to be deleted following Spector, the derivative special cases explained in that section of the CMC must surely also be deleted, or at least revised. If the FSA now chooses not to do so, it will be unclear whether the remaining special cases guidance in the CMC is legally sound. Other important special cases, on which market participants regularly rely, include dealings which take place as a result of orders placed, or a non-discretionary trading plan put in place (such as a buy-back programme), before the firm concerned came into possession of inside information.

What then would be the better solution? Post-Spector, the CMC could instead treat Chinese wall and comparable special case situations as circumstances where the dealing falls outside the intended scope of the market abuse regime, because these cases will not lead to market participants being at a disadvantage to the firm concerned which possesses inside information. This is a line of analysis that was endorsed, in principle, by the ECJ in Spector and which the FSA could therefore reflect in the CMC.

(A secondary point, not addressed by the FSA in its consultation, is that in legal terms the Spector decision impacts only on those elements of FSMA which implement MAD. It would therefore be open to the FSA to retain MAR 1.3.4E for the non-MAD market abuse provisions, and it may indeed be helpful for it to do so.)

In the absence of legally sound supporting commentary in the CMC, however, users of the market will be left with some uncertainty as to the validity of established practices to manage and avoid insider dealing risk, including Chinese walls and non-discretionary trading plans, and will therefore need to form their own views as to whether the FSA, and importantly a court, can accept that, in light of Spector, such practices can still act to neutralise the insider nature of certain dealings.

**Tribunal decision in the Scerri case**

In this regard, it is interesting to note that one case heard by the Upper Tribunal (Financial Services) after the Spector decision, which turned on the nature of the facts in possession of an individual engaged in suspicious dealing, did not refer to the ECJ’s judgment, even though it would seem to have been relevant.

In Scerri, the issue was whether a rumour concerning a placing at an advantageous price, or hard inside information about the placing, prompted an existing shareholder – Mr Scerri – to sell stock (or enter into derivatives that were economically equivalent to a sale) immediately prior to the announcement of the placing.

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On evidence, the Tribunal found that Mr Scerri had received inside information prior to his dealing. The Tribunal concluded:

“It follows that each of Mr. Scerri’s dealings … was prompted by his receipt of that inside information and was therefore a dealing by an insider ‘on the basis’ of ‘inside information’.”

Following Spector, it was not strictly necessary for the Tribunal to infer a ‘prompting’, which has the flavour of being the “reason for, or a material influence on” the decision to deal.

Accordingly, the decision will be of limited value to future defendants – even if there is no evidence of “prompting”, the FSA will be able to argue that there is a presumption of insider dealing once possession is established, and it will be for the defendant to show that there is no connection between possession of information and his dealing.

2. ISSUER DISCLOSURE DUTIES – THE TRICKY BUSINESS OF MANAGING OR (NOT) MEETING MARKET EXPECTATIONS

There have been two significant developments concerning the obligations of issuers under the FSA’s Disclosure and Transparency Rules (DTRs) in respect of the handling of price sensitive information.

In June 2010, the FSA fined Photo-Me International plc (PMI) £500,000 for failing to disclose price sensitive information in relation to the loss of, or failure to obtain, certain large contracts where market expectations concerning the securing of those contracts had been raised by previous announcements of the company.

In October 2010, the FSA then publicly condemned what it sees as the unacceptable (and unlawful) practice of companies or their advisers privately briefing financial journalists in advance of the announcement of price sensitive developments, in order to manage market expectations. This provoked an outcry from the editors of the leading broadsheets, who claimed that the FSA’s hard line threatens the ability of newspapers to investigate and expose corporate malpractice and/or secrecy. At present, the FSA seems to be unconvinced by the editors’ arguments.

