Market abuse

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MARKET ABUSE

On 1st December 2001, the Financial Services and Markets Act 2000 ('FSMA') came into force. One of its most controversial sections is Part VIII which gives the Financial Services Authority ('FSA') the power to impose civil penalties for market abuse. Despite the many doubts raised about these provisions and their as yet untested nature, the European Commission has proposed a European Directive on Market Abuse[1], to extend the concept of 'administrative sanctions' for market abuse across the whole European Economic Area ('EEA'). This paper looks at the issues currently raised by the UK legislation and any further problems the European legislation may bring.

Background

Until now, the UK has largely relied on criminal sanctions against any forms of market abuse, namely:

1. The common law crime of conspiracy to defraud to cover rigging a [1]market;
2. The statutory offences of 'misleading statements' and 'market manipulation', re-enacted in FSMA as 'misleading statements and practices'; and
3. Separate legislation making insider dealing a criminal offence[2].

All these criminal sanctions have been retained in the new regime and the FSA given the power to prosecute the statutory offences[3]. However the Government was dissatisfied with reliance upon the criminal law. Proving the elements of these crimes 'beyond reasonable doubt' meant few successful prosecutions. So the FSA has also been given the power to reprimand and/or fine authorised and non-authorised persons for 'market abuse' based on a civil burden of proof. As the Economic Secretary put it:

> 'There is a gap in the protections [of the financial markets]. The criminal law covers all market participants, but only a narrow range of serious criminal offences. The regulatory regime is capable of dealing with a wider range of damaging behaviours, but applies only to the regulated community'[4].

However, Part VIII of FSMA had a rough passage through Parliament[5] and the FSA's Code of Market Conduct ('Market Code') an equally rough passage

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through the required consultation process thereafter[6]. The issues raised fell into three areas:

1. the width of the basic definition in FSMA;
2. the extent to which the Market Code and any safe-harbours reduced that width; and
3. the protections from unfair or inappropriate enforcement.

To those must now be added the problems that may be encountered under the proposed European Directive.

1. Definition of Market Abuse

Market abuse is basically defined as:

1. behaviour (action or inaction) anywhere in the world, directly or indirectly affecting investments traded on a UK market[7];
2. that is likely to be regarded by regular users of the market as falling below the standard reasonably expected of a person in that position[8]; and
3. which is at least one of three types:
   a. based on information not generally available to the market but which is likely to be regarded by a regular user as relevant in deciding the terms on which to deal in such investments (ie insider dealing);
   b. likely to give a regular user a false or misleading impression as to the market or value of such investments (ie misleading statements and practices); or
   c. regarded by a regular user as likely to distort the market in such investments (ie rigging the market)[9].

It is also indirect market abuse if a person requires or encourages (by action or inaction) another to engage in behaviour that, if done by the defendant, would have amounted to direct market abuse. Market abuse can thus be committed via an innocent third party and, indeed by one or more persons acting together[10].

Although the three types of market abuse are similar to the underlying crimes, their scope is not identical. In particular, the definitions are objective. No intent, recklessness or actual knowledge needs to be proved. The overarching standard being applied is that of this hypothetical regular user, a sort of expert 'man on the Clapham omnibus' and what he is 'likely to' think. 'Likely to', here as elsewhere in the definition, may just mean 'could' and such a weak causal link does seem to be the FSA's initial interpretation[11]. This wide drafting is deliberate and gives rise to serious definitional problems.

Information which 'can be obtained by research or analysis by or on behalf of users of a market' is deemed to be 'generally available'[12] which gives some protection for market analysts in respect of the first type of market abuse. But unlike proving the crime of insider dealing, information does not have to be 'known' to be non-public and from an inside source[13]. It just has to amount to an informational advantage that a regular user of the market could consider relevant and reasonable not to expect the person to exploit. That still leaves plenty of scope for argument between those, like the Supreme Court in the United States, that believe that 'market abuse' must involve some exploitation of a breach of confidence, and those like the European Commission who believe that almost any exploitation of an informational advantage will do[14].

An example of the second type of market abuse was given in the Parliamentary Debates. If an internet user publishes a false announcement about a company that, for example, it is going to face a massive compensation suit, just so as to destroy the company's share price, the person would have engaged in market abuse. The fact that he might not stand to gain financially is irrelevant[15]. However, this example is based on intent. Other examples given in the same debates, like mistakes in, or complete failures to make, company announcements, trading reports etc are often not going to be deliberate and the extension of market abuse to inaction can give rise to some very difficult judgments. For example, the Economic Secretary said:

> 'Someone who squeezes the market may not take any action, but merely by continuing to hold a particular position, could be involved in an abuse.'[16]

Squeezing or cornering a market is probably the clearest example of the third type of market abuse, which otherwise tends to overlap with the second type. One particular problem here is that for commodity derivatives, the underlying market is often naturally dominated by a small number of producers. The Economic Secretary did not believe that a strike by workers of any such producer would breach the standard of behaviour expected by regular users of a UK market[17]. That is rather a remote example, but the major producers themselves will often have better information, will be wanting to keep their long or short positions hidden, will expect super profits from any quasi-monopolistic positions etc. What amounts to acceptable exploitation of such strong bargaining positions as against market abuse? As the FSA itself has pointed out in its Consultation Paper 10, it is hard to distinguish 'wash trades' from normal repos and riskless principal trades; 'abusive squeezes' from bona fide speculation and super profits from monopolies; 'misleading markets' from spreading or acting on rumours; and 'misuse of information' from good research and market-making. The facts in *R v The Securities and Futures Authority Ltd, ex p Fleurose ('Fleurose')*[18], a case decided under the old regime, are illustrative.

