If there was one dominant theme relating to market abuse which emerged in 2012 it was the question of what constitutes inside information and where the boundaries concerning its disclosure should be drawn. This fourth Market Abuse Update considers this theme, as manifested in certain important decisions (all more or less contentious) of the FSA and, in one case, the ECJ.

1. THE CONTENTIOUS CASE OF IAN HANNAM

In April 2012, the FSA also drew a great deal of comment, mostly critical, following the publication of its decision to fine Ian Hannam of JP Morgan Cazenove for market abuse.

The FSA published its preliminary decision after concluding that Mr Hannam had improperly disclosed inside information concerning a possible takeover and a potential oil find of his corporate client Heritage Oil to a third party with commercial and potential investment interests in the fortunes of Heritage.

Although much commentary has been directed at the FSA’s assessment of the standard of proof in market abuse cases (a balance of probabilities test, says the FSA, in spite of the quasi-criminal nature of the proceedings) there is another interesting aspect of the FSA’s decision worthy of note, namely the FSA’s finding that Mr Hannam had not acted in the “proper course of the exercise of his employment, profession or duties”.

The extent of an adviser’s ability to disclose
Mr Hannam contended that he was a strategic and financial adviser to Heritage, that at the time Heritage was in negotiations with a potential acquirer, and that the disclosures that Mr Hannam had made to a third party were intended to advance Heritage’s commercial interests by stimulating other potential interest in the company.

The FSA, in contrast, held that: “[Mr Hannam] disclosed inside information where this was unnecessary, unwarranted and purely in furtherance of his client’s commercial interests. Doing so was not reasonable, nor was it in fulfilment of a legal obligation…”, notwithstanding that the FSA had also conceded that Mr Hannam was, for the most part, acting with the implicit authority of his client.

So when is disclosure in the course of an employment, profession or duty “proper” for these purposes? The FSA appears to have taken an extremely narrow, and therefore arguably an impractical view, stating that for disclosure of information to be proper in these circumstances it must be necessary or legally required and that pursuit of commercial interests alone is somehow improper.
Whilst it must be true that a corporate finance adviser, even when in a long-term and strategic advisory relationship, does not have carte blanche to discuss his client’s price-sensitive affairs with anyone who might further his client’s interests, the FSA has surely drawn the boundary too narrowly and, at the same time, without providing practical guidance. Subsequent press coverage reported understandable bewilderment among financial advisers as to where that boundary now lies and anecdotal evidence suggests that a general fear of stepping over that boundary is now stifling the ability of financial advisers to facilitate corporate activity in the UK.

There will doubtless be many who now hope that the Upper Tribunal, to which Mr Hannam is appealing the FSA’s decision, will take a more pragmatic approach to this important element of the market abuse provisions. After all, most if not all sensitive (but proper) corporate finance discussions and negotiations take place in pursuit of the commercial interests of the participants.

2. THE DAIMLER CASE AT THE ECJ

In the third edition of our Market Abuse Update¹, published in February, we noted the opening salvo in a case² involving the German car manufacturer, Daimler, and allegations of the mishandling of inside information relating to the departure of the group’s Chairman. At that time the ECJ had been asked two questions:

First: In circumstances where there is a series of interim steps leading to a final event or decision, such as was involved in the resignation of the group Chairman of Daimler AG, and those steps are intended to lead to a particular future event, is it only the anticipated occurrence of that future event which is to be regarded as precise information capable of being inside information for the purposes of the EU Market Abuse Directive (MAD)?

If the answer was yes, then for the purposes of the MAD inside information test, it would only be that future event which should be assessed as to whether it can “reasonably be expected” to occur (a requirement for determining whether information is sufficiently “precise” to constitute inside information). The alternative view was that an intermediate but instrumental step could also involve sufficiently precise information and therefore be capable of giving rise to a disclosure obligation, provided that the intermediate step had already occurred or could reasonably be expected to occur.