What is the test for price sensitivity?
The FSA’s reasons for fining PMI establish a number of important points for listed companies and their directors:

• the decision as to whether information is price sensitive (and therefore disclosable) must be determined by reference to the market’s expectations at the time. There is particular sensitivity where those expectations have been created by the company’s own public statements, which are subsequently not borne out by events;

• the price sensitivity of information cannot be assessed by using a formula to calculate the impact of the information on the company’s profits;

• rather, the key test is whether information would be material to a “reasonable investor”, such investor having had his expectations raised by the prior announcements; and

• as a subsidiary matter, the fact that information may not have come to the attention of particular key directors is not an excuse for the company’s failure to announce.
The issues at stake for PMI

The question of whether the information concerning the contracts was "inside information" turned on whether the information "would, if generally available, be likely to have a significant effect on the price of the qualifying investment [in this case, shares in PMI]."

The relevant provision of FSMA provides 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".

PMI adduced expert evidence that applied a formula which multiplied the fall in the probability of securing the contract by its potential value and translated this number into a negative impact of 3% on pre-tax profits. PMI argued that such an impact was not price sensitive. Further, PMI argued that its group monthly management accounts were still projecting profits in line with market expectations.

An additional, secondary, issue was that revised sales information and reduced sales forecasts were sent as an attachment to an email addressed to the relevant PMI director around the time when the FSA alleged that an announcement should have been made. For a variety of reasons the director did not open the attachment and was then out of the office for a prolonged period. PMI argued that, in the circumstances, the company should not be considered to have been aware of the information.

The FSA's conclusions

The FSA's judgment on these matters was delivered in fairly emphatic terms:

- The FSA rejected a formulaic approach to price sensitivity, stating:
  
  "the DTR guidance makes it clear that there is no set percentage or other figure to determine whether an effect on price is significant. The application of the "reasonable investor test" will depend on the circumstances of each case and will not necessarily be determined by calculating the potential profit impact, particularly when information is viewed in the context of previous announcements."

- The crucial fact was that PMI had put out a number of announcements by which it "created an expectation in the market that it would benefit substantially from strong … sales and, in particular, from the securing of certain large … sales contracts". This, in the view of the FSA, would lead a "reasonable investor" to conclude that there was "a high degree of confidence that a new large contract would be won", and that strong sales were "central to meeting market expectations for pre-tax profits".

- It follows, the FSA concluded, that the company's loss of confidence concerning its contracts would indeed be "information of a kind which a reasonable investor would be likely to use as part of the basis for his investment decisions".

- In particular the FSA stated that:
  
  "it is not acceptable for issuers to announce good news which can be expected to have a positive impact but to withhold bad news on the same matter which is likely to have an adverse effect; investors must be allowed the opportunity to make their own assessment of both types of information."
The argument that PMI had no knowledge of the inside information because the director concerned failed to open an email attachment was rejected:

"the FSA takes the view that if a company is shown to be in possession of inside information, a failure to consider or identify the inside information does not preclude a breach of [the DTRs]."

Although its decision did not refer to Listing Principle 2, the FSA may well have had this in mind, as it requires a company to "take reasonable steps to establish and maintain adequate procedures, systems and controls to enable it to comply with its obligations".

The important message of the PMI decision is that the creation of market expectations brings with it a presumption that any information which is contrary to those expectations is likely to be considered, at least by the FSA, as information that a reasonable investor would regard as material, and would thus require an announcement.

3. **THE FSA'S ATTACK ON "STRATEGIC LEAKING"**

In September 2010, the FSA published the results of a wide-ranging investigation into disclosures of inside information to the media ahead of certain announcements (Market Watch, Issue No. 37). In particular, the FSA focused on what it calls "strategic leaks... those deliberate leaks of inside information sanctioned by the senior management of an issuer or its advisers with the intention of achieving a strategic advantage through media positioning".

In spite of previous calls by the FSA for issuers and their advisers to tighten up their procedures and controls, the FSA found that the use of strategic leaking does not appear to have declined.