JP Morgan Securities Ltd stood to lose nearly £1/2 million on some options if the FTSE-100 closed above 4842 on 28 November 1997. Twenty minutes before the close it stood at 4856, but at the close it was at 4832. The Stock Exchange discovered that JP Morgan had put in orders to sell parcels of shares in the five largest companies in the FTSE-100 during the final eight minutes of trading. The firm was fined £350,000 for breach of Stock Exchange rule 2.10 through '… conduct the sole intention of which was to move the index value'. This rule requires an intention and the manager of the department had clearly given instructions to deal with that purpose.

The question then became whether the trader who had executed the deals had breached the FSA's Statements of Principles 1 and 3 on high standards of integrity, market conduct and fair dealing which the Securities and Futures Authority ('SFA') imposed on all their registered dealers. The case was a judicial review of the SFA's disciplinary procedures and raised some interesting points about the European Convention on Human Rights dealt with below. What is of interest here is that the trader's defence which was summarised (at para 74) thus:

> 'This case is about intent and knowledge. [The applicant] strongly denies any impropriety. His case is that he did not have the intention or motive of depressing the FTSE-100 Index, and that at all times he was acting on the instructions of his superior… and that, at all times, he believed he was participating in the unwinding of a hedge.'

What is noteworthy about this case, is that in this disciplinary action brought under the old regime against an authorised firm and registered employees (ie market *insiders*), their intent and knowledge was treated as crucial. *Prima facie*, under the new regime and market abuse, actions can be brought even against market *outsiders* without such proof of intent or knowledge. However, as market abuse cases can only be brought by the FSA, much will depend on how it uses this incredibly wide discretion. That may be gleaned from its Market Code.

Before looking at Code, however, there are two general defences created by FSMA, where a defendant:

1. believed, on reasonable grounds, that the behaviour did not amount to direct or indirect market abuse; or
2. took all reasonable precautions and exercised all due diligence to avoid engaging in direct or indirect market abuse.

The onus is on the defendant in representations to the FSA to show that 'there are reasonable grounds for it to be satisfied' that the defences are met. It is not clear that these defences are of any great use since to show a reasonable belief or due diligence will generally require one to show that the danger of market abuse was actively considered in the first place. This is borne out by the considerations the FSA has been required to list in its Enforcement Manual[19]. The one useful factor seems to be showing there was consultation with the FSA, other authorities or lawyers before embarking on any questionable activity.

2. The Market Code and Safe Harbours

FSMA only defines the outer limits of what can constitute market abuse. The FSA is required to draw up a Market Code, in effect evidential rules, to help determine whether or not behaviour does amount to market abuse[20]. The purpose of the Market Code is to allow the FSA the sort of flexibility that the non-statutory Takeover Panel has to adapt and amend its rules in the face of rapidly changing market practices.

FSMA does give the FSA various powers to create safe harbours, specifying behaviour that will definitely not amount to market abuse. The FSA has granted safe harbours for compliance with its stabilisation rules, its Chinese wall provisions, some of the Listing Rules and some of the Takeover Rules. It has also listed nine specific safe harbours in the Market Code[21]. Otherwise the Code 'may be *relied* upon so far as it *indicates* whether or not that behaviour should be taken to amount to market abuse'[22]. The Market Code concentrates on elucidating the 'regular user test' and the three types of market abuse, which it refers to as 'misuse of information', 'false and misleading impressions' and 'distortion'.

Regular user test

The Market Code confirms that the regular user test is hypothetical. Even if a particular market accepts behaviour falling within one of the three types of abuse, it can still be market abuse[23]. The FSA believes this will be an exceptional situation and is more likely to lead to new guidance for the future than enforcement against past actions. The rules and normal practices of the markets (including overseas markets) will always be taken into account and will usually be taken as indicating what is legitimate behaviour.

The Market Code also confirms the objective nature of the regular user test and that abuse does not generally require ‘an intention or purpose to be present in order for behaviour to fall below the objective standards’[24]. This does allow cases to be brought against firms without difficult issues of attribution, although rather grudgingly the Market Code (at para 1.2.6) admits:

> ‘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 test does not impose a uniform standard. It varies according to the person’s experience, skill and level of knowledge and the markets and investments concerned. For example, the FSA seems to accept that disclosure standards in equity markets are generally higher than in commodities markets. On the other hand it is more reluctant to accept behaviour permitted in an overseas market but affecting a UK market, if the behaviour would not have been permitted in the UK market directly[25]. This is presumably because it fears regulatory arbitrage by global firms.

Misuse of information

To be misuse of information, four conditions have to be met:

(1) The information must be ‘one of the reasons’ for the behaviour[26].

(2) The information must not be ‘generally available’. The FSA has listed the same sorts of factors for determining this as are listed for determining whether information is ‘public’ under the insider dealing legislation. The observation of public events is added to diligent research as being generally available, even if through lack of resources or opportunity neither is available to others[27].

(3) The information must be ‘relevant’. The Market Code does not require information to be specific or precise or indeed price-sensitive, but they are factors that the FSA will consider along with how current and reliable (near to the source) it is and what other information is available. Where

'soft information' about the future is concerned, the significance of the information and its apparent level of certainty will be important. The information does not have to emanate from a source connected to the investments affected, eg it can be official information or information about the supplies of a commodity[28].

(4) The information must be of the type where disclosure (now or in the future) would reasonably be expected, either because:

(a) there is a legal or regulatory requirement, eg listing or transparency rules ('disclosable information'); or
(b) it is publicly announced routinely, eg changes in interest rate or in published credit ratings ('announceable information')[29].