Second: As noted above, MAD requires that there be a reasonable expectation that an event will occur. The ECJ was asked whether this meant that there must be a high degree of probability or whether the degree of probability required to give rise to an “expectation” could vary according to the likelihood that the event would be likely to affect significantly the price of an investment?

In other words, is it the case that the greater the probability that a possible event will affect the share price, the lower the threshold becomes to found a reasonable expectation that the event will in fact occur, perhaps even to the extent that the reasonable expectation test is satisfied if the event is simply “not improbable”, even if still uncertain?

In cases presented to the ECJ, the Advocate General of the Court is asked to express an opinion on the legal arguments and the Court commonly endorses the opinion expressed by the Advocate General.

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² See ECJ Case C19/11, Markus Geltl v. Daimler AG, 28 June 2012
In the *Daimler* case, the Advocate General’s opinion on the first question was uncontroversial (at least, to UK practitioners), holding that an intermediate but instrumental step (such as the Chairman’s internal announcement of his intention to retire) could constitute precise information, capable of giving rise to a disclosure obligation. His opinion on the second question, however, was in many respects highly controversial, holding that “where the potential of the information for affecting share prices is significant, it is sufficient that the occurrence of the future set of circumstances or event, albeit uncertain, be not impossible or improbable”.

It was a worrying proposition and one that could have undermined legal certainty for issuers and investors alike, not to mention bringing the prospect of voluminous but un-illuminating public announcements: information concerning an uncertain future event could be inside information even if the probability of that event occurring could be negligible (i.e. “not impossible”) simply because the likelihood of that information having a price impact is high. There is nothing in the text or recitals of MAD which, on their face, would have supported such an extreme reading.

**The ECJ’s conclusions**

As had been expected, at the end of June 2012 the ECJ confirmed the Advocate General’s opinion on the first question, on the grounds that the opposite view would have undermined the policy purpose of MAD (and, indeed, run against the ordinary broad meaning of the terms “set of circumstances” and “event”).

The Court pointed out that, if there had been no obligation to disclose an intermediate step, even if it had been quite specific, not only would there be a lack of transparency but insiders could then exploit price-sensitive information with impunity.

The Court stressed that its ruling covered not only intermediate steps which had actually occurred, but also those which “may reasonably be expected” to occur – and this led the Court on to the second question, where in great contrast, and to the relief of many practitioners, the Court mostly ignored the Advocate General’s opinion.

Indeed the judgment is, by implication, highly critical of that opinion. The Court explained that:

- All of the various translation versions of MAD (apart from the German translation) use the adverb “reasonably”. This indicates a “criterion based on the rules of common experience”, on a case by case assessment of the relevant factors.

- “Reasonably to be expected” does not translate into a requirement for “high probability”. Such a reading would undermine the purpose of MAD and allow insiders to exploit information about future events with impunity.

- But “market participants, including issuers”, are entitled to legal certainty. In particular, information about events whose prospect of occurring is “implausible” should not be regarded as precise.

- The correct test is therefore whether there is a “realistic prospect” that the circumstances or events in question will come into existence or occur.

- The Advocate General’s suggestion that the tests of probability and price-affecting impact should be linked, so that the greater the price impact of a future event the lower the probability threshold, is unsupported by MAD’s drafting. Probability and price effect are distinct and separate elements of the relevant definition. The “magnitude of the effect” on prices of an event is not to be taken into consideration when assessing whether there is a “realistic prospect” of the event occurring.
The ECJ’s robust and straightforward reading of MAD (in what was a relatively short judgment) was welcomed by market participants and their advisers. The court’s ruling struck something of a balance between investors’ need for transparency (and the linked prohibition of insider dealing) on the one hand and legal certainty for issuers and market participants on the other.

