Market abuse – whither the reasonable grounds defence?

Practitioners will be familiar with the defences to market abuse prescribed by s.123(2) of the Financial Services and Markets Act 2000 (FSMA) ("the defences"), writes ***Toby Robinson*** *of Travers Smith. In summary, the FSA may not impose a financial penalty on, or publicly censure a person who has engaged in market abuse if, having considered any representations made to it in response to a warning notice, it is satisfied that that person: (i) had reasonable grounds for believing that his/her behaviour did not amount to market abuse ("the reasonable grounds defence"); and/or (ii) took all reasonable precautions and exercised all due diligence to avoid engaging in market abuse ("the reasonable precautions defence"). The reasonable grounds defence relates to a person's state of mind at the time of the conduct. By contrast, the reasonable precautions defence looks at the actions taken by a person to avoid engaging in the allegedly abusive behaviour.*

Prior to the recent decisions in the case of the two Dresdner bond traders, Darren Morton and Christopher Parry, there had been little or no authority on how the defences would apply in practice. Previous Final Notices published following unsuccessful representations by individuals to the Regulatory Decisions Committee (RDC) had made no reference to an attempt to rely on the defences. Similarly, whilst the defences have been mentioned in passing in some of the (few) market abuse cases that have gone all the way to the Tribunal, s.123(2) has not been looked at in any detail[1]. Accordingly, until recently, there had been no body of case law to which practitioners could refer for guidance as to how these defences might apply in practice.

This article focuses on the reasonable grounds defence, which was run by Mr Morton, and considers the implications of the RDC's rejection of the defence for those individuals (or firms) seeking to rely on it in the future. The article will also touch on the reasonable precautions defence, although this was not an issue before the RDC.

The reasonable grounds defence (*s.123(2)(a)*)

There are, in effect, two limbs to the reasonable grounds defence. The first limb requires that the person actually believed that his behaviour did not amount to market abuse. The second limb requires that this belief be based on reasonable grounds.

In relation to the first limb, the question arises as to whether for the requisite belief to be held there is a requirement for the individual to have actually applied his mind at the time to the question of whether or not the market abuse regime was potentially engaged. In this regard, *s.123(2)(a)* does not specify how a belief must be formed in order to bring a person within its scope – it merely requires that the belief be held. It is submitted that on its ordinary and natural meaning a belief can be formed in a number of ways, including not only through conscious questioning and assessment, but also through experience gained over time.

To apply a more restrictive interpretation would be to limit the ordinary and natural meaning of the words as drafted. The requirement that there be conscious steps taken is set out very clearly on the face of *s.123(2)(b)* (discussed below under "the reasonable precautions defence"). If such a requirement had also been intended in *s.123(2)(a)*, the legislature could and would have said so. *S.123(2)(a)* does not, for example, say "he formed the belief, on reasonable grounds…" (or similar) to indicate an additional requirement of a belief positively formed at the relevant time. It simply says "he believed", without limiting how or when that belief was formed.

In summary, if the person is able to say "it never occurred to me that this was market abuse" and the reason for it not so occurring was reasonable, the section ought to be just as much engaged as if the person had given active consideration to the issue at the time. In either case, the requisite belief under *s.123(2)(a)* is made out.

Assuming the belief that the behaviour did not constitute market abuse is made out, the individual must establish that such belief was based on reasonable grounds. The Act gives no guidance as to what might amount to reasonable grounds. However, *s.124(3)* requires the FSA to indicate the circumstances in which the FSA is to be expected to regard a person as bringing himself within the scope of either of the defences. DEPP 6.3.2G contains a non-exhaustive list of factors which the FSA may take into account when deciding whether either of the defences apply. This list largely reflects the factors at 14.5.1 of the now defunct Enforcement Manual. However, unlike ENF 14.5.1, which separated out the factors to be taken into account for each of the defences, the eight factors listed

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in DEPP 6.3.2G are pooled together and are of potential application to each of the defences.

Those factors listed in DEPP 6.3.2G that appear most relevant to the *s.123(2)(a)* defence and are most likely to be relied on in practice can be summarised as follows:

- whether, and if so to what extent the behaviour in question was analogous to behaviour described in the Code of Market Conduct as amounting/not amounting to market abuse;
- to the extent there is any FSA guidance on the behaviour in question, the individual sought to follow that guidance; and
- the level of knowledge, skill and experience to be expected of the person concerned.

As stated above, these factors are non-exhaustive and therefore the FSA (including the RDC) must consider the reasonableness of any other grounds for the belief put forward by the individual or firm.

The reasonable precautions defence (*s.123(2)(b)*)

On its face, it is rather easier to anticipate whether or not this defence might be available as, unlike the reasonable grounds defence, there is no element of subjectivity. It relates to actual steps taken by the individual to avoid abusive behaviour as opposed to the individual's state of mind. The common-sense factors listed in DEPP 6.2.2G that are most likely to apply in practice are whether or not the individual:

- sought to follow any applicable guidance from the FSA;
- followed internal consultation and escalation procedures (eg, did he discuss the proposed behaviour internally with his managers or internal legal or compliance departments?); and
- sought and followed appropriate external legal or other expert professional advice.

The RDC's rejection of the reasonable grounds defence

In brief, the allegations of market abuse against Mr Morton and Mr Parry arose following various calls received by a Dresdner structured investment vehicle, known as K2, in order to gauge likely appetite for a new issue of Barclays debt. At no point was it by any means certain that the issue would proceed. Having received the calls, K2 dealt in an existing Barclays debt security. Whilst both individuals were ultimately found to have engaged in market abuse, the RDC declined to impose either a financial penalty or a Prohibition Order on either of them. Instead, the RDC decided that the appropriate sanctions were public censures under *s.123(3)* of the Act.