This fourth condition does narrow the scope of the statutory definition. For example, in the commodity derivatives markets generally with low disclosure requirements, dealers who are suppliers of the underlying commodity will often have an informational advantage that just has to be accepted by regular users, even if such an informational advantage would not be acceptable in an equities market. Also, since market surveys, research documents and journalists' newspaper tips are not disclosable or announceable, they can presumably be front-run[30].

The FSA has specified five safe harbours in respect of misuse of information:

(1) The deal was required by a legal or regulatory of contractual obligation.

(2) The deal was not based on or influenced by the information, eg because there was a Chinese Wall operating

(3) The information is trading information (ie that someone intends to deal), unless it is about a possible takeover bid or primary market activity. Front-running customers orders (unless part of a possible takeover, placement or new issue) will not, therefore, be market abuse, although it will be a breach of the Conduct of Business Rules for authorised firms and possibly the crime of insider dealing.

(4) The information is information about acquiring or disposing of an equity stake (including a takeover), but the dealing is for or on behalf of the potential offeror and for the *sole* purpose of pursuing the principal transaction. This allows stakebuilding, irrevocable undertakings, and arranging cash alternatives before a takeover, but does not allow dealing

aimed at providing financial protection, eg selling a put option that will not lead to delivery of the stock to the potential offeror.

(5) Agreeing to underwrite[31].

It should be noted that under misuse of information, unlike the crime of insider dealing, it is not a defence that the person did not expect a profit to be made (or loss avoided) from the information.

False or misleading impression

The Market Code lists four categories of such behaviour:

1. Artificial transactions – There is an amazingly complex definition based on the objective ‘principal effect’ being to produce a false or misleading impression, whether deliberately or negligently, but with a subjective defence of having a legitimate ‘principal rationale’. The FSA lists a number of factors that it will take into account, like whether the transaction causes a brief price fluctuation and what interest the person might have in that fluctuation[32].

2. Disseminating information - Here the abusive behaviour is that a person disseminates relevant information which he knows, or ought to know, is false or misleading where an actuating purpose is to create a false or misleading impression. Again a factor that will be taken into account is whether the person has an interest in any affected investment[33].

   This is an odd definition since it is difficult to see how dissemination can have the purpose of creating a false or misleading impression if the person does not *actually* know that the information is false or misleading. The problem the FSA is struggling with is to distinguish between the inevitable passing on of market rumours and promulgating them to mislead. PR agents (even Government Press Officers) could find their informal activities caught under this heading. Their more formal activities may fall within the next.

3. Dissemination of information through an accepted channel – Where information is to be disseminated, for example, through the Stock Exchange’s Regulatory News Service, the person responsible for its submission remains under a positive obligation to take reasonable care to ensure that it is not false or misleading. So, accidental misreporting of

transactions or figures could be market abuse unless the person can show he has taken sufficient care to try and prevent such mistakes[34].

4. Course of conduct – The test here is similar to that in 1. above, but covers a course of conduct other than transactions. Again there is a principal rationale defence. This heading is particularly relevant to commodity derivatives markets and the movements of stocks and transport of the underlying commodity[35].

The FSA has also specified three safe harbours in respect of false or misleading impressions:

(1) certain regular market transactions like bed and breakfasts, arbitrage between different markets and stock-lending;
(2) reporting legitimate transactions as required by law or regulation;
(3) dissemination of false or misleading information by a firm through innocent employees (eg because of effective Chinese walls)[36].

Distortion

The FSA itself has admitted in Consultation Paper 59 that it is incredibly difficult to distinguish the distortion of a market from normal market volatility caused by the interplay of major players in the market. Although this third type clearly overlaps with the second, there are two specific circumstances that the Market Code defines as distortion:

(1) Price-positioning – where a person enters into a transaction or a series of transactions with an actuating purpose of distorting prices, ie moving them without a legitimate commercial rationale. This can be ramping prices of an investment or of a relevant index. Although this is most commonly done to profit (or avoid losses) on derivative positions, it might be to improve a manager’s quarterly performance figures[37].

(2) Abusive squeezes – where, with an actuating purpose of distorting prices, a person
    (a) has a significant influence over supply, demand or delivery mechanisms of a investment or the underlying product; and
    (b) directly or indirectly holds positions under which he expects delivery of them.

> Having a significant influence over supply, indeed extracting 'super-normal' profits thereby, is not of itself abusive. The abuse is cornering the market and then using the position to distort[38].

Again, in both cases, the Market Code lists a number of factors the FSA will consider. There is only one specified safe harbour, following the rules in the London Metal Exchange's 'Market Aberrations: The Way Forward'[39].

Conclusions on the Market Code

One of the most significant features of the Market Code is that subjective knowledge and intention have crept back in to market abuse through concepts like the 'principal rationale' and an 'actuating purpose'. However, knowledge of the status of information is not required to be guilty of misuse of information and innocent motives may not be a complete defence for those, like directors, responsible for disseminating false information through 'accepted channels'[40]. In this last case the Code notes (at para 1.5.20) that it is:

> '…. appropriate that those who disseminate information through [accepted channels], for example, the company itself, its financial advisers or its public relations advisers, take reasonable care to ensure the information is not inaccurate or misleading'.

This may seem appropriate, but as directors have discovered to their cost in the US, hindsight is a wonderful thing, and that is in a jurisdiction where liability has been restricted to deliberately, or perhaps, recklessly misleading the market.

In summary, market abuse through misuse of information, or disseminating false or misleading information through accepted channels, can be committed negligently. In other cases, defendants have either to show that their principal motive was a proper one (ie having a legitimate 'principal rationale') or, which is probably harder, to rebut any suggestion of an improper motive (ie not having an illegitimate 'actuating purpose'). In addition to these slight reductions to the original scope of market abuse, the FSA has created safe harbours. These, however, are mainly examples of circumstances that would not have passed the overarching regular user test anyway and do not make up for the shortcomings in the original definition.

