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a summary of the Financial Services Authority's
market abuse regime
in the United Kingdom



INTRODUCTION

On 1 July 2005, the Financial Services and Markets Act 2000 (Market Abuse) Regulation 2005 (the “Regulations”) came into force in order to implement the EC Directive on Insider Dealing and Market Manipulation (Market Abuse) (2003/6/EC) (the “Directive”). The Regulations amend the market abuse provisions in Part 8 of the Financial Services and Markets Act 2000 (“FSMA”).

The market abuse regime applies to the public at large and not only to the regulated sector. The amendments to the FSMA market abuse regime introduced important changes for publicly traded issuers, their advisors and senior management, those authorised under FSMA, those who recommend investments or investment strategies and those who participate in the investment markets.

The sanctions which may be imposed following a finding of market abuse are severe. Offenders may face unlimited financial penalties and, if they work in the financial services industry, they may have their livelihood removed by having their authorisation/approval withdrawn or a prohibition order made against them.

The Directive also introduced into the UK a new requirement for firms to report transactions giving rise to suspicions of market abuse. “Transaction reports” as they are called play a key role in the FSA’s market abuse monitoring work. The FSA takes a serious view of firms which fail to report transactions in line with FSA rules or which do not have in place adequate internal transaction reporting procedures and systems (see below).

Even in cases of market misconduct which do not necessarily fall within the definition of civil market abuse, the FSA can still take action against a firm or individual (if they are authorised to conduct investment business) based on a breach of its Principles in the FSA Handbook. For example, in June 2005 the FSA took enforcement action against Citigroup for a bond trading strategy which temporally disrupted the operation of the relevant bond trading platform despite the FSA not characterising the strategy as market abuse (see paragraph [] below).

A person who engages in conduct amounting to market abuse may find that it is also in breach of the provisions of the criminal law which runs in parallel to the FSMA market abuse regime. Sections 401 and 402, FSMA give the FSA power to prosecute a number of offences under FSMA and other legislation. The offences, for which the FSA can take criminal action, are broad. Some of the most important are:

- offences relating to breaches of the FSA Listing Rules, including that of offering new securities to the public in the UK before publishing a prospectus, if required by Listing Rules under section 84, FSMA (section 85(2), FSMA);
- making misleading statements and market manipulation (section 397, FSMA);

- misleading the FSA (section 398, FSMA);
- insider dealing under Part V of the Criminal Justice Act 1993 (the “CJA”); and
- breaches of prescribed regulations relating to money laundering.

When the FSA commences a criminal investigation, in many cases the FSA will use the regulatory enforcement process instead of, or alongside, its criminal powers. The FSA has stated that where it considers that behaviour justifies criminal rather than civil penalties, the FSA will be prepared to pursue such cases through the criminal courts.

The following sections of this note:

- summarise the key features of the FSA’s civil market abuse regime in the UK and the obligations on firms to report suspicious transactions;
- discusses some of the other regulatory powers of the FSA for market misconduct; and
- introduces the criminal law applicable to market abuse, focusing on the offences of insider dealing (Part V, CJA) and recklessly making misleading statements (section 397, FSMA).

OVERVIEW OF CIVIL MARKET ABUSE REGIME

In the majority of cases, the FSA is likely to commence an investigation based on breaches of the civil market abuse regime. Under FSMA, market abuse is behaviour (which includes action or inaction) which:

- occurs in relation to “qualifying investments” (see below) admitted (or in respect of which a request has been made for admission) to trading on a “prescribed market” (see below) (or in the case of the market abuse insider dealing and the improper disclosure behaviours only, in relation to investments which are related investments in relation to such qualifying investments (that is, an investment whose price or value depends on the price or value of the qualifying investments)) (section 118(1)(a) FSMA); and
- falls within any one or more of the seven types of behaviour set out in sections 118(2) to 118(8) of FSMA, that is:
 - insider dealing (section 118(2), FSMA);
 - improper disclosure of inside information (section 118(3), FSMA);
 - misuse of information (section 118(4), FSMA);
 - manipulating transactions (section 118(5), FSMA);
 - manipulating devices (section 118(6), FSMA);
 - disseminating information likely to give a false or misleading impression (section 118(7), FSMA); and
 - misleading behaviour or market distortion (section 118(8), FSMA).

Each of the above key elements of market abuse is examined below.

The three behaviours of misuse of information ((iii) above), misleading behaviour and market distortion ((vii) above) will cease to have effect on 30 June 2008. In practice, this is unlikely to make a difference since there will be few situations where the conduct complained of will not fall in at least one of the other behaviours set out in FSMA.

The market abuse provisions apply to anyone (including a body corporate or individual), whether they are authorised in the regulated sector or not.

THE CODE

Under FSMA, the FSA is required to prepare and issue a code containing such provisions as the FSA considers, or give appropriate guidance, for those assessing whether or not behaviour amounts to market abuse (section 119, FSMA). Following the implementation of the Directive, the FSA issued a substantially reworded Code of Market Conduct (the “Code”) which forms chapter one of the FSA’s Market Conduct Sourcebook (“MAR 1”). The Code sits alongside the types of market abuse specified by FSMA and the two therefore need to be considered together.

