

# Financial Regulation: Market Abuse Update

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## Recent cases and what they mean for financial businesses

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The last few months has seen a flurry of arrests, searches and court decisions relating to the market abuse and insider dealing regimes. This has resulted in a high profile for the Financial Services Authority ("FSA") investigations and its prosecutions of those it considers to have abused the market. The media focus has been mainly on the increased number of criminal prosecutions. But the FSA's increased appetite is only part of the story - the courts have got in on the act too.

Two key decisions have come from the European Court of Justice and the Court of Appeal. Those decisions have emphasised the fact that market abuse need not be intentional in order to be subjected to penalties - whether the regime is that dictated by the Market Abuse Directive ("MAD") or the United Kingdom's domestic regime under Part VIII of the Financial Services and Markets Act 2000 ("FSMA").

## The Cases

### Spector Photo Group NV

Spector is a Belgian publicly quoted company. It offers a stock option programme to its staff. Spector planned to use shares in its possession to cover the options and to buy any balance of shares needed on the market. As required by the relevant Belgian legislation, Spector informed the market of its intention to buy shares for the stock option programme.

Spector made a number of acquisitions, including two orders that were placed (it

seems) shortly before Spector's publication of its results. Those orders were at an average price below the exercise price of the options. Spector subsequently published its results and the company's share price is stated to have then increased.

The two purchases made shortly before publication of results were punished as insider dealing by the Belgian regulator (the CBFA). Under the law applied by the CBFA the 'use' of inside information (in this case, Spector's results) is not required for there to be insider dealing - mere 'possession' is sufficient. The decision was appealed to the Belgian courts, who referred key aspects to the European Court of Justice.

The ECJ judgment begins with a careful review of the changes made by the MAD compared with its 1989 predecessor. In particular the ECJ noted the dropping of the phrase "with full knowledge of the facts" from the proposed MAD, and even the replacement of "to take advantage of" by "to use" during MAD's development to remove any element of purpose or intention from the definition of "insider dealing".

The ECJ considered that the lack of an express reference to "intention" was done with a view to harmonising the law across the EU. It considered that it was explicable by the nature of insider dealing itself and the purpose of MAD. In its opinion the chain of events leading to someone entering into a transaction who has inside information, leads to an inevitable presumption (though rebuttable) that the inside information has been "used" in the transaction. However,

the fact that MAD does not expressly provide for a mental element does not inevitably mean that an insider who deals falls within the prohibition on insider dealing (as pointed out by Italy and the UK). The prohibition applies to preclude taking unfair advantage of the benefit gained from inside information. It follows (in the ECJ's view) that a primary insider who holds inside information and trades in the instruments to which the inside information relates, prima facie "used that information" - subject to the right to rebut that presumption, and the potential need for a thorough examination of the facts to identify whether the "use" was unfair.

Thus the ECJ clearly considered that the prohibition on insider dealing in MAD required more than possession of inside information and the fact of dealing. But, perhaps equally importantly, the ECJ emphasised that there was no need specifically for intention in pursuing insider dealing market abuse cases.

The UK Government's and the FSA's reaction to the judgment was to indicate that they would review whether there was any need to change the formulation in FSMA. Currently it deviates from the MAD wording - instead of "use" it uses the concept of trading that is "on the basis of" inside information. The FSA's Code of Market Conduct suggests that the concept involves some material connection between the trading and the inside information. Given the way the ECJ expressed itself, it is possible that the UK will decide there is no need to change the formula. However, the ECJ analysis can only assist the FSA further in its market abuse crackdown.

## Winterflood Securities v FSA

Similarly we now have clarity that intention is not needed in other kinds of market abuse. Only recently, we saw the first market abuse case reach the Court of Appeal from the Financial Services and Markets Tribunal. Even though the case relates to the pre-MAD regime, it is still important (particularly when viewed alongside the Spector case) in clarifying the scope of market abuse.

The facts of the case were not disputed on the appeal - the case was disposed of on the basis of a relatively narrow legal argument. The end result was a fine of £4 million for Winterflood and a total of £250,000 for two individual traders at the market maker.

In summary, Winterflood, as market-maker, traded extensively in shares of F

Plc (an AIM quoted company) over several months at the behest of a Mr Simon Eagle and SP Bell (a small stockbroker controlled by Mr Eagle). This trading, as assumed in the appeal, had the effect of assisting Mr Eagle's scheme to ramp F Plc's share price. Winterflood was accused by the FSA of failing to spot, when it should have done, that its trading was assisting the scheme and thus failed to take the steps it should to avoid assisting the scheme. The FSA did **not** allege that Winterflood **intended** to assist the scheme.

The FSA alleged that Winterflood's behaviour was:

- behaviour "likely to give the regular user of the market a false or misleading impression as to the ... demand for, or as to the price or value of, investments of the kind in question"; and
- behaviour that " a regular user of the market would, or would be likely to, regard ... as behaviour which would, or would be likely to, distort the market in investments of the kind in question".

Winterflood's defence (for both types of behaviour) rested on the way in which the FSA's Code of Market Conduct (the "Code") interacts with the provisions in FSMA, and what that means for the way in which the FSA has described certain behaviours in the Code.