Given the complexity of the Code, the FSA will give informal oral advice as situations arise.

3. Enforcement

The FSA has a choice of sanctions which can be applied to anyone within and without the perimeter, namely:

1. to prosecute through the courts for insider dealing, or for misleading statements and practices;
2. to publicly reprimand or impose its own fines for market abuse;
3. if the defendant is authorised or approved, to discipline for breaches of its principles and rules; or
4. if the defendant is a member of a recognised market or clearing house, leave the matter to their disciplinary procedures[41].

The position is complicated further by the supplementary powers the FSA has to seek High Court injunctions and restitution, or in the case of market abuse, impose restitution itself[42].

There are at least three contentious issues arising from the FSA's enforcement powers in respect of market abuse:

1. Do they comply with the European Convention on Human Rights, particularly Articles 6 and 7 on fair procedures;
2. Who should be responsible for dealing with market abuse arising during the course of a takeover; and
3. In what circumstances should the FSA seek to impose a fine or restitution?

The European Convention

FSMA was one of the first pieces of legislation to come before Parliament since the partial incorporation of the European Convention into domestic UK law under the Human Rights Act 1998 ('HRA 1998'). The HRA 1998, section 19 requires ministers to declare whether any new legislation is fully compliant with the Convention. This gave the City a wonderful opportunity to challenge the Government on whether the original disciplinary procedures proposed in FSMA met the requirements of Articles 6 and 7 of the Convention.

Article 6(1) applies to all civil and criminal procedures and lays down that "…everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law". At first sight this seems to be met by having the right to a full hearing before the Financial Services and Markets Tribunal (the 'Tribunal') of any disciplinary or market abuse matter not settled with the FSA[43]. The remainder of Article 6 and

Article 7(1) appear only to apply to criminal proceedings. They require that a defendant:

1. can have reasonably foreseen the legal consequences of his actions because the offence is sufficiently defined;
2. is presumed to be innocent until proved guilty and maintain a privilege against self-incrimination;
3. is properly informed of the nature of any charge and has time and facilities to prepare his defence;
4. is allowed to defend himself or to be legally represented (free when the interests of justice so require); and
5. can summon his own witnesses and cross-examine those against him[44].

Two issues arise from these articles:

1. Does the Convention treat disciplinary proceedings of the sort contained in FSMA as civil or criminal?
2. Even if they are civil, to what extent do the fair procedures specified for criminal proceedings, nevertheless apply to civil ones?

The Government maintained that all the disciplinary procedures under FSMA would be viewed as civil. The City, through its legal representative, Lord Lester, maintained they were criminal. In the end, the Government reluctantly accepted that, proceedings against market abuse *might* be treated as criminal under the Convention. This led to three concessions limited to market abuse:

1. a restriction on the use of compelled statements as evidence;
2. the introduction of legal assistance; and
3. a tightening up of the definition, including the introduction of safe harbours[45].

Was the Government right to concede on market abuse and market abuse alone? The decision in *Fleurose* seems to suggest yes. The case was conducted as though the HRA 1998 had been in force. Morison J reviewed the jurisprudence of the European Court of Human Rights on these issues and concluded that to decide whether proceedings were criminal or civil, a three-stage test has to be applied:

> (1) Has the Contracting State classified the case as subject to disciplinary law or criminal law?
> (2) What is the nature of the offence charged?

(3) What is the nature and severity of the penalty that was or might have been imposed?[46]

On the first test, SFA cases were (and now all FSA cases are) classified by the UK as disciplinary. On the third test, Morison J held (at para 50) that the fact that the SFA (and now the FSA) could impose an unlimited fine did not make the proceedings criminal:

> 'In the field of financial regulation, the size of the fine can, I think, fairly remain open. There is no doubt that some financial improprieties may cause millions of pounds of damage… The essential feature of the financial penalty imposed through the SFA disciplinary process is that it is recoverable only as a civil debt, without the possibility of recourse to the sanction of imprisonment for default or contempt of court.'

Penalties under FSMA remain a civil debt[47]. This leaves the second test. Here Morison J, following the Human Rights Commission's view expressed in *Wickramsinghe v UK*[48], said (at para 52):

> 'The core distinction in the classification process between what might, for shorthand, be called civil and criminal in Convention Law seems to me to rest on the fact that it is a necessary condition for the existence of a criminal charge that what is being alleged is a breach of a person's obligations to the State arising from being a citizen, through laws which have universal application or whose application is not dependent upon an individual's choice. Whereas, disciplinary cases involving a breach of obligations imposed on a class or group of individuals through their voluntary participation, do not fulfil the condition.'

Morison J therefore held the SFA's procedures to be civil. As a body, the SFA did look more like a traditional professional association (like the BMA in *Wickramsinghe*) than does the FSA regulating 7% of the UK's GDP. Nevertheless, when disciplining authorised and approved persons, the FSA's procedures are also probably civil. However, for market abuse, the FSA has powers against the regulated and non-regulated and that probably tips the balance into making the procedures criminal. The Government was therefore wise to add the extra protections in for market abuse cases.

If this is right, it suggests that, in order to avoid proceedings being treated as criminal, the FSA will bring actions for market abuse against authorised and approved person as breaches of its Principles and Rules (as the SFA did in *Fleurose*) rather than under the specific market abuse provisions. This, however, may not gain the FSA a great deal. In *Fleurose*, Morison J went on to say, (at para 52):

> 'But after the distinction [between civil and criminal] is drawn, there may be some disciplinary procedures whose characteristics are so akin to criminal proceedings that the concept of fairness requires more or less the same protections in both.'