In general terms, the Code approaches each type of market abuse by setting out those factors which point to whether there might be market abuse, before considering whether there is some reason why the behaviour concerned is not market abuse. The Code does not provide an exhaustive list of behaviours which may or may not amount to market abuse. To the extent that a person behaves in a way which is described as behaviour that, as specified by the Code, does not amount to market abuse that behaviour is to be taken, for the purposes of FSMA, as not amounting to market abuse (section 122(1), FSMA).

TERRITORIAL SCOPE

Behaviour can amount to market abuse if it occurs:

- in the UK; or
- in relation to qualifying investments¹ which are admitted to trading² on a prescribed market situated or operating in the UK (section 118A(1), FSMA).

Civil market abuse is not limited to conduct within the UK. Certain types of behaviour amounting to market abuse under the Directive (that is, the categories of market abuse outlined in paragraphs [] above) apply to behaviour within and outside the UK which relates to UK markets and to behaviour within the UK that relates to any other EEA regulated market. Where, for example, trading takes place on an EEA exchange from a place in the UK, the market abuse regimes of both the UK and the other EEA jurisdiction potentially will apply.

PRESCRIBED MARKETS

The definition of prescribed markets is found in the Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001 (as amended) (SI2000/996) (the “2001 Order”).

For the behaviours noted in [] [] above, prescribed markets include any market established under the rules of a UK Recognised Investment Exchange (“RIE”), OFEX and all other regulated markets based in EEA countries. For the behaviours noted in [] [] above, prescribed markets include any market established under the rules of a RIE and OFEX only.

Currently, the prescribed UK markets are:

- The London Stock Exchange plc (including the AIM market³).
- EDX London Ltd.
- LIFFE Administration and Management.
- OFEX3.
- NYMEX Europe Limited.
- ICE Futures.
- The London Metal Exchange Limited.
- vert-x Exchange Limited.

Regulated market has the meaning given in article 1(13) of the Investment Services Directive 1993/22/EC (the “ISD Directive”). A list of EEA regulated markets can be found at http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2005/c_300/c_30020051130en00230028.pdf

QUALIFYING INVESTMENTS

Article 5 of the 2001 Order defines qualifying investments as all financial instruments within the meaning of the Directive, that is:

- “Transferable securities” as defined in the ISD Directive (for example, shares and other securities equivalent to shares in companies, bonds and other forms of securitised debt which are negotiable on the capital market and any other securities normally dealt in giving the right to acquire any such transferable securities by subscription or exchange or giving rise to a cash settlement, excluding instruments of payment).
- Derivatives on commodities.
- Financial–futures contracts, including equivalent cash–settled instruments.
- Forward interest–rate agreements.
- Interest–rate, currency and equity swaps.

¹ Or, in the case of the insider dealing and improper disclosure behaviours, investments which are related investments in relation to such qualifying investments.

² Or for which a request has been made for admission to trading.

³ This is an area where the UK regime is wider than the Directive, as the Directive only applies to “regulated markets” which do not include AIM or OFEX.

- Money–market instruments.
- Options to acquire or dispose of any instrument falling into these categories, including equivalent cash–settled instruments. This category includes in particular options on currency and on interest rates.
- Units in collective investment undertakings.
- Any other instrument admitted to trading on a regulatory market in a Member State or for which a request for admission to trading on such a market has been made.

INSIDER DEALING

The first type of behaviour categorised as market abuse is insider dealing which occurs where an “insider” (see below) deals or attempts to deal in a qualifying or “related investment” (see below) on the basis of “inside information” (see below) relating to the investment in question (section 118(2), FSMA). This sits alongside the existing criminal offence of insider dealing under the CJA (see below).

Insider

An insider is defined in section 118(b), FSMA as any person who has inside information:

- as a result of his/her membership of an administrative, management or supervisory body of an issuer of qualifying investments;
- as a result of his/her holding in the capital of an issuer of qualifying investments;
- as a result of having access to the information through the exercise of his/her employment, profession or duties;
- as a result of his/her criminal activity; or
- which he/she has obtained by other means and which he/she knows, or could reasonably be expected to know, is inside information.

In relation to the first four points (a – d above), the person concerned does not need to know that the information is inside information, that is, there is no subjective element to those tests (MAR 1.2.9G).

Related investment

In relation to the behaviours of insider dealing and improper disclosure, the behaviour must occur in relation to either a qualifying investment or a “related investment”. The term related investment is defined in Section 130A(3), FSMA as an investment, in relation to a qualifying investment, whose price or value depends on the price or value of the qualifying investments. This definition includes, for example, an over the counter (“OTC”) swap which is settled by reference to the price of an International Petroleum Exchange contract. Physical commodities, however, would not qualify as they are not investments for the purposes of FSMA.