In particular, notwithstanding the use among regulated firms of formal policies for media contact, the FSA found that "regulated firms usually have unwritten informal exemptions to their general policy, permitting staff members to respond to the media without the media relation team's authorisation". These unwritten exemptions, the FSA fears, effectively give a blanket permission to senior staff to speak to the media.

Besides the obvious risks that leaking may involve either market abuse or criminal insider dealing, the FSA lists its concerns as:

- the facilitation of insider trading;
- the impairment of the flow of inside information to the market in an orderly and fair manner, thereby increasing market volatility;
- the prevention of the legitimate delaying of disclosure, to the detriment of shareholders and investors; and
- abnormal price movements ahead of the announcement of transactions, damaging market confidence.

**The FSA's recommendations**

The final section of Market Watch, Issue No. 37 contains the FSA's recommendations, applicable to both regulated and unregulated firms (including issuers), under the headings:

- **Media policies**;
- **Handling leaks** (which focuses on the investigation of leaks);
• Staff training and communication;
• Internal reporting culture; and
• Disciplinary action.

In particular, the recommendations on media policies state that:

"Internal policy should require all initial media enquiries received by a regulated firm’s staff to be immediately directed to the firm’s media relations team. All non-media-relations personnel at regulated firms should be prohibited from directly responding to any initial enquiry from the media, regardless of seniority."

If it is necessary to involve other personnel, contact between such personnel and the media must be authorised by a media relations team. Either one member of that team must be present, or conversations should be recorded. However, the FSA’s expectation is that any enquiry that relates to inside information will be solely handled by the media relations team with "standard protocol responses”.

Condemnation in the press
The recommendations, especially those concerning media contact, have been roundly condemned by financial journalists. The editors of the Financial Times, The Guardian, The Times and Thomson Reuters wrote an open letter to Hector Sants, the CEO of the FSA, complaining of:

"… an overly prescriptive approach to preventing leaks … the recommendations would greatly restrict the capacity of the media to carry out investigations of regulated firms such as banks, asset managers and brokers. … [A]s the credit crisis has underlined, these firms are key parts of the financial structure and economy and more public scrutiny of their transactions is required, not less."

The FSA did not appear to be impressed by this response. Mr Sants said:

"I’m afraid I cannot see how reminding firms of the importance of seeking to minimise the opportunity for employees to commit market abuse is constraining press freedom."

4. THE FSA TAKES AIM AT ANOTHER MARKET PRACTICE – DISCLOSING SENIOR MANAGEMENT SHARE SALES

In Market Watch, Issue No. 35 (July 2010), the FSA gave a warning that it finds another fairly widespread market practice to be at risk of constituting market abuse.

Where a "person discharging managerial responsibilities" towards an issuer (a PDMR) sells shares in that issuer, it is sometimes the practice for the broker acting on behalf of the PDMR to make a voluntary disclosure to potential buyers of those shares, regarding either the identity of the PDMR or the fact that the seller is an unidentified PDMR.

According to the FSA, where this happens the broker runs the risk of committing market abuse by an improper disclosure of inside information "otherwise than in the proper course of the exercise of his employment, profession or duties".
The FSA has conducted an informal consultation with market participants, and found that:

“The majority market view seems to be that a broker, who gets advance notice of the fact that it is a PDMR selling, can (not should) disclose to a potential counterparty the fact that they are acting on behalf of a PDMR.”

Although the FSA’s discussion of the issue in Market Watch is not always clear, the FSA summarises the arguments in favour of the market practice as follows:

- there is a “duty of care” to the purchaser to make the PDMR disclosure;
- such duty is “as important if not more important” than client confidentiality and securing best execution for the PDMR;
- especially in the ‘small cap’ market, there is an expectation from purchasers that a PDMR disclosure will be made by a selling broker (and therefore brokers may lose buy-side business if they fail to make the disclosure); and
- the PDMR disclosure is allowed under the market abuse exception for a disclosure made in the “proper course of the exercise of an insider’s employment, profession or duties”, and this is supported by the relevant provisions of the CMC.