Certainly the European Court of Human Rights took the view in *Albert & Le Compte v Belgium*[49] that in disciplinary procedures, the protections of a clear charge, time to prepare a defence and the right to call and cross-examine witnesses applied even if the proceedings were civil. In *Fleurose*, however, the issues were the vagueness of the FSA's Principles, the right to legal representation, and the privilege against self-incrimination[50].

On the issue of vagueness, Morison J maintained at para 66 that this was common with provisions against professional misconduct, was perfectly acceptable and presumably will remain so under the new regime. On legal representation, he pointed out at para 62 that the European Court of Human Rights had only ever required this for courts, not tribunals. On self-incrimination, he said (at para 59(2)):

> 'In pursuance of the need to protect the investing public, it is justifiable to require traders to co-operate with proper investigations. Indeed, the investigatory process itself is dependent upon answers given, and if answers could be refused on grounds of self-incrimination, or if given, those answers could not be used in a disciplinary case, then the regulatory authority would be hampered in its function of protecting the public and, effectively forced to continue to accept as a registered person someone who it knew was unfit to be so. That cannot be the rule.'

Such a pragmatic approach seems attractive, until one substitutes 'suspected terrorist' for 'trader' and 'free' for 'registered'.

Takeovers

One of the most vociferous attacks against the FSA's enforcement powers was launched by the Takeover Panel and pursued in Parliament by its former Chairman, Lord Alexander[51]. The fear was that during takeover bids, parties would either:

1. be reluctant to co-operate with the Takeover Panel, lest admissions later be used by the FSA to bring market abuse actions; or
2. resort to the FSA and the courts rather than accept informal Takeover Panel rulings.

The Government rejected the plea to carve out an area of responsibility for the Takeover Panel to determine issues of market abuse in takeovers and an Opposition proposal for a statutory safe harbour where the Takeover Panel was the arbiter of what amounted to conformity was narrowly defeated.

However, the FSA has introduced into the Market Code a limited safe harbour for behaviour conforming to certain Takeover Code rules[52]. It has also agreed to consult with the Panel before exercising its market abuse powers in a way that could affect a takeover bid and refrain from intervening where the Panel can take effective action itself. In addition, to support the Takeover Panel, it has endorsed the Takeover Code, the Substantial Acquisition Rules, and any Takeover Panel rulings in respect of them, in effect making them FSA rules applying to firms conducting designated investment business. Finally, the FSA requires firms not to act for anyone whom they reasonably believe will not comply with the Takeover Code or Substantial Acquisition Rules[53].

Only time will tell whether the Economic Secretary was right to say:

> 'The Panel's view will be highly persuasive in takeover matters. If disagreement arises, we believe that, as the statutory regulator in respect of market abuse, the FSA's view should be the determining factor; however, we also believe that disagreement is most unlikely in such cases.'[54]

When to Fine or Seek Restitution

Breaches of the Market Code or failure to follow guidance issued by the FSA will not automatically lead to market abuse proceedings. The FSA has laid out the criteria that it will consider. Above all, the FSA has to decide whether the behaviour falls within one of the three categories covered by market abuse and falls below the standard expected by 'a reasonable person who regularly deals on the market in investments of the kind in question'[55].

The FSA is required to publish a statement of policy on fining for market abuse just as it is for fining authorised firms and approved individuals, and as with disciplinary fining, it is reluctant to produce a tariff. The FSA's has produced a list of factors:

1. the adverse effect on the market;
2. the extent to which the behaviour was deliberate or reckless;
3. whether the individual is an individual;
4. the amount of profits accrued or loss avoided;
5. conduct following the contravention;
6. disciplinary record and compliance history;
7. previous action taken by the FSA; and
8. action taken by other regulatory authorities[56].

This is clearly aimed at calming some fears about the draconian nature of this power and limiting the levels of fines for individual negligence. To maintain orderly settlement in the market, the imposition of a fine does not make the transaction void or unenforceable[57]. Still, the person could be subject to a restitutionary claim. The FSA may only pursue such restitutionary claims for accrued profits or losses suffered ‘as a result’ of the contravention or market abuse on behalf of anyone ‘to whom the profits… are attributable; or who has suffered the loss or adverse effect’. There are also reasonable belief and due diligence defences[58].

Where the market has been positively mislead and others deal at too high or too low a price, the causal link is relatively straightforward. But where the abuse is misuse of information, it is often not clear who the victim is. Those dealing contemporaneously do not normally lose ‘as a result’ of the abuse. If anything, the price they will have obtained at that time will have been ‘more accurate’ than if no abuse had been taking place. Of course, the abuser may well have profited but are those profits ‘attributable’ to the contemporaneous dealers?

The other possible claim could be on behalf of the party whose information was exploited, usually, but not necessarily, the issuer of the securities. This party has not usually lost anything. One case where a claim could be established is where a bidder is proposing to ‘sweep the market’ before launching the bid and the abuser has pre-empted it. It could then be claimed that by analogy with fiduciary duties, any profits made by the abuser are attributable to the bidder.