The relevant version of the Code (i.e. the pre-MAD version) contained provisions opining that behaviour involving an "actuating purpose" for each of the two relevant types of behaviour would be market abuse. Winterflood argued that these provisions preclude the FSA from alleging that behaviour without a relevant actuating purpose can amount to market abuse of either kind, because the FSA could then effectively disregard the Code when bringing allegations of market abuse, even though FSMA requires that all parties be allowed to rely on the Code (s119 FSMA).

The FSA argued simply that the statutory "offence" of market abuse in s118 FSMA does not require an "actuating purpose". The Code has two effects under FSMA: to provide "safe harbours" (i.e. descriptions of behaviour that are not market abuse), and to provide guidance to market participants (which cannot alter the statutory test in s118). Provisions setting out descriptions of behaviour that the FSA considers to be market abuse (such as

"The damaging effects of abuse depend not on the state of the perpetrator's mind, but on the impact on markets and consumers"

Melanie Johnson,  
Economic Secretary  
to the Treasury –  
February 2000

those relied on by Winterflood) merely express its views on the particular behaviour described - different behaviour requires a fresh analysis against s118. In effect the FSA argued that an actuating purpose is not a necessary part of market abuse - merely an example.

The unanimous Court of Appeal agreed with the FSA. Their lordships were not at all impressed with arguments that the Code should be read as indicating by implication that a variation of an explicit example of market abuse was indicated by the FSA as not being abuse. Lord Justice Moore-Bick (giving the judgment) said:

*"... I do not think that the provisions of the Code ... are to be read as restricting market abuse of a kind which creates a false impression or distorts the market to cases in which the transaction was motivated ... by an intention to achieve either of those results"*

In many ways this outcome is not surprising. The absence of intention or any other mental element was a consistent message from the FSA, and from the Government during FSMA's passage through Parliament and in the FSA's development of the Code. In February 2000 Parliament was told that the market abuse regime was designed to cover negligent as well as deliberate behaviour because the regime's focus was on the potential damage to markets and consumers.

The original version of the Code recognised that "a mistake is unlikely to fall below the objective standards expected where the person in question has taken reasonable care to prevent and detect the occurrence of such mistakes". The Winterflood case reflects that (the Code no longer does so explicitly) - although no intention to commit market abuse is required, some degree of fault is needed to fail the "regular user" test. Failing to give risks due attention is sufficient – and that is what Winterflood was found guilty of.

## Things to think about

### The FSA's current approach

Recent events have clearly demonstrated an enthusiastic embracing of Hector Sants' comment that firms ought to be afraid of the FSA. The FSA has geared up its capability of investigating and prosecuting criminal cases - and has had a run of success in the Crown Court as

well as a major success in the Winterflood case.

Equally the FSA has been expanding the range of those accused of misbehaviour. Those found to have committed market abuse or insider dealing include individuals a long way from the corporate finance teams or issuers - even printers have now been charged. We can expect the FSA to keep up its charge, not least because of the concern (now more high profile) as to the existence of insider dealing rings.

### Do your procedures/policies go far enough?

It is very tempting to think that away from corporate finance or agency private client stockbroking a quick trot through the FSA's Code of Market Conduct is sufficient training. But these cases (and the criminal charges brought by the FSA) demonstrate that any financial services business needs to think about its activities and how to maintain standards of behaviour. The FSA has become keen on stress-testing and challenging management. How long will it be before supervisors start asking whether policy/procedures manuals cover all that they need to, and what steps have been taken to test that?

### Do you need to know what your clients are up to?

A key aspect of the case against Winterflood was that it failed to identify what Eagle/SP Bell was up to. Neither was, in fact, a customer of Winterflood - the trading was between professionals.

Likewise the FSA have long regarded intermediaries as being at risk of committing market abuse when executing transactions for clients, particularly where there is considerable interaction. The Winterflood case takes that several steps further - its systems did not give a sufficient picture to key individuals that the pattern of trading was suspicious. According to the representations recorded in the FSA's Final Notice Winterflood has improved its systems considerably to improve its chances.

For there to be market abuse, behaviour must have fallen below an acceptable standard. But as the Winterflood case shows, that can encompass a failure to ask enough questions.

"We are determined to stamp out market abuse and that we will not back down simply because cases are tough and hard fought"

**Margaret Cole,  
Director of  
Enforcement, FSA –  
April 2010**

# Our expertise

LG's specialist financial services regulatory team has broad experience of both contentious and non-contentious regulatory matters. It comprises individuals from across the firm's practice areas, and includes specialist corporate lawyers as well as regulatory experts and litigators.

Richard Everett, who heads the team joined us after more than 10 years with the FSA, as a senior lawyer in its General Counsel's Division and latterly as head of the legal advisory function for the Regulatory Decisions Committee.

Our team has extensive experience and advises regularly on matters relating to:

- The Financial Services and Markets Act 2000, and related statutory materials including European legislation; and
- The Financial Services Authority's Handbook, guidance and other regulatory materials.

The team regularly advises on complex financial services and regulatory issues and is able to deploy large teams at short notice should the need arise.

For further information or assistance on market abuse issues, please contact:

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