Market Abuse Update – No.3

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The long-awaited review of the Market Abuse Directive was published by the European Commission at the end of October 2011. The proposals for reform contained in that paper, and the draft legislative measures attached to it, have provoked a fairly heated response. On the domestic front, the FSA has continued to pursue a range of (mis)behaviours, with some continuing success.

1. MANY SPECTORS HAUNTING MAD: THE EU’S REVIEW OF THE MARKET ABUSE DIRECTIVE

In our last update on market abuse and related issues (January 2011), we explained the decision of the European Court of Justice (ECJ) in the Spector Photo case and the uncertainties it had created for the Market Abuse Directive (MAD) and the market abuse provisions of the Financial Services and Markets Act 2000 (FSMA) which implement MAD.

In brief, the ECJ in Spector decided:

- There is a rebuttable presumption that a person who deals while in possession of inside information “uses” that information and is prima facie subject to MAD’s prohibition. (We commented that, while this ruling fell short of imposing strict liability, it “certainly rendered the mental element of insider dealing less flexible”.)

- However, the scope of MAD is limited to conduct which would “disadvantage” other market participants. In reaching this purposive conclusion, the ECJ referred to certain of the Recitals to MAD which state, for example, that market makers going about their “legitimate business” are not to be considered to be insider dealing by using information which comes to them in that capacity. The ECJ said, crucially, that this category of “legitimate use” is not necessarily a closed one – thus allowing for a “Chinese Wall” exception, as is provided for in the FSA’s Code of Market Conduct.

We commented that the Spector judgment, and what we felt was the FSA’s less-than-adequate response to it, left the UK regime in a position of legal uncertainty. But that is as nothing compared to uncertainties which will be visited upon EU and UK law if the new proposals for reform of MAD are implemented in their current form.
Our recent briefing on the proposals to revise MiFID and MAD (November 2011) discusses the market abuse reforms in some detail, noting in particular the plans greatly to extend the number and types of trading venues covered and to tighten the rules applying to commodity derivatives markets. Here, we focus on the proposals relating to insider dealing and what appears, both at first and subsequent sight, to be an amplification of the legal uncertainties created by the Spector decision. (One of the more surprising aspects of the Commission’s package for revising MAD is its failure to discuss the implications of the ECJ judgment.)

Disturbing aspects of the draft proposals include:

- The dropping of the helpful recitals which assisted the ECJ’s ruling on the limits of MAD’s scope. Although a specific Chinese Wall exception is now proposed, its condition – that a firm ensures no contact (including social contact) between individuals on either side of a wall – is in practice unworkable.

- The extension of the definition of inside information to include any unpublished information which would be “relevant” to the decision of a reasonable investor. Although this new provision has strong echoes of the UK’s traditional domestic concept of “relevant information not generally available” (RINGA), the latter is qualified by conditions which confine RINGA to information which in due course would be the subject of mandatory public announcement. This UK limitation closes the category of RINGA and provides some certainty as to what is covered. By contrast, an unqualified category of “relevant” information (as the Commission has proposed) is very wide and not necessarily confined to price sensitive information (for example, knowledge of new product feasibility studies might be “relevant” in a wide sense even if far from price sensitive). However, it appears from the Commission’s commentary and the draft Recitals that something very similar to the UK’s RINGA is in fact what is aimed at. It is therefore hoped that the drafting can be better aligned with the assumed purpose.

Another controversial proposal risks extending an interpretation of price sensitivity (a core quality of “inside information”) which was the subject of comment in our earlier briefing on the Massey UK Tribunal case.

The current MAD legislation provides, in the MAD implementing directive, that an item is to be judged as price affecting if it is information that a reasonable investor would use in an investment decision. This requirement is now reflected in FSMA, and has given rise to two opposing views:

- The view, apparently held by the Tribunal in Massey, that the latter condition effectively substitutes the normal meaning of “price affecting”, so that the definition is entirely focussed on “relevance” (in Massey, the information in question concerned a new issue of shares which would doubtfully have a “significant effect” on price).