The FSA has listed the factors that it will take into account before launching a restitutionary claim, such as the number of persons affected, the costs of any action, whether redress is available elsewhere and whether the losses are quantifiable and identifiable. On this last matter, it is not clear what the FSA’s attitude, in particular to misuse of information cases, might be. It has in the past expressed the view that:

> ‘The rationale for the proposed market abuse regime in the UK is… directed at protecting the integrity of market mechanisms, rather than protecting the interests of any particular group of market users…. We do not anticipate that the exercise of the FSA’s restitution powers would normally be appropriate for the purposes of disgorging profits for the benefit of, for example:
>
> - “Contemporaneous traders” – ie persons trading in the market at the some time as person found to have been insider dealing or misusing information in a manner which constitutes market abuse
> - Companies or issuers whose investments have been the subject of manipulation, insider dealing or information misuse.’[59]

Such a statement does not appear in the final Handbook, but the FSA may still be cautious about restitution in market abuse cases, not least because losses tend to be incurred by market professionals and the FSA does say:

> ‘The number of instances in which the FSA might consider its power to obtain restitution for market counterparties (ie professionals) are likely to be limited.’[60]

Still, this may not leave abusers entirely in the clear. One could see civil claims ‘piggy-backing’ on any successful market abuse actions the FSA may bring, as happens in the United States.

Proposed European Directive

One striking feature of Part VIII of FSMA that has gone largely unquestioned is its extraterritoriality. To be market abuse in the UK does not require any part of the behaviour to take place in the UK, only the effect to be on a UK market. This is clearly aimed at stopping individual operators acting from operating outside the jurisdiction or global players exploiting any opportunities for regulatory arbitrage. Nevertheless, such ambitious regulatory claims can create large areas of overlapping, even contradictory regulation. Ever mindful of ‘competitive distortions’ to its beloved, albeit misconceived, ‘level playing field’, the European Commission has proposed replacing the Directive on Insider Dealing with a Directive on Market Abuse (‘MA Directive’).

Following FSMA and the FSA's Market Code, the Commission recognises three types of market abuse, misuse of information, false or misleading impressions, and distortion, but in the proposed Directive's definitions, the first is still based on 'inside information' and the other two are merged under 'market manipulation'[61].

Inside Information

Although the Commission refers to inside information as being 'confidential information', it has retained its wide definition of inside information, amounting to any material informational advantage obtained 'by virtue of' being a director, security holder, or 'having access to the information through the exercise of [one's] employment, profession or duties'[62]. It has removed the knowledge requirement for these primary insiders, although it is retained for tippees. Insider dealing is not confined to individuals, in possession of inside information about securities, themselves dealing, or procuring, recommending or disclosing to others, to deal on regulated markets[63]. It now covers:

1. legal persons (companies etc);
2. all financial derivatives including commodity derivatives; and
3. primary markets and off-market transactions[64].

These extensions are not going to be easy to cope with, as can be seen from the problems the UK had implementing the old Insider Dealing Directive and in devising the current Market Code. Including legal persons raises difficult issues of knowledge attribution and Chinese walls. Markets in commodity derivatives are often dominated by major suppliers of the commodities who will always have informational advantages. Effective primary markets require the ability to bring in major investors to place and/or underwrite securities without premature publicity.

To cut down the potential for insider dealing, 'issuers of financial instruments' will be under an obligation 'to inform the public as soon as possible of inside information[65]. That is an understandable obligation that is already imposed on issuers of tradeable securities, but how will that work for commodity derivatives?

The proposed Directive does recognise that there will have to be exemptions, for example, buy-backs, price stabilisation, public sector debt management[66]. Many of the details are left to the comitology (sic) procedures proposed by the Committee of Wise Men; ie rules left to the Commission to devise after taking advice from the European Securities Committee[67]. This does not fill one with confidence, particularly as the proposed Directive already requires 'issuers or entities acting on their behalf [to] establish a regularly updated list of those persons working for them and having access to inside information' and those producing 'research or other relevant information… to ensure that information is fairly presented and disclose their interests or indicate conflicts of interest…'[68]

All of this reveals a deep misunderstanding of the way that markets operate on snippets of information, half-truths and pure rumour. The Commission's misguided attachment to 'the level playing field' is going to make it deeply resistant to exemptions. Although the FSA will no doubt fight for an Anglo-Saxon understanding of the way markets work, this European comitology procedure does threaten to render the elaborate consultation exercises required under FSMA otiose in the whole area of market abuse[69].

Market Manipulation

Market manipulation is defined as:

> '(a)Transactions or orders to trade, which give, or are likely to give, false or misleading signals as to the supply, demand or price of financial instruments, or which secure, by one or more persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level, or which employ fictitious devices or any other form of deception or contrivance.
>
> (b)Dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to the supply, demand or price of financial instruments, including the dissemination of rumours and false or misleading news.'[70]

Paragraph (a) above clearly covers what are referred to in the Market Code as 'artificial transactions' and 'price-positioning' and paragraph (b) more than covers 'disseminating information' whether informally or through accepted channels. Indeed, even innocently passing on any information that later turns out to be materially incomplete or untrue seems to be covered! The definition does not so clearly cover the Market Code's 'course of conduct' and 'abusive squeezes', but such behaviour is in the attached non-exhaustive list of typical methods of market manipulation[71].

These definitions are vague and, in particular, there is no clarity about the *mens rea* required or indeed any indication that such issues will be clarified, although the Commission can use the comitology procedures to amend the definitions and the attached list. Again one takes little comfort from the Commission's view that the 'adaptation and clarification of the definitions and exemptions' are 'non-essential technical implementing details'[72]. As the FSA fully understands, when it comes to distinguishing legitimate from illegitimate transactions in a market based system 'the devil is in the detail'.

One other provision on market manipulation has caused great excitement, the power to act against journalists for market abuse. Member States do not have to implement provisions specifically against journalists front-running recommendations or misleading the market by reporting information that turns out to be false or misleading. The FSA, by its definition of 'disclosable' and 'announceable' information and its distinction between the obligations on those disseminating information through an accepted channel and others, has clearly tried to avoid dragging journalists in to the market abuse regime. Presumably it will try to maintain that stance. However, unless the general definitions and examples in the proposed Directive are clarified, journalists may be brought in. If they are caught, the UK could use the special provision on journalists to exempt their activities again[73]. Of what worth such a special exemption may be to Financial Times journalists read throughout Europe, would still depend upon the provisions adopted by other Member States.