In a further positive step, the key substance of the Daimler decision has been absorbed into the latest versions of the draft text for a new European market abuse package. In the definition of inside information provided in that legislative proposal, intermediate steps are expressly referred to as being capable of constituting precise information. A recital to the proposed EU Regulation on Market Abuse confirms that position (referring to the “realistic prospect” test), but also notes that “the magnitude of the effect” of a possible future set of circumstances need not be considered.

3. The “Reasonable Investor” Test in Europe

The FSA and the Upper Tribunal have previously been the subject of critical commentary over their apparent intent, when assessing whether information is inside information for market abuse purposes, to conflate the requirement for information to be price-affected with the additional specification (derived from MAD) that the information must be material to the investment decisions of a “reasonable investor”.

Both the FSA and the Tribunal have suggested that MAD and the corresponding UK legislative provision (section 118C(6) of the Financial Services and Markets Act 2000) should be read as requiring that anything which is material to the investment decisions of a reasonable investor should be treated as inside information without further consideration of whether that information is price-affecting in relation to relevant financial instruments (see, for example, our Market Abuse Update No. 3 of February 2012, and our 2011 coverage of the Massey Tribunal case in our briefing Market Abuse and the Definition of Inside Information: Massey v. The FSA).

Our view has been, and remains, that the reasonable investor test should be regarded as a limiting and additional test to be applied to information which has already been determined to be price-affecting. Information which might otherwise be price-affecting should not therefore be regarded as such unless a reasonable investor would be likely to use it when making an investment decision. Conversely, information which is price-affecting only because, for example, a leak has led to unwarranted and irrational market panic (and any reasonable investor would thus discount that information), might not be regarded as meeting the basic price-affectedness condition such that it needed to be disclosed.

It has therefore been encouraging to see that the European Commission’s proposals to refresh the EU market abuse package appear now to be moving towards acceptance of this view, or at least undermining the FSA and Tribunal’s attempts to construe the existing MAD requirement so broadly. The most recently published draft for an EU regulation on market abuse confirms that, when assessing price-affectedness, “account shall be taken” of the likely use to be made of that information by a reasonable investor.

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5 Article 6.3 of the 20 November Presidency Compromise text of the proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse)
4. IF THE FSA CAN'T USE MAD, IT CAN STILL GET EVEN

And finally... the announcement in March 2012 of the FSA’s enforcement action against Nicholas Kyprios, the head of European credit sales at Credit Suisse in London, exposed a rather unconventional wall-crossing scenario in which it should not have been difficult for those involved to identify the boundary between acceptable and unacceptable disclosures of information.

In this case the buy-side parties had declined to be wall-crossed in relation to an imminent new debt issuance being sold by Credit Suisse, but it appears that Mr Kyprios nevertheless set out to propel various highly pertinent pieces of information over the wall, expressly or impliedly encouraged by the fund managers sitting on the other side. This was achieved by means of an apparently crude and quite blatant guessing game (the facts were not fully disclosed in the FSA’s Final Notice, so one had to read between a few lines).

Interestingly in this case, though Credit Suisse’s internal systems had identified the information concerning the new issuance as sensitive, and required that it be treated as inside information, the FSA had to conclude that it was not technically inside information because neither the bonds nor the CDS that were price-affected by the sensitive information were admitted to trading on a relevant regulated market; thus the UK’s market abuse regime was not engaged.

Nevertheless, the FSA found that Mr Kyprios’ behaviour in disclosing the information was effectively akin to market abuse (and suggest in their Final Notice that the conduct would have been pursued as such had legal technicalities not intervened). For that reason, the FSA took action on the basis that Mr Kyprios’ behaviour did not meet the more generic “proper standards of market behaviour” prescribed by the FSA for an approved person (the FSA’s Third Statement of Principle for Approved Persons).

The decision appeared to be a de facto extension of the market abuse regime in one sense, although perhaps an understandable response when one reads the facts of the guessing game as described in the FSA’s Final Notice. This was a lesson one might have expected a senior investment professional should not have needed to learn.