- The view (which we consider to be the correct one) that, as an implementing directive cannot enlarge the scope of the primary directive, the “relevance” condition is an additional requirement, tempering the possibility that the effect on price would be exaggerated by, for example, irrational market reaction leading to wide price swings.

However, the draft text of the Commission’s proposal for a Market Abuse Regulation (MAReg) has tipped the scales towards the former view by “promoting” the relevant condition to the primary instrument (and thus undermining one of the compelling reasons for the latter view). Again, it is to be hoped that sensible policy and clearer drafting will prevail.
To add to an already crowded debate, the ECJ has been asked to rule on the existing MAD definition of inside information, in the context of an issuer’s disclosure obligations. One question is to what extent “intermediate steps” taken to bring about a disclosable event (e.g. steps preparatory to a takeover) may themselves constitute announceable inside information; the other question (which has an indirect bearing on the new proposals concerning “relevant information” discussed above) is whether the nature of the assessment of the probability that a future price sensitive event may occur varies according to how much of a price impact the event is likely to have: i.e. the higher the impact, the less stringent the probability test, so that, for example, the possibility of the loss of a company’s most significant contract must be disclosed at an earlier stage than the possibility of the loss of a major but somewhat less significant contract.

MAD to be replaced by MAReg

Under the proposals to revise MAD the directive itself would be replaced by a regulation having direct effect throughout the EU. This is intended to ensure consistency and a levelling-up of standards in place of the somewhat patchwork array of national regimes implementing MAD at present. It will necessitate the replacement of the UK’s FSMA provisions concerning market abuse, and represents the removal of most, if not quite all, of the UK Government’s and the FSA’s discretion in this area.

2. THE FSA DEPLOYS ITS POWERS; THE FCA SET TO CONTINUE THE TREND

It is now a relatively safe assumption that at some point in 2013 the Coalition Government’s new structure for financial regulation will be switched on, replacing the FSA’s present empire with one ruled from three centres of power: at the Bank of England, the Prudential Regulation Authority and the Financial Conduct Authority. In fact, the FCA will be the same legal entity as the FSA but with a regulatory remit much reduced in scope. However, in the area of financial crime and market abuse there is likely to be substantial continuity of policy, with the FCA having similar powers. Moreover, by putting “conduct” at the top of the FCA’s agenda (and at the centre of its title) the Government has already changed the climate in which the FSA operates in anticipation of the future regime. As a result, the pace and severity of the FSA’s enforcement action has increased, even before the ambitious changes which are contemplated at EU level begin to take effect.

Evidencing these developments, 2011 has seen a number of “firsts” for the FSA; the level of fines for market abuse continues to rise; and the FSA is continuing to pursue a number of alleged insider dealers in the criminal courts.

FSA “firsts”

- In the case of Samuel Kahn, not only did the FSA fine the individual in question for market abuse but it also obtained a High Court injunction restraining him from committing further market abuse. It appears that Mr Kahn had previously been the subject of FSA enforcement in respect of so-called boiler room fraud; notwithstanding which, he also engaged in a deliberate and lengthy scheme of share manipulation. The injunction means that the FSA can use the weapon of “contempt of court” against Mr Kahn, as well as its other powers, should he engage in future misconduct in breach of the injunction.

- In the case of David Mason, the FSA secured its first conviction for boiler room fraud, which was later followed by another successful case against a family gang (the Wilmots) which over the years had enjoyed shocking success in defrauding UK investors. This case involved a major co-ordinated international investigation of sophisticated offshore structures, and might be seen as FSA’s debut in the successful prosecution of “big time” fraud.
• More controversially, in the case of the Canadian firm Swift Trade, which the FSA fined £8 million for market abuse, the FSA has used new powers to publicise the fact that it is taking enforcement action before the matter is finally disposed of (Swift Trade being in the process of appealing the FSA’s decision to the Tribunal). Swift Trade is accused by the FSA of widespread price manipulation by the technique known as “layering” (a technique which was also the subject of a second injunction gained by the FSA in the course of the year). “Layering” involves alleged manipulation by the rapid entering and subsequent rapid deletion of multiple orders on automated trading books (and, according to the FSA, appears to be associated with certain sophisticated high frequency trading techniques).