Other Provisions

On the issue of territoriality, the proposed Directive requires Member States at least to deal with actions undertaken within their territory, although this does not appear to rule out the wider approach taken by the UK. Indeed, there are quite elaborate provisions to be supplemented under the comitology procedure on pan-European co-operation[74].

As to enforcement, the proposed Directive does push the Treaty of Rome provisions to their limits. The Commission has commented:

> 'In principle it is unacceptable in an integrated financial market for wrongful conduct to incur a heavy penalty in one country, a light one in another and no penalty in a third. However, a full harmonisation of penal sanctions is not foreseen in the EC Treaty.'[75]

The proposed Directive requires there to be a 'single administrative authority competent to ensure that the provisions of the Directive are applied' with suitable investigative powers, although constrained by any legal requirements on confidentiality and subject to 'the right to apply to the courts'[76]. The controversial provision is Article 14 which requires there to be criminal *and* administrative sanctions that are 'effective, proportionate and dissuasive', albeit, 'in conformity with their national law'. As the Commission concedes, that national law will, for all Member States, have to comply with their interpretation of the European Convention on Human Rights, which brings us back to *Fleurose*[77].

In a global market like that for financial services, there are advantages for those involved in having a common regulatory approach that operates over as wide an area as possible. However, the proposed Directive only lays down a basic minimum standard, albeit one to be fleshed out by the comitology procedure. As the Commission admits:

> 'The new disciplinary framework set out by this Directive is not intended to replace the national provisions by directly applicable Community provisions, but contribute towards helping some convergence among the different national regimes through compliance with the requirements of the Directive.'

Such convergence will be of no value at all, unless the Directive and the Commission's subsequent details take account of the problems the UK has already had in legislating in this area and any adjustments that the FSA may yet have to make, once the market abuse provisions have operated here for a period. Refining the UK provisions has required lengthy and detailed consultation with practitioners. After the failure to secure the 13th Company Law Directive on Takeovers, one senses a degree of desperation on the part of the Commission to make fast progress on both this Directive and the one on Prospectuses[78]. Both are highly controversial and if the Commission is not careful, Member States and their citizens may lose faith in its ability to deal with this area altogether.

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[1] COM(2001) 281 final.

[2] *R v de Berenger* (1814) 105 Eng Rep 536; *Scott v Brown, Doering, McNab & Co* [1892] 2 QB 724; FSMA s 397, formerly Financial Services Act 1986, s 47; Criminal Justice Act 1993, Part V.

[3] FSMA ss 401 to 403. In Scotland, prosecution powers remain the monopoly of the Crown Office.

[4] Economic Secretary in Standing Committee A, 2 November 1999, c 652. The ability of an outsider to undermine a market was demonstrated by the effect Sumitomo Bank had on the London Metal Exchange even though it was not a member of that exchange, see Lord Bagri at Hansard Vol 610 HL, 21 February 2000, c 58.

[5] Joint Committee, Second Report; Standing Committee A, 2 November 1999, cc 651 to 708.

[6] FSMA ss 119 and 121. The FSA produced three Consultation Papers (10, 59 and 76), a number of other documents and took advice from groups of practitioners and representatives of markets and clearing houses.

[7] FSMA s 118(3) to (5); Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001, SI 2001/996. The markets are the Stock Exchange, LIFFE, OM London, London Metal Exchange, International Petroleum Exchange of London, COREDEAL, Jiway, and virt-x. Investments are not confined to securities and their derivatives. Behaviour can include squeezes on underlying commodity markets and exploiting inside information by using spread bets even if done overseas, provided that indirectly affects an investment traded on one of these UK markets

[8] The official definition of the regular user is ‘a reasonable person who regularly deals on the market in investments of the kind in question’, FSMA s 118(10).

[9] FSMA s 118(1)(b) and (2).

[10] FSMA ss 118(9) and 123(1)(b)

[11] Policy Statement: Code of Market Conduct (FSA April 2001) paras 4.10 and 5.3 to 5.5. This expansive view is reiterated, at least in respect of false or misleading impressions, Market Code 1.5.4(2).

[12] FSMA s 118(7).

[13] Criminal Justice Act 1993, s 57. Knowledge of the source is key in distinguishing true inside information from mere rumour that turns out to be true.

[14] Rule 10b-5 as interpreted in cases like *US v O'Hagan* 117 S Ct 2199 (1997). Directive on Insider Dealing, 89/592/EEC, Article 1.

[15] Standing Committee A, 2 November 1999, cc 683 and 684.

[16] Standing Committee A, 2 November 1999, c 676.

[17] Standing Committee A, 2 November 1999, c 674.

[18] [2001] EWHC Admin 292.

[19] FSMA ss 123(2) and 124(3); FSA Handbook, Enforcement, Chapter 14.5

[20] FSMA s 119(1). Market Code 1.3 also gives an indicative list of what might count as 'behaviour' including dealing, arranging deals, advising on deals, making statements about investments, corporate finance activities, managing funds.

[21] FSMA ss 118(8), 119(1), 120 and 122(1). Market Code 1.1.10 and 1.7.

[22] FSMA s 122(2). The Market Code gives both examples of what the FSA considers market abuse and factors it will take into account, FSMA s 119(2)(3).

[23] Market Code 1.2.4 and 1.2.8 to 1.2.11. An example of what would now be market abuse that was encouraged by a market was the distortion of London FOX's trading in property futures in 1991.