Inside Information

Insider dealing (section 118(2), FSMA) uses the concept of “inside information”. This is also used for “improper disclosure” (section 118(4), FSMA) (see below).

There are three definitions of inside information in FSMA:

- the first relates to qualifying investments/related investments which are not commodity derivatives (section 118C(2), FSMA – see below);
- the second relates to qualifying investments/related investments which are commodity derivatives (sections 118C(3) and 118C(7), FSMA – see below); and
- the third relates to persons charged with the execution of orders concerning any qualifying investments/related investments (section 118C(4), FSMA – see below).

Investments which are not commodity derivatives

Where the qualifying investments or related investments are not commodity derivatives, inside information is information of a “precise nature” (see below) which:

- is not “generally available” (see below);
- relates directly or indirectly to one or more issuers of the qualifying investment or to one or more of the qualifying investments themselves;
- would, if generally available, be likely to have a “significant effect” (see below) on the price of the qualifying investments (that is, qualifying investments actually issued by the issuer) or on the price of related investments;

(section 118C(2), FSMA).

Precise

Information is precise if it:

- indicates circumstances that exist or may reasonably be expected to come into existence or an event has occurred or may reasonably be expected to occur; and
- is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of qualifying investments or related investments;

(Section 118C(5), FSMA).

Not generally available

Information which can be obtained by research or analysis conducted by the users of the market is to be regarded as being generally available to them (Section 118C(8), FSMA).

The Code gives guidance on the meaning of “not generally available”. MAR 1.2.12 states that, in the opinion of the FSA, certain factors are to be taken into account in determining whether or not information is generally available, for example whether the information has been disclosed to a prescribed market through a

Regulatory Information Service (“RIS”) or otherwise in accordance with the rules of that market or whether the information is otherwise generally available, including through the internet, or some other publication (including if it is only available on payment of a fee) or is derived from information which has been made public.

According to the Code, it is not relevant that the information is only generally available outside the UK. Except in relation to information contained in records which are open to inspection by the public above, it is also not relevant that the observation or analysis is only achievable by a person with above average financial resources, expertise or competence (MAR 1.2.13E).

Likely to have a significant effect

Information would be likely to have a significant effect on price if it is information of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions (section 118C(6), FSMA).

The FSA’s Disclosure Rules (“DR”) give some guidance on the concept of significant effect in relation to the disclosure obligations of issuers in possession of inside information. The guidance states that, in determining the likely price significance of the information, an issuer should assess whether there would be a significant effect on the price of the issuers’ financial instruments. The guidance provides that there is no figure that can be used for determining what constitutes a “significant effect” on the price of the financial instruments. According to DR, any assessment should take into consideration the anticipated impact of the information in light of the issuer’s total activities, the reliability of the source of the information and other market variables likely to effect the relevant financial instruments in the given circumstances.

Commodity Derivatives

As noted above, there is a separate definition of inside information for commodity derivatives. Section 118C(3) provides that, for commodity derivatives, inside information is information of a “precise” nature (see above) which is “not generally available” (see above), relates directly or indirectly to one or more commodity derivatives and users of markets on which the derivatives are traded would expect to receive in accordance with any accepted market practices on those markets.

Section 118C(7), FSMA provides that users of markets on which investments in commodity derivatives are traded are to be treated as expecting to receive information which is:

- routinely made available to users of those markets; or
- is required to be disclosed in accordance with any statutory provision, market rules or contracts or customs on the relevant underlying commodity market or commodity derivatives markets.

This means that a person will not be in receipt of inside information, in relation to commodity derivatives, where there is no obligation to publish such information, for example monthly production statistics or capacities.

Execution of Orders

As noted above, there is a separate definition of inside information for persons charged with the execution of orders (i.e. traders and market makers). Section 118C(4), FSMA provides that, for such persons, inside information includes information conveyed by a client and related to the client’s “pending orders” which is of a “precise” nature (see above), is “not generally available” (see above), relates directly/indirectly to one or more issuers of qualifying investments or to one or more qualifying investments and would, if generally available, be likely to have a “significant effect” (see above) on the price of those qualifying investments or the price of related investments.

The purpose behind this provision is to expressly ensure that the practice of “front running” is classified as market abuse (i.e. purchasing shares for a trader’s own benefit on the basis of, and ahead of, orders from investors in order to benefit from an anticipated impact on prices). Section 118C(4), FSMA is also broadly in line with the Client Order Handling provisions of the Implementing Directive of MiFID, which provide that a firm should not misuse information relating to pending client orders.

Factors which indicate that there is a pending order for a client are set out in the Code and include the situation where a person is approached by another in relation to a transaction and:

- the transaction is not immediately executed on an arm’s length basis in response to a price quoted by that person; and
- the person concerned has taken on a legal or regulatory obligation relating to the manner or timing of the execution of the transaction;

(MAR1.2.16E).