2012 continues the theme: not “wall crossing” a crumbling wall
Trying not to receive inside information is not the same as actually not receiving it. This is one of the main messages of the FSA Decisions against Greenlight Capital and its founder and main principal, David Einhorn, who have been fined in aggregate £7.2m for market abuse ahead of an equity fundraising by Punch Taverns. The company was, as is the custom, sounding out key investors (Greenlight held 13.3 per cent) about the feasibility and desirability of an equity issue prior to making the final decision. Normally, such investors would agree to being “wall crossed” – given confidential inside information against a formal agreement not to disclose and an acknowledgement that receipt of the information would preclude them from trading before the public announcement. Einhorn was asked if he (and therefore Greenlight) would be wall crossed but he refused. However, a call did take place between Einhorn, the company and its broker on the basis that inside information would not be given. Nonetheless the broker and the company imparted a number of facts from which (the FSA found) it could reasonably be inferred that an equity issue would be likely to take place fairly shortly and that the amount sought to be raised would be around £350m. This information qualified as inside information notwithstanding:

• Mr Einhorn’s express desire not to be given inside information; and

• that neither the company nor the broker warned Mr Einhorn that inside information had in fact been given.

Although the FSA found that Mr Einhorn “did not act deliberately or recklessly”, he “should have been aware that he had been given inside information, or at the very least that there was a risk of this”. Mr Einhorn immediately instructed the sale of Greenlight’s holding of Punch shares without taking legal or compliance advice.

Mr Einhorn, who, along with Greenlight, is based in the US, was unrepentant, saying that his actions bore as much resemblance to insider trading as “soccer does to football”. Unfortunately, in the UK the analogy proved all too true. (See below for brief comment on further cases which are ancillary to this affair.)

Fines
2011 saw the first market abuse cases where fines have been calculated under the FSA’s new penalties regime introduced in March 2010, which “loads” fines according to the nature of the wrongdoing, the identity of the culprit and the presence or absence of mitigating or aggravating factors. This has culminated in the highest fine so far imposed on an individual for market abuse – US$6.5 million, against a Dubai-based investor who manipulated the price of GDRs traded in London.

It is to be noted, by contrast, that records for fines against firms have not been broken in 2011. This is not to say that the FSA has slowed up in its enforcement zeal.
Criminal insider dealing cases
The FSA has prosecuted and is prosecuting several cases under insider dealing legislation. A notable feature of the FSA's strategy is the publicity it is giving to such prosecutions, both successful and pending – on its website; and as an addendum to every press release announcing the result of a particular prosecution.

“Market practice”: disclosing senior management share sales
In our Market Abuse Update No.2 (January 2011) we noted that the FSA had fired a shot across the bows of the widespread market practice of brokers disclosing to potential buyers that the seller is a senior manager or director of the issuer concerned. The FSA was and is of the view that this could amount to market abuse (improper disclosure of inside information) and does not fall within any of the exceptions set in its Code of Market Conduct (MAR). The FSA is now proposing to put a shot beneath the waterline: amending MAR to make this clear, subject to a safe harbour for very illiquid stock (Quarterly Consultation No.31 (CP11/27)).

3. EU short selling regime – 2012 overture
In November 2011 the EU announced the final formalities for its Regulation on Short Selling and Credit Default Swaps. The new regime is intended to come into force on 1 November 2012 and, being in the form of a regulation, will have direct effect throughout the EU, replacing any domestic rules in the area covered.

Not a great deal has changed since the original proposals were made (see our briefing of October 2010 on the subject). In short, the principal aims of the Regulation are: increased transparency; bans or restrictions on “naked” short selling; and wider bans at a domestic or EU level in cases of market “emergency”, with the European Securities and Markets Authority (ESMA) given powers of co-ordination or direct intervention.

