The FSA has continued to devote significant resource to the pursuit of market conduct cases, giving these cases the highest profile and priority. There has been a marked increase in the number of successful cases, including a number of criminal convictions (the majority of which have been punished by imprisonment), and the largest fine imposed against an individual for market abuse (against Simon Eagle in May 2010) has now increased to £2.8 million. The FSA's pipeline of cases has every appearance of continuing to be strong, with the early part of this year seeing a number of high profile arrests and cases being laid down for trial.

Introduction

The past year or so has seen the FSA prepared to test the boundaries of the behaviour it considers to be abusive, leading in some cases to an extension to the scope of the regime as previously understood. It is these scope issues which firms should ensure they understand, disseminate to appropriate staff and reflect in updated procedures.

We have summarised very briefly some of the more interesting themes below.

Insider dealing

Insider dealing encompasses dealing or attempting to deal in a relevant investment on the basis of inside information. Recent cases have examined:

- what constitutes inside information;
- the point at which information becomes inside information; and
- when dealing is "on the basis" of that information.

Inside information – significant effect on price

Summary – in assessing whether information is likely to have a significant effect on price, account should be taken of each individual piece of information; possible temporary movements in price immediately post announcement; and, even if no price movement is expected, whether the information would nonetheless be relevant to a reasonable investor's decisions

For information to be inside information, it must meet all four of the following tests – (1) it must be sufficiently precise; (2) it must be not generally available; (3) it must relate directly or indirectly to one or more issuers of relevant investments or to one or more relevant investments; and (4) it must, if made generally available, be likely to have a significant effect on the price of those investments. The meaning of the last of these – "significant effect on price" – has been subject to comment in recent cases. In particular, the following threads can be extracted from the FSA's final notices:

1. When a number of pieces of unpublished information are available in relation to the same issuer or investment, those pieces of information must be assessed both individually and in aggregate. For example, if there is both good news and bad news in relation to a single issuer, each must be assessed individually and not solely by reference to the expected net effect of that news on the price of the investment.

   See, for example, the cases against Wolfson Microelectronics plc (www.fsa.gov.uk/pubs/final/Wolfson_20jan09.pdf) and Entertainment Rights plc (www.fsa.gov.uk/pubs/final/ent_rights19jan09.pdf).

2. Temporary movements in price occurring immediately after announcement must be taken into account in assessing an expected significant effect on price. While many prices react by temporary change before a more considered level is established, the significance of any such change is particularly difficult to anticipate.

   See, for example, the cases against Darren Morton (www.fsa.gov.uk/pubs/final/morton.pdf) and Christopher Parry (www.fsa.gov.uk/pubs/final/parry.pdf).

3. It may not be necessary for any movement in price to be expected if the information is of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions.

   See, for example, the cases against Woolworth Group plc (www.fsa.gov.uk/pubs/final/woolworths_11jun08.pdf) and Photo-me International plc (www.fsa.gov.uk/pubs/final/photo_me.pdf).

4. It is possible for a routine trading update stating that results are in line with expectations to be inside information as it could constitute information relevant to the terms on which to invest. We consider it likely to be rare that this would be so, but this is the conclusion reached by the Financial Services and Markets Tribunal in the case against Robin Chhabra and Sameer Patel (http://www.tribunals.gov.uk/financeandtax/Documents/decisions/FSMTribunal/072_Chhabra_Patel.pdf).

When does information become inside information?

Summary – there is a willingness to consider information to be inside information at a very early stage

The time at which information as to possible future or uncertain events becomes inside information can be difficult to judge in practice. The judgement commonly focuses on whether the tests of precision and price sensitivity are met. In the context of precision, the law provides for a reasonable expectation test in relation to events which have not yet occurred and also requires that the information be specific enough to enable a conclusion to be drawn as to the possible effect of the information on price (at least in relation to the directional impact). In the market abuse case against Messrs Chhabra and Patel, the Financial Services and Markets Tribunal had to consider whether a message left by a person in the corporate finance department of a firm for a colleague in the investment research team of the same firm was "relevant information not generally available" (a concept with many similarities to inside information). There was some doubt as to the content of the message but the Tribunal considered it probable that the message indicated that the corporate financier needed to speak to the analyst urgently and that there was to be an announcement. The Tribunal also considered it probable that the analyst knew to which company the message related. The Tribunal found that there was no mention in the message that the announcement was to be negative although it was considered probable that the analyst concluded, without being told, that this was the case. The Tribunal concluded that the message was sufficient to constitute relevant information. The Tribunal indicated that the fact that something urgent had happened in relation to the company could in itself be information not generally available and could be regarded by a regular user of the market as relevant. Any knowledge of directional impact appears to have been irrelevant to the Tribunal's view on this point, although it went on to indicate that the fact that it was probable that the analyst had been told that there was to be an announcement and that he had concluded (without being told) that it was likely to be negative would also be relevant information not generally available.