The nature of this guidance suggests that, where, following a request from a client, a trader provides a quote on the price of a particular investment, the information the trader has ascertained from the client’s request will not be inside information if the client informs the trader that he does not wish to go ahead with any transaction in respect of that investment. The trader will probably not commit market abuse insider dealing if, following this, he purchases the investments for his own account. This is because the trader has not assumed a legal or regulatory obligation relating to the manner or timing of the execution of a transaction for the client.

The situation is less straight forward however where, for example, a trader provides a quote on the price of an investment but, after providing the quote, the client does not contact the trader again to execute the transaction. If the trader trades in the particular investment for his own account after providing the client with the quote, the question of whether his conduct will amount to market abuse will depend on the particular factual circumstances of the case, for example the size of the trade, the liquidity/price volatility of the investment and the period of time which elapsed after the quote was given.

“On the basis of”

For the behaviour to comprise insider dealing, the dealing must be “based on” the inside information so that the insider has consciously taken advantage of it. Indications that a person’s behaviour is not “on the basis of” inside information are:

- if the decision to deal or attempt to deal was made before the person possessed the relevant inside information;
- if the person concerned is dealing to satisfy a legal or regulatory obligation which came into being before he possessed the relevant inside information; and
- where a person is an organisation, if non of the individuals in possession of the inside information had any involvement in the decision to deal, or behaved in such a way as to influence, directly or indirectly, the decision to engage in the dealing or had any contact with those who were involved in the decision to engage in the dealing whereby the information would have been transmitted (MAR 1.3.3E).

Where the inside information is the principal reason for the decision to deal or attempt to deal, the FSA has indicated that it will view this as an indication that the persons behaviour is “on the basis of” inside information (MAR 1.3.4E).

Examples of behaviour not amounting to Insider Dealing

The Code sets out specific examples of behaviour which do not amount to market abuse. One such example relates to those persons that may lawfully deal in qualifying investments or related investments on their own account (ie traders and market makers). For such persons, pursuing their “legitimate business” will not amount to market abuse (MAR 1.3.6C & 7C). The purpose behind this is to ensure that such traders will not commit market abuse in relation to client pending orders by reason of section 118C (4), FSMA.

Legitimate business is defined to include certain factors, such as the extent to which the relevant trading is carried out in order to hedge a risk or that the person’s behaviour was reasonable by the proper standards of conduct of the market concerned or that the relevant trading had been disclosed to the client and he had not objected to it (MAR1.3.10E).

The nature of this guidance suggests that, where a trader is asked by a client to provide a quote on the price of a particular investment, the trader is unlikely to commit market abuse if he goes into the market and selectively buys investments for the purpose of giving the requested quote and the client enters into a transaction as a result of that quote. Although the trader is acting on the basis of information relating to a pending order, he will be able to rely upon the legitimate business exemption in the Code (assuming that, for example, the behaviour was in order to hedge a risk or that the relevant trading was first disclosed to the client who had not objected to it).

The Code also provides that, if inside information is not limited to “trading information”, this indicates that the behaviour is not in pursuit of legitimate business. “Trading information” is defined in the FSA rules as (a) information that investments of a particular kind have been or are to be or not to be bought/sold or are under consideration or the subject of negotiations, (b) or information on the quantity of investments or the price or range of prices at which investments are to be bought/sold, or (c) information on the identity of persons involved or likely to be involved in any capacity in a purchase/sale.

Where particular trading does not amount to market abuse, it may nonetheless amount to some other form of improper conduct for which the FSA could take action if the execution of the trade appears to the FSA to be, for example, generally unfair to customers (such as a breach of the FSA’s Principles - see below).

IMPROPER DISCLOSURE

The second type of behaviour categorised as market abuse is improper disclosure. This occurs where an insider discloses inside information to another person otherwise than in proper performance of his employment, profession or duties (section 118(3), FSMA (commonly referred to as “tipping off”).

The definitions of “insider” and “inside information”, as described above, apply to improper disclosure in the same way that they apply to insider dealing.

FSA guidance on improper disclosure can be found in the Code (MAR 1.4). According to the FSA, certain factors are to be taken into account in determining whether or not disclosure is made by a person in the proper performance of his employment, profession or duties and are indications that it was. For example, whether the disclosure is permitted by FSA rules, the rules of a prescribed market, or the Takeover Code or whether the disclosure is accompanied by the imposition of confidentiality requirements upon the person to whom the disclosure is made and is reasonable and is to enable a person to perform the proper functions of his employment, profession or duties.

The Code sets out examples of improper disclosure such as where a director of an issuer discloses inside information to another in a social context (MAR 1.4.6G).

MISUSE OF INFORMATION

The third type of behaviour amounting to market abuse is misuse of information (section 118(4), FSMA). This occurs where behaviour (not amounting to insider dealing or improper disclosure):

- is based on information which is not generally available to those using the market but which, if available to a regular user of the market, would be, or would be likely to be, regarded by him as “relevant” (see below) when deciding the terms on which transactions and qualifying investments should be effected; and
- is likely to be regarded by a regular user of the market as a failure on the part of person concerned to observe the standard of behaviour reasonably expected of the person in his position in relation to the market.