Transparency
• For shares whose principal market is an EU market: short positions at a 0.2% threshold will be disclosable to the regulator and disclosable to the market at a 0.5% threshold.

• For EU sovereign bonds: “significant” net short positions will be disclosable to the regulator only.

• Derivatives on shares or sovereign bonds: derivative positions producing the economic effect of a short position will be disclosable as above.

Naked short selling – equities and sovereign bonds
• For EU shares: such short selling will be prohibited, unless the seller has at least a “reasonable expectation” of being in possession of sufficient stock to settle the sale (the so-called “locate rule”).

• For EU sovereign debt: a similar restriction will apply, save that a seller may enter into a naked short in order to hedge a long position in a corporate bond where the price is highly correlated to the price of the relevant sovereign bond.

ESMA is given the power to develop technical standards to implement these rules. There are also exceptions for primary market operations and market making.
Naked sovereign CDS
There is to be a ban on entering into a CDS other than to hedge against an actual risk incurred by the buyer of default by the sovereign issuer. Such actual exposure can be to assets or liabilities whose value is correlated with that of the sovereign debt.

Exceptions are allowed in market conditions such that the presence of the restrictions is adversely affecting the issue of sovereign debt or the pricing of sovereign debt.

Emergency powers
- Competent authorities in member states will have the power (as already exists in the UK following the Financial Services Act 2010) to ban short selling temporarily in times of market turmoil.
- ESMA is given the task of monitoring the exercise of such powers (or their lack of exercise). In certain circumstances ESMA may intervene directly to impose a ban where there is a threat to the "whole or part" of the EU's financial system or the orderly function and integrity of cross-border markets (and the relevant domestic regulator is failing to act).

Implications for the UK
The practical implications for the UK’s present regime consist mainly of the extension of the transparency obligations beyond financial institutions, the standing restrictions on naked short selling and CDS and the possibility that ESMA may restrain or prompt action by the FSA (or, in due course the FCA) or intervene directly in UK markets.

This latter implication is important in legal terms but is now also increasingly significant in political terms. The apparently ambitious intent of ESMA to acquire powers of intervention and, thereby (directly or indirectly) supervision of markets at a national level (doubtless now with the support of some key EU member states) looks set to create a flashpoint in the coming year. We can expect resistance from the UK Government to any greater powers for ESMA (or its fellow authorities, the EBA and EIOPA), but query what effect such resistance will have now that this particular genie has started to escape its bottle and, at the same time, the UK's position at the EU negotiating table seems to be weakened.

4. **FINALLY: BLIND OR CARELESS EYES – A WARNING**

In recent disciplinary actions (not limited to market abuse cases) one can detect moves by the FSA to highlight lack of care about regulatory obligations, or even plain ignorance, on the part of firms and individuals (whether or not formal enforcement ensues). As examples:

- The case of JJB Sports, fined £455,000 for failing to disclose the true cost (by a factor of 3) of an acquisition and the burden of a £6.5 million overdraft which came with another acquisition for a “nominal” sum. Ignorance or disregard of disclosure obligations can be inferred. In addition, the corporate broker responsible for the company’s announcements, although apparently unaware of the first transaction, failed diligently to analyse correspondence passed to it, which would have revealed the second omission.

- The cases (discussed above) of David Einhorn and Greenlight Capital where unfamiliarity with UK rules appeared to play a part in the decision to trade but that excuse finding little sympathy with the FSA. The FSA also went on to fine two individuals (one at Greenlight and one at its executing broker) for failing to take note...
of and report the suspicious circumstances surrounding the trades. Clearly, the FSA intends to send a message that secondary players participate in or facilitate abusive activities at their peril.

- In the case noted above involving the record individual fine (for manipulation of GDRs), the FSA drew attention to the roles of two FSA-approved individuals in London who apparently advised on, and helped execute, the strategy.

Although these cases are outliers, the message coming through is that firms and individuals should not just know their responsibilities, but should also exercise due diligence in discharging them in all circumstances.