The Code of Market Conduct
The relevant provisions of the CMC are MAR 1.4.5E (2) and (3).

MAR 1.4.5E (2) permits disclosure:

- which is accompanied by confidentiality requirements;
- when it is reasonable; and
- when it enables the person concerned to perform the proper functions of his employment, profession or duties.

MAR 1.4.5E (3) permits disclosure where:

- the information is “trading information” (which includes the identity of a potential participant in a transaction (such as a PDMR));
- the disclosure is made only to the extent necessary and solely in order to dispose of, or acquire, the investment; and
- it is reasonable for the disclosure to be made to enable the person to perform the proper functions of his employment, profession or duties.

“Duty of care”
Clearly, it would assist the argument of the brokers if there was indeed a “duty of care” to make the PDMR disclosure. It is, however, difficult to see how such a duty could ever arise as a matter of law, as:

- the duty would be in direct conflict with the traditional agency duties of a broker to its client (including the duty of confidentiality); and
it is difficult to see what objective grounds there might be for such a duty – it does not seem necessary to support its existence on the grounds either that the market would not otherwise function properly or that market participants would be unacceptably disadvantaged.

Indeed, the only grounds for the duty which can be discerned in the Market Watch discussion is the somewhat self-serving ground that potential buyers expect the disclosure and might somehow ‘punish’ any failure to disclose by taking future business away from the broker concerned.

The market abuse exception
In the absence of any duty to make a disclosure, the argument that PDMR disclosures fall within the market abuse exception and are supported by the relevant provisions of MAR becomes weak. Although the identity of a PDMR is indeed "trading information", such disclosure is neither "necessary" to effect a sale, nor is it a "reasonable" means of enabling a broker to perform the "proper functions" of acting as selling broker for the PDMR. The FSA comments:

"In particular, the existence of a supposed market convention or understanding that the identity of the seller will be disclosed does not make such disclosure ‘necessary’ and ‘reasonable’."

Comment
The FSA's warning to market participants on this issue applies only where the identity or existence of a PDMR seller amounts to "inside information". This is a judgement to be made by the broker concerned on a case-by-case basis. Yet where the PDMR information does amount to inside information, then the FSA's analysis appears to be substantially correct.

This is another example of the FSA's recent campaign against market practices that it considers to fall short of acceptable standards (see, for example, our briefing paper "Regulatory Challenge to Market Norms: No more safety in numbers" of June 2010).

5. REVIEW OF THE MARKET ABUSE DIRECTIVE – INSIDE INFORMATION AND COMMODITY DERIVATIVES

The European Commission is expected to publish draft legislation to amend MAD and its Level 2 Directives in the first part of 2011. We intend to report separately on that development. For the UK market abuse regime, one of the most significant proposals is likely to be a change to the definition of "inside information" for the purposes of dealing in commodity derivatives.

The current definition is notoriously vague, almost to the point of irrelevance, referring to information that market users "would expect to receive" in accordance with "accepted market practices".

Accordingly, it is likely that the definition will be dropped altogether in favour of the existing general definition which focuses on the price sensitivity of information.

Taken together with the related proposals in the MiFID Review (see our separate briefing paper on the MiFID Review of January 2011), it is clear that a tougher regulatory regime for commodity derivatives trading is on the near horizon. In tandem with this development, the Commission has separately proposed a new legislative...
measure\(^5\) aimed at abusive practices in the physical electricity and gas markets. Consistent with G20 objectives, the commodity markets look set to become the next major battleground for market regulators in Europe and beyond.

6. EU SHORT SELLING REGIME

For details of, and commentary on, the proposed new EU regime to regulate short selling, see our October 2010 briefing paper: *The European Commission’s proposal for the regulation of short selling*\(^6\).

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\(^5\) See the Commission’s draft *Regulation on energy market integrity and transparency*, December 2010.

\(^6\) Searchable at www.slaughterandmay.com