Regular user is defined, in relation to a particular market, as a reasonable person who regularly deals on that market in investments of the kind in question (section 130A(3), FSMA).

An example of this behaviour is where an employee of a company informs a friend over lunch that the company has received a takeover offer and the friend then places a fixed odds bet with a bookmaker that the same company will be the subject of a bid within a week (MAR.105.10E(1)). The person making the bet would not be guilty of insider dealing as he would not be “dealing” in qualifying investments which is a requirement of the insider dealing behaviour.

Misuse of information will cease to be market abuse on the 30 June 2008.

Relevant Information

The information which is capable of being relevant is wider than that which falls within the definition of inside information. For example, information will only be inside information within the meaning of section 118(C), FSMA (see above) if, amongst other things, it would, if generally available, be likely to have a significant effect on the price of the a company's shares. Such information, however, is capable of being relevant information even if it would not have a significant effect, provided that the regular user of the market on which the company shares are traded would regard it as relevant in deciding whether or not to buy or sell the company shares.

MANIPULATING TRANSACTIONS

The fourth type of behaviour amounting to market abuse is manipulating transactions (section 118(5), FSMA) which occurs where the behaviour consists of effecting transactions or orders to trade (otherwise than for legitimate reasons and in conformity with accepted market practices on the relevant market) which:

- give, or are likely to give, a false or misleading impression as to the supply of, or demand for, or as to the price of, one of more qualifying investments (for example, entering orders onto an

electronic trading system at prices which are higher than the previous bid or lower than the previous offer and withdrawing them before they are executed in order to give a misleading impression that there is demand for, or supply of, the qualifying investment at that price (MAR 1.6.2E)); or

- secure the price of one or more such investments at an abnormal or artificial level (for example trading on one market or trading platform with a view to improperly influencing the price of the same or related investments that are traded on another prescribed market (MAR1.6.4E)).

An “abusive squeeze” is considered by the FSA to be a manipulating transaction under the Code (MAR 1.6.16E). For example, a trader with a long position in bond futures buys or borrows a large amount of the cheapest-to-deliver bonds and either refuses to re-lend those bonds or will only lend them to parties he believes will not re-lend to the market. His purpose is to position the price at which those with short positions have to deliver to satisfy their obligations at a materially higher level, making him a profit from his original position.

This type of behaviour will not occur however where the behaviour is for “legitimate reasons” and in accordance with accepted “market practices”. The Code sets out indications of behaviour that is for legitimate reasons (MAR1.6.6E) and behaviour which is not for legitimate reasons (MAR1.6.5E). A non-exhaustive list of factors that the FSA takes into account in assessing whether to accept a particular market practice is also set out in the Code at Annex 2G. Such accepted market practices do not constitute safe harbours and, in the absence of a legitimate purpose, the accepted market practice defence would not be available.

The only accepted market practices expressly stated by the FSA to not amount to market abuse are those practices set out in the London Metal Exchange's document “Market Aberrations: The Way Forward” published in October 1998 which governs the behaviour expected on long position holders.

The Codes further sets out specific examples of market abuse amounting to manipulating transactions (MAR1.6.15E).

MANIPULATING DEVICES

The fifth type of behaviour constituting market abuse is manipulating devices, which consists of effecting transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance (section 118(6), FSMA).

The Code sets out behaviours which, in the opinion of the FSA, constitute manipulating devices (MAR1.7.2E) for example taking advantage of occasional or regular access to the traditional or electronic media by voicing an opinion about qualifying investments whilst having previously taken positions on the investments and profiting subsequently from the impact of the opinions voiced on the price of that instrument, without having simultaneously disclosed that conflict of interest to the public in a proper and effective way.

“Pump and dump” (i.e. taking a long position in an investment and then disseminating misleading positive information about that investment, with a view to increasing its price) and “trash and cash” (i.e. taking a short position in an investment and then disseminating misleading negative information about that investment, with a view to driving down its price) are both considered by the FSA to be manipulating devices within the meaning of civil market abuse (MAR 1.7.2 E (3) and (4)).

The Code also sets out the factors to be taken into account which indicate that behaviour amounts to manipulating devices (MAR1.7.3E). For example disseminating misleading information by persons before or after the purchase of shares.

DISSEMINATION

The sixth type of behaviour amounting to market abuse is dissemination which consists of the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knew or could reasonably be expected to have known that the information was false or misleading (section 118(7), FSMA).

An example of behaviour, in the opinion of the FSA, which falls within this category is knowingly or recklessly spreading false and leading information about a qualifying investment through the media, for example by posting information which contains false or misleading statements about a qualifying investment on an internet bulletin board or in a chat room in circumstances where the person knows that the information is false or misleading. (MAR 1.8.6 E).

MISLEADING BEHAVIOUR OR DISTORTION

The seventh and final type of behaviour amounting to market abuse is misleading behaviour or distortion which is not covered under the previous headings (section 118(8), FSMA).