In addition to arguing that the information provided to him was not inside information, Mr Morton sought to rely on the reasonable grounds defence. Amongst other things, he represented (and the RDC agreed – see paragraph 6.11 of the Final Notice) that: (a) there was at the time of the conduct in question (March 2007) no industry or FSA guidance to the debt markets on the potential regulatory issues involved at the pre-marketing stage and the only specific guidance available to Mr Morton was therefore that reflected in interim communications from his Compliance department stating, inter alia, that: "In the past it has been determined that [Mr Morton's team] is not routinely privy to price sensitive non-public information"; and (b) that he was working in an environment where until a deal had closed, the accepted view was that, in the absence of information generally regarded as inside information, that information was not regarded as specific or price sensitive and therefore any activity related to such information could not be abusive.

Ultimately, despite accepting that at the time of the conduct in question Mr Morton genuinely believed that what he was doing was not abusive and that this belief was a product of the working environment in which he operated and market practice, the RDC rejected the reasonable grounds defence on the ground that his belief was not reasonable: Mr Morton "had a responsibility to consider whether the information was capable of being inside information, regardless of the market practice and the guidance from his compliance department" (paragraph 6.12 of the Final Notice).

With the greatest of respect, it is difficult to see the logic in this. The RDC appears to be saying that his belief was not reasonable <u>because</u> he did not actively apply his mind to the potential application of the market abuse regime to his actions. However, this is putting the proverbial cart before the horse. Given (a) that the RDC had found that Mr Morton's belief was genuinely held and (b) the absence of any suggestion in the Final Notice that the grounds for this belief were unreasonable, it is strongly arguable that the defence should have succeeded. Mr Morton had the belief and the grounds for that belief were reasonable, so how can it be right that he was nevertheless expected to go on to question the reasonableness of the belief?

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Conclusion

Until the Morton decision, the absence of any pronouncements regarding the circumstances in which the reasonable grounds defence might apply meant that practitioners were operating in something of a vacuum. It was therefore very difficult to advise clients with any degree of certainty as to whether or not, on the particular facts of the case, the defence might be successfully deployed. Unfortunately, the Morton case has, if anything, muddied the waters even more. Perhaps the best that can be said is that the decision clarifies the near impossibility of successfully invoking the defence. After all, if someone in the position of Mr Morton, who was found not to have breached internal guidelines and who worked in the environment described above cannot successfully invoke the defence, who can? Nevertheless, given the stakes involved for individuals accused of engaging in market abuse (shortly to be raised once DEPP is amended to incorporate the FSA's proposals relating to enforcement penalties), in addition to running arguments relating to whether or not the substantive offence is made out, consideration should always be given to relying in the alternative on the defences.

Notes

1. Note, however, the Tribunal's criticism of the RDC in its September 2006 judgment relating to the successful applications by Paul Davidson and Ashley Tatham for costs orders against the FSA following the Tribunal's earlier findings that Mr Davidson and Mr Tatham had not engaged in market abuse. In its judgment, the Tribunal criticised the RDC for failing to take into account the reasonable grounds defence. The Tribunal held that having heard Mr Tatham's oral representations, the RDC ought to have concluded that Mr Tatham reasonably believed that his behaviour did not amount to market abuse. It is not clear what grounds were raised by Mr Tatham in support of the reasonableness of his belief or, indeed, whether the defence was formally raised, although the wording of s.123(2) suggests that the onus is on the individual or firm to raise the defence at the representations stage following receipt of a warning notice.

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Liquidity regime on stream

Following the global Credit Crunch, bank failures and economic recession, financial regulators have issued policy statements designed to tighten the regulatory environment. Their goal: to prevent a recurrence; to reassure investment markets and the general public after the collapse of Northern Rock and the "rocking" it gave to a large part of the UK banking system, which was nothing nothing to the earthquake that was to come with the fall of Lehman Brothers.

It is clear that local action by the Financial Services Authority (FSA) on bank solvency and liquidity regulation can only go so far in global financial markets. Regulatory pronouncements from London may lead to meaningful changes in the UK but, say **David Ellis** and **Dr Silvano Stagni** of Howard Kennedy, other initiatives look like 'an exercise in just doing something' either because they merely touch the surface of a specific and complex issue or because real, effective action will need international coordination (or supervision). Banks unhappy at the treatment they receive in a given jurisdiction may well shift activities to 'friendlier' shores and service their clients from there.

Early in October, the FSA published a Policy Statement on Liquidity. This article looks at some of the key new rules and considers the UK's lead role in shaping the new regulatory order; if there is a "first mover advantage"; and whether, acting alone, it can control financial liquidity in enough depth to put the domestic banking industry on a secure footing longer term. We need to look at whether this approach will justify the extra costs involved for the banks operating here or whether, overall, it will reduce liquidity in the market, making credit even more scarce without securing protection against another potential meltdown.

At core, the FSA's statement lays down clear rules on what constitutes an acceptable 'Liquidity Buffer' in terms of types of assets, amounts to be held and how different banks will be treated. The new regime will be easier for smaller and simpler banking firms, which will be able to hold a wider range of qualifying assets (including money market funds offering same day liquidity), and on a more flexible basis. The intention is that those hedge funds that have operated as 'shadow

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