The decision leaves many questions unanswered, in particular as to how the applicable legal tests were met, but it is an indication of a worrying trend to consider information to be relevant information or inside information (and therefore to be caught by the market abuse regime) at a very early stage.

"On the basis of"

Summary – there may be a rebuttable presumption that information in a person's (or firm's) possession has been used by him

As indicated above, it is a necessary element of insider dealing that the dealing occurs "on the basis of" the inside information. There is some guidance as to the meaning of this in the FSA's Code of Market Conduct. The guidance covers a range of matters including, the effect of information being held behind a Chinese wall; circumstances where the decision to deal is made before receipt of the inside information; and the extent of the influence of the information on the decision to deal.

The UK concept of "on the basis of" is derived from the EU Market Abuse Directive where the equivalent test is whether the information has been "used". The European Court of Justice considered this aspect of the Directive in the Spector Photo case. In essence, it concluded that there is a presumption that if a person is in possession of inside information he has used it. The presumption is rebuttable and so could be disproved by the defendant. This approach applies a much wider interpretation of the concept of insider dealing than the UK – and the FSA – has taken until now in this respect. This may lead to adjustments to the UK law, adjustments to FSA guidance in the Code of Market Conduct and/or simply a hardening of the position in enforcement cases. In the meantime, firms should take a very cautious approach to relying on an argument that dealing is not "on the basis of" inside information in all but very clear-cut circumstances.

The European Court of Justice decision can be found here (http://www.bailii.org/eu/cases/EUECJ/2009/C4508.html).

The non-equity markets

Summary – behaviour is likely to be assessed by reference to the standards in the equity markets

Until recently the focus of market abuse cases has been the equity markets. Last year saw a departure from this with the first published insider dealing decision in relation to the debt markets. The case examined the behaviour of two Dresdner bond traders who had received pre-marketing calls in relation to a possible new bond issue. Pre-marketing calls of that type are common in the debt markets but (in contrast to the equity markets) at the relevant time they were not generally regarded as either specific or price sensitive enough to constitute inside information for market abuse purposes. The FSA sent a clear message that this analysis was, in its view, incorrect. In doing so it underlined its willingness - rightly or wrongly - to use the equity markets as a benchmark for behaviour in other markets. Firms would be wise to assume that the FSA will view market conduct through an equity market lens and assess their practices accordingly.

Our note on the bond trader case can be found here (http://www.traverssmith.com/assets/pdf/Legal_Briefings/fsadebtissues.pdf) and the final notices can be found here (www.fsa.gov.uk/pubs/final/morton.pdf) and here (www.fsa.gov.uk/pubs/final/parry.pdf).

Accepted vs acceptable behaviour

Summary – common market practice will not necessarily be considered by the FSA to be acceptable behaviour

The FSA made it clear at an early stage that there may be circumstances in which behaviour accepted by the markets may fall short of the standards it considers to be acceptable. This point was tested in the Dresdner bond trader case referred to above where it appeared that the behaviour conformed to accepted market practice (and also seemed to comply with the firm's internal compliance guidelines) but the FSA nonetheless arrived at a finding of market abuse.

Market manipulation

Summary – those who assist others (even if unwittingly) to commit market abuse may themselves also be committing market abuse

In addition to covering misuse of non-public information (including insider dealing) the market abuse regime extends to misleading and manipulating the markets. There have been two recent cases where there have been findings of market abuse against those who did not instigate the abuse.

1. The finding against Andrew Kerr was unsurprising on the basis of the facts as presented in the final notice (http://www.fsa.gov.uk/pubs/final/andrew_kerr.pdf). It appears that he knowingly assisted a client's scheme to manipulate the coffee options reference price by means of carefully timed trades on LIFFE's coffee futures and options market.

2. The finding against Winterflood Securities Limited and its two traders was long and hard fought and related to their involvement as market maker in a share ramping scheme (www.fsa.gov.uk/pubs/final/winterflood.pdf). The FSA did not find that Winterflood acted knowingly or recklessly, but nonetheless concluded that its activities were pivotal to the operation of the scheme in circumstances in which its suspicions ought reasonably to have been aroused. The FSA concluded that the participation of Winterflood and its two employees in the arrangements was sufficient to constitute market abuse even though they had not themselves intended to distort or mislead the market. Winterflood referred the decision to the Financial Services and Markets Tribunal and later appealed to the Court of Appeal – both decisions went against it. (See further below – 'The status of the Code of Market Conduct'.)

Suspicious transaction reports

Summary – if a person has reasonable grounds for suspecting that certain transactions constitute market abuse it must notify the FSA without delay

Firms authorised by the FSA which have reasonable grounds for believing that a transaction which they arrange or execute for a client might constitute market abuse must notify the FSA of that fact without delay (http://fsahandbook.info/FSA/html/handbook/SUP/15/10). These suspicious transaction reports assist the FSA to identify possible market abuse. Linked to its drive to combat market abuse, the FSA last year brought its first enforcement action against an individual at a firm for failing to make the relevant notification in circumstances in which the FSA considered that the defendant should have known or suspected that a trade placed through him was based on inside information. In failing to make the report, the FSA found that the defendant had failed to observe proper standards of market conduct and was fined. The case against Mark Lockwood can be found here (www.fsa.gov.uk/pubs/final/mark_lockwood.pdf).