This occurs when behaviour:

- is likely to give a regular user of the market a false and misleading impression as to the supply of, demand for or price or value of, qualifying investments (“misleading behaviour”); or
- would be, or would be likely to be, regarded by a regular user of the market as behaviour that would distort, or would be likely to distort, the market in such an investment (“distortion”); and
- the behaviour is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market.

The behaviour described in section 118(8), FSMA is a revised version of market distortion from the UK market abuse regime which existed before 1 July 2005. Like misuse of information, this will cease to have effect on 30 June 2008.

The Code provides an example of when behaviour will fall within this category. For example, the movement of an empty cargo ship, which might create a false or misleading impression as to the supply of, or the demand for, or the price or value of, a commodity, could amount to misleading behaviour. As the offence is wider than the behaviours of manipulating transactions, manipulating devices and dissemination, as in this particular example, behaviour does not involve effecting transactions orders or trade or the dissemination of information.

ENCOURAGING MARKET ABUSE

In addition to the primary offence of market abuse, a person (“A”) who takes or refrains from taking any action that requires or encourages another person or persons to engage in behaviour, which if engaged by A, would amount to market abuse is guilty of an offence (section 123(1) - (6), FSMA). An example of this is where a person recommends or advises a friend to engage in behaviour which, if he himself engaged in it, would amount to market abuse (MAR 1.2.23G(2)). There is no requirement, however, for the person to have actually benefited from the offence.

EXCEPTIONS

Section 122, FSMA provides that, if a person behaves in a way which is described in the Code as behaviour that, in the FSA’s opinion, does not amount to market abuse, that behaviour of his is to be taken as not amounting to market abuse.

The Code sets out three safe harbours to the market abuse regime:

- Behaviour which conforms with the Buyback and Stabilisation provisions in Commission Regulation EC 2273/2003 (MAR 1 Annex 1 sets out the requirements of the “Buyback and Stabilisation Regulation”). The Code points out that buyback programmes which are not within the scope of the Buyback and Stabilisation Regulation are not, in themselves market abuse (MAR1.10.1G(3)). However, the FSA has declined to give any further guidance for determining whether a particular share buyback arrangement amounts to market abuse if it does not fall within the Buyback and Stabilisation Regulation (FSA Market Watch Newsletter, Issue No. 12, June 2005).
- Conformity with a rule which includes a provision to the effect that the behaviour conforming with the rule does not amount to market abuse (section 118A(5), FSMA). This applies to, for example, COB2.4.4R(1)(Chinese walls) and those parts of FSMA which relate to the timing, dissemination or availability, content and standard of care applicable to a disclosure, announcement, communication or release of information.

- Behaviour conforming with:
 - Any of the rules of the Takeover Code or Substantial Acquisition Rules (“SAR”) about the timing, dissemination or availability, content of standard of care applicable to a disclosure, announcement, communication or release of information;
 - Rule 4.2 of the Takeover Code if the behaviour is expressly required or is expressly permitted by that rule and it conforms to any General Principle set out in Section B of the Takeover Code relevant to the rule.

PENALTIES FOR MARKET ABUSE

If the FSA is satisfied that a person is engaging in, or has engaged in market abuse, or has required or encouraged another person to do, it may:

- impose an unlimited civil fine;
- make a public statement that the person has engaged in market abuse;
- apply to the Court for an injunction to restrain threatened or continued market abuse;
- require a person to disgorge profits made or losses avoided as a result of market abuse;
- require the payment of compensation to victims.

In some cases, the FSA may rely on individual Recognised Investment Exchanges (“RIE”) to take action and the FSA has agreed operating arrangements with such RIE’s in relation to market conduct for this purpose.

It should be noted that the FSA may not impose a penalty if there are reasonable grounds to be satisfied that the person in question believed on reasonable grounds, that his behaviour did not amount to market abuse, or took all reasonable precautions and exercised due diligence to avoid engaging in market abuse.

SUSPICIOUS TRANSACTION REPORTING

In addition to the amendments to the civil market abuse regime under FSMA, the Directive introduced into the UK a new requirement for financial intermediaries to report transactions giving rise to suspicions of market abuse. An FSA authorised firm which arranges or executes a transaction with or for a client in a qualifying investment admitted to trading on a prescribed market, and which has reasonable grounds to suspect that the transaction might constitute market abuse, is required to notify the FSA without delay (SUP 15.10.2R).

Where a notification is made, the FSA authorised firm must provide the FSA with the description of the transaction and the reasons for the suspicion. Any such notification will be deemed a “protected disclosure” and so will not amount to being an improper disclosure of inside information within section 118(3), FSMA.

The FSA takes notifications it receives seriously and the FSA has indicated that it will pursue cases where firms notify transactions without having first seriously considered whether they meet the test of reasonable suspicion. Ultimately, the FSA’s main concern is to ensure that the firms have the necessary procedures and systems to meet these requirements (see FSA Market Watch, Issue No. 12, June 2005).