[24] Market Code 1.2.5, although purpose has crept back in to a number of the definitions in the three categories under the guise of a 'principal rationale' or an 'actuating purpose'.

[25] Market Code 1.2.3, 1.2.7 cf 1.2.9.

[26] Market Code 1.4.4(1). It does not have to be the principal reason.

[27] Criminal Justice Act 1993, s 58; Market Code 1.4.4(2), 1.4.5 – 1.4.8. The observation of the burning factory from the train example is specifically mentioned as not amounting to abuse, even if it could possibly be the crime of insider dealing.

[28] Market Code 1.4.4(3). 1.4.9 – 1.4.11. The US Supreme Court has also said when considering the US equivalent of market abuse, Rule 10b-5, that

determining the materiality of soft information requires 'balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event', *Basic v Levinson* 485 US 224 (1988) at 238.

[29] Market Code 1.4.4(4) and 1.4.12 - 1.4.18. Perhaps mere consideration of, and certainly negotiations over, a merger, takeover or major contract is 'disclosable' for this purpose, even though under *Listing Rules* 9.1 to 9.5, there is no immediate obligation to disclose.

[30] Market Code 1.4.17. Consultation Paper 59, paras 6.24, 6.31 and 6.39 – 6.47. The Press Complaints Commission may act against journalists as it did in the 'Mirrorgate Affair'.

[31] Market Code 1.4.19 – 1.4.30.

[32] Market Code 1.5.8 – 1.5.11. The rationale must be a legitimate commercial rationale executed properly. It need not be the sole purpose for the transaction.

[33] Market Code 1.5.15 and 1.5.16. An 'actuating purpose' does not have to be the principal purpose.

[34] Market Code 1.5.18 – 1.5.20.

[35] Market Code 1.5.21 – 1.5.22.

[36] Market Code 1.5.23 – 1.5.29.

[37] Market Code 1.6.9 - 1.6.12. Again the purpose does not have to be the principal purpose. See above *Fleurose* [2001] EWHC 292.

[38] Market Code 1.6.13 – 1.6.18.

[39] Market Code 1.6.12, 1.6.16 and 1.6.19

[40] Market Code 1.4.4 and 1.5.18.

[41] CJA 1993, Part V; FSMA ss 123, 397, 402 and 403. The FSA's general approach to market abuse is contained in the Enforcement section of its Handbook, particularly Chapter 14.

[42] FSMA ss 380 to 386 and 392.

[43] FSMA ss 127 and 133.

[44] Convention Art 6(3) and 7(1) as interpreted by cases like *Kokkinakis v Greece* (1993) 17 EHRR 397, *Murray v United Kingdom* (1996) 22 EHRR 29 and on compelled statements *Saunders v United Kingdom* (1996) 23 EHRR 313.

[45] FSMA ss 114(8), 122, 123(2), 134 to 136 and 174(2).

[46] *Fleurose* para 34; *Engel v The Netherlands (No 1)* [19876] 1 EHRR 647.

[47] FSMA s 390(9).

[48] [1998] EHRLR 338.

[49] [1983] 5 EHHR 533

[50] In fact the defendant had been legally represented except at the disciplinary appeal and Morison J actually doubted that the defendant had been compelled to give evidence.

[51] *Hansard* vol 613 HL, 12 June 2000, cc 1377 – 1380.

[52] FSMA s 120; Market Code 1.7.4.to 1.7.13.

[53] FSMA s 143; FSA Handbook, Market Conduct, Chapter 4.1 to 4.3. Designated investment business is the type of business that required authorisation under the Financial Services Act 1986, ie not deposit-taking or general insurance.

[54] *Hansard* vol 351 HC, 5 June 2000, c 105.

[55] FSA Handbook, Enforcement, Chapter 14.4; FSMA s 118(1)(c) and (10).

[56] FSMA ss 124 and 125; Consultation Paper 17, para 143; FSA Handbook, Enforcement, Chapter 14.7.

[57] FSMA s 131.

[58] FSMA ss 382(1) and (8), 383(1), (3) and (10) and 384(1) and (6). Market abuse again includes indirect market abuse through requiring or encouraging others to engage in actions. The Secretary of State can not seek remedial orders for insider dealing or market abuse.

[59] FSA Handbook, Enforcement, Chapter 9; Consultation Paper 17, paras 155 and 158.

[60] Enforcement Chapter 9.3.2.

[61] MA Directive Art 1.

[62] MA Directive, Explanatory Memo section 1(b) and Arts 1 and 2.

[63] MA Directive Arts 3 and 4.

[64] MA Directive Arts 2, 9 and Annex section A.

[65] MA Directive Art 6(1).

[66] MA Directive Arts 6 to 8.

[67] 1999/468/EC; MA Directive Art 17.

[68] MA Directive Art 6(2) and (4).

[69] FSMA ss 121 and 125.

[70] MA Directive Art 1.

[71] MA Directive Annex Section B, which also includes ‘wash sales’, ‘pumping and dumping’, ‘scalping’ etc.

[72] Explanatory Memo section 1(d).

[73] MA Directive Art 5 as interpreted by Explanatory Memo on Art 5.

[74] MA Directive Art 10 (as interpreted by Explanatory Memo on Art 10) and Art 16.

[75] Explanatory Memo section 1(d).

[76] MA Directive Arts 11 to 13 and 15. The FSA, together with the Financial Services and Markets Tribunal, would seem to meet all these requirements. The UK has always allowed regulators a wide discretion to share information, FSMA ss 348 to 353.

[77] Explanatory Memo on Art 14.

[78] COM(2001) 280 final.