Other legal issues

The status of the Code of Market Conduct

Summary – evidential provisions in the FSA's Code of Market Conduct do not qualify the statutory definition of market abuse

The high profile case against Winterflood and its two traders referred to above centred on the role of the FSA's Code of Market Conduct in scoping the statutory market abuse regime.

The key issues considered were:

- whether merely falling within the language of the statutory definition of market abuse is sufficient, or whether it is necessary also to prove an intention to distort or mislead the market; and

- whether the evidential provisions (as opposed to the conclusive, or "safe harbour", provisions) in the FSA's Code of Market Conduct qualify the statutory definition.

It appears to have been accepted that the test set out in the statutory definition was met.

It was decided (first by the Tribunal and then by the Court of Appeal) that (i) satisfaction of the statutory definition of market abuse is sufficient even in the absence of an intention to distort or mislead the markets, and (ii) the evidential provisions under consideration, which related to whether there needed to be an "actuating purpose" to mislead or distort the market, did not qualify the (very broad) statutory definition.

The Court of Appeal and Tribunal decisions can be found here (http://www.bailii.org/ew/cases/EWCA/Civ/2010/423.html) and here (http://www.tribunals.gov.uk/financeandtax/Documents/decisions/FSMTribunal/066_WinterfloodSecuritiesLimitedStephenSotiriouJasonRobins.pdf).

The market abuse defence

Summary – the FSA appears to have set the test for reliance on the statutory defence almost impossibly high

A person has a defence to an allegation of market abuse if (broadly) he can show that he believed on reasonable grounds that his behaviour did not amount to market abuse. This defence was considered in the Dresdner bond trader case where it was argued that the individuals had reasonable grounds for such a belief on the basis that their actions conformed to both accepted practice in the bond markets and their internal compliance guidelines. The FSA, in finding that reliance on these factors was insufficient to establish the reasonableness of the individuals' beliefs, has sent a clear signal that it considers the circumstances in which the defence will be available to be extremely narrow - and probably far narrower than the draftsman intended.

Is circumstantial evidence sufficient?

Summary – the FSA can base findings of market abuse on circumstantial evidence

The cases against Robin Chhabra and Sameer Patel focused, from an evidential perspective, on a significant number of telephone calls between the two. The defendants were firm friends and the number of calls was high. While there were records of the fact that calls were made and the time of the calls there were no records of what was said. Central to whether the FSA would be successful in its allegations was therefore the extent to which the Financial Services and Markets Tribunal would be prepared to admit circumstantial evidence in the case – evidence which, in this case, relied on coincidences as to the timing of the calls and inferences as to their content. The Tribunal appeared readily to accept circumstantial evidence and, in doing so, applied the principle that before drawing inferences from the evidence it would need to be sure that there were no other co-existing circumstances which would weaken or destroy the inference. It concluded that the evidence as a whole, and the pattern of behaviour in particular, was consistent with the inference alleged by the FSA.

Lessons to be learnt/action points

All market abuse decisions should be treated with some caution. They are often determined by reference to the particular facts of the case and many of the conclusions on matters of law and interpretation have not been tested by the courts. As such, statements of law and interpretation are often simply representative of the FSA's own opinion on such matters and may not (always) be correct.

However, the FSA's views should not be ignored lightly and therefore firms should heed the views and trends which emerge from the above cases. Particular steps which should be considered include the following.

- Firms should re-assess their analysis as to (i) what constitutes inside information and (ii) the point at which information becomes inside information in the light of the above cases. The conclusions should be reflected, where appropriate, in amended internal policies and procedures and staff training.

- Particular analysis should be undertaken in relation to the circumstances in which the firm may be in possession of inside information but relies on the argument that it does not trade "on the basis of" that information. Circumstances in which we are aware that firms rely on this argument include:

  - information held behind a Chinese Wall

  - formulaic trading

  - the decision to deal is made before receipt of the information

  - the expected impact of the information is counter-directional to the trade.

These should be assessed in the light of the Spector Photo case and policies and procedures should be updated as necessary.

- Firms operating in the debt and other non-equity markets should re-visit the analysis of their activities in those markets. Comparisons should be made with the more considerable body of analysis in the equity markets and accepted market practices should be challenged. Firms should be prepared to justify deviations from equity market practices.
- All firms should have monitoring procedures which are designed to alert staff to unusual patterns of behaviour – whether on the firm's own account or where the firm is processing transactions on behalf of clients.
- All members of staff should be reminded of the obligation to make suspicious transaction reports and of the firm's procedures for considering and, if appropriate, making such reports.
- Training should be provided which is tailored to business models: firms should not assume that staff will apply the necessary (or correct) read-across to examples designed for different business models or markets. This means a more bespoke approach to training based on relevant case studies.

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