OTHER FSMA PROVISIONS

In cases of market misconduct which do not necessarily fall within the definition of civil market abuse or satisfy the requirements of the criminal law (see below), the FSA can still take action against a firm or individual if they are authorised to conduct investment business based on breaches of other provisions.

Principles

Behaviour which constitutes market abuse will also constitute a breach of Principle 5 of the FSA High Level Principles for Business set out in the FSA Handbook. Principle 5 requires a firm to observe proper standards of market conduct. Conduct which constitutes a breach of Principle 5 will not necessarily constitute market abuse (for example, because it does not involve behaviour in relation to a prescribed market for the purposes of the market abuse regime). Where it is unclear or arguable where the main misconduct lies, the FSA may elect to bring proceedings for both market abuse and, in the alternative, Principle 5.

On 10 April 2006, the FSA issued a final notice against Deutsche Bank AG in which it imposed a financial penalty of around £6 million for acting in breach of (amongst other matters) Principle 5. The offence related to market practices by Deutsche Bank in and around March 2004 in connection with its agreement to purchase shares from AB Volvo and to dispose of them by way of an “accelerated book build” (ie where a bank acquires a block of securities and compiles a “book” of orders from clients). The FSA’s civil market abuse regime did not apply because, at the time of the offence, the relevant shares were not listed on a prescribed market. This case is a good illustration of the FSA taking action against a firm for breach of Principle 5 where the civil market abuse regime does not technically apply.

In addition, where behaviour has a negative market impact but does not necessarily constitute market abuse, the FSA may commence disciplinary proceedings even where there is no breach of specific FSA rules or breach of FSA Principle 5.

In June 2005, Citigroup Global Markets Limited (“Citigroup”) were ordered by the FSA to relinquish profits of £9.96 million and to pay an additional penalty of £4 million for a bond trading strategy which temporarily disrupted the operation of the relevant bond trading platform, resulting in a short term drop in bond prices. Notably, the FSA did not find that the trading amounted to market abuse, but the FSA nonetheless found Citigroup liable for its trading strategy because it had breached FSA Principle 2

and 3 (it had failed to conduct its business with due skill, care and diligence, or take reasonable care to organise and control its affairs reasonably and effectively). The FSA's decision is controversial because it casts doubt generally on the legitimacy of market impact trades that do not result in any contravention of specific FSA rules or FSA principles which directly concern market confidence or fair treatment to investors.

In March 2004, the FSA took action against Morgan Grenfell and Co Limited (Final Notice, 18 March 2004) for the firm's conduct towards customers and the management of conflicts of interests in the course of a blind bid principal programme trade conducted in April 2002. The FSA did not find that the programme amounted to market abuse, but did find that there had been a breach of FSA Principles 6 and 8 in that the firm had failed to pay due regard to the interests of its customers and to treat them fairly and had failed to manage conflict of interests fairly.

Listing Rules

Under section 91(1), FSMA, the FSA can impose civil penalties on an issuer and its directors who were knowingly concerned in a breach of the FSA's Listing Rules. Under section 88, FSMA the FSA also has power to cancel a person's approval as a sponsor and, under section 89, FSMA the FSA can publicly censure sponsors. These are separate to the criminal offence of making misleading statements to the market under section 397(1), (see above).

In some cases where there are potential breaches of the FSA's Listing Rules or the Combined Code, a range of enforcement actions will be available to the FSA, including action for breaches of the FSA Principles (where a regulated firm is involved), civil law remedies and the criminal law. In the Shell case, Shell was fined £17 million in 2004 for market abuse (the current relevant provisions are 118(5), FSMA) by the FSA although no separate penalty was imposed for Listing Rule breaches.

In March 2004, the FSA fined the former CEO of SportsWorld Media Group plc £45,000 for Listing Rule breaches (Listing Rule 9.2 concerning notifications of relevant information) and, in May 2004, fined the CEO of Universal Salvage plc £10,000 for similar breaches (Listing Rule 9.1(a)).

THE CRIMINAL LAW

A person who engages in market abuse may find that it is also in breach of the provisions of the criminal law. As briefly noted above (paragraph []), there are three key prohibited activities specifically in relation to market abuse which are treated as criminal offences for which the FSA can take action:

- Insider dealing (Part V, CJA) (the Department of Trade and Industry ("DTI") also has the power to investigate and prosecute insider dealing offences – Annex 1G to the FSA's Enforcement Manual sets out the general guidelines for determining whether the FSA or DTI should deal with a particular case of suspected Insider Dealing).

- Misleading statements (section 397(1), FSMA formerly section 47(1), Financial Services Act 1986 (the "1986 Act"));
- Market manipulation (section 397(3), FSMA formerly section 47(2), 1986 Act);

The FSA has described these three offences as "a relatively narrow range of very serious misconduct" (paragraph 2.10, FSA Consultation Paper 59). A person found guilty of these offences is liable to imprisonment (not exceeding seven years), a fine or both.

The FSA may take action against individuals or corporations (except for the criminal offence of insider dealing, where proceedings can only be taken against an individual). Where an offence by a corporation is shown to have been committed with the consent or connivance of an officer, or be attributable to any neglect on his part, the officer, as well as the corporation, is guilty of the offence and liable to punishment (section 400(1), FSMA).

The criminal offences for which the FSA can take action are broad and the FSA has stated that where it considers the behaviour justifies criminal, rather than civil penalties, the FSA will be prepared to pursue such cases through the criminal courts.⁴ The FSA demonstrated its commitment and ability to do this in 2005 by the successful prosecution of the directors of AIT (see below). However, the higher standard of proof in criminal cases and the consequential higher costs make proceedings under the enforcement route a more likely option for the FSA than the criminal courts and the FSA's powers have, to date, been used primarily within the regulatory framework.

When the FSA decides to commence criminal proceedings, it will take into account those factors set out in the Code for Crown Prosecutors (ENF 15.5).

Where, for example, a suspect is interviewed by the FSA using its compulsory powers under Sections 171-173, FSMA the responses given in the interview cannot be used in evidence against the suspect in subsequent criminal proceedings. This is in contrast to the position where statements made by a person to an investigator, other than in compliance with an information requirement (such as statements made voluntarily), can be used in evidence in any subsequent criminal proceedings (see Morgan Lewis' brochure on Enforcement Procedures in the UK, April 2006).

There may be cases where behaviour which amounts to criminal market misconduct under FSMA may also be behaviour which will be subject to investigation by the SFO, the DTI, or the police. The FSA provides the secretariat for the Financial Fraud

⁴ The FSA has stated that it is not its policy to impose a sanction for market abuse where a person is being prosecuted for market misconduct or has been finally convicted/acquitted of market misconduct in a criminal prosecution arising from substantially the same facts (FSA Enforcement Manual "ENF" 15.7.4G). It may nonetheless take other regulatory action (for example applying to the Court for an injunction).

⁵ The definition of inside information in the CJA is broadly similar to, but uses different terms to, the definition of inside information in FSMA.

Information Network which brings together regulatory and law enforcement agencies to co-ordinate efforts and share information. The FSA is, in any event, required under FSMA (section 354) to co-operate with others on the prevention and detection of financial crime (including market abuse) so is likely to pass on any information it receives to other organisations, for example the police, the SFO or the British Bankers Association.

Insider Dealing

The definition of the criminal offence of insider dealing is very similar to the definition of the civil offence of insider dealing under FSMA, although there are some subtle differences in the wording and both sets of rules must therefore be considered when analysing insider dealing has occurred.

The criminal offence is committed if:

- an “insider” (see below) deals in price affected “securities” (see below) when in possession of “inside information” (see below);
- an insider encourages another to deal in price affected securities when in possession of inside information; and
- an insider discloses inside information otherwise than in the proper performance of his employment, office or profession.

The first two offences are committed either when the dealing in securities takes place on a “regulated market” (see below) or where the person dealing in the price affected securities relies on a professional intermediary or is himself acting as professional intermediary (section 52(3), CJA).

An “insider” is defined in the CJA as a person who holds inside information and knows that it is inside information and it was acquired knowingly from an inside source (for example himself, him being a director, employee or shareholder of a company, or by virtue of his employment that does not relate to the company to which the information relates or from a person who obtained it in one of these ways).

Under the CJA³, inside information is defined as information which:

- relates to particular securities or particular issuers but not to securities or issuers of securities generally;
- is specific or precise;
- has not been made public (section 58, CJA contains a non exhaustive list of what “made public” means); and
- is price sensitive (i.e. if it were made public it would be likely to have a significant effect on the price of any securities).

“Securities” is defined in the CJA and comprises shares, debt securities, warrants, depositary receipts, options, futures and contracts for differences (section 54 in schedule 2 CJA). The scope of the criminal regime is narrower than civil market abuse which applies to all “qualifying investments” so includes, for example, derivatives on commodities.

“Regulated market”, for the purposes of the CJA, is defined in the Insider Dealing (Securities and Regulated Markets) Order 1994 to mean any market established under the rules of:

- the London Stock Exchange plc (including the AIM market) (the “LSE”).
- LIFFE Administration and Management.
- OMLX.
- the London Securities Derivatives Exchange Ltd.
- virt-x Exchange Limited.
- CoredealMTS.
- OFEX.
- the Regulated Markets set out in the attached Schedule.

This can be contrasted with the market abuse definition of “prescribed market” which is different and includes the LSE, LIFFE, virt-x, OFEX, EDX Ltd, NYMEX Europe Ltd, ICE Futures, the London Metal Exchange Limited and all other regulated markets based in EEA countries (see attached Schedule)..

There are a range of defences which are available to a person suspected of committing insider dealing. These defences are similar to the defences available to a person charged with civil market abuse though there are some differences. The defences are that, first, no advantage was gained. Secondly, that a person would have traded anyway if he had not had the inside information. Thirdly, that the person believed that the information had been widely disclosed.

There are also a number of “special defences” set out in Schedule One to the CJA in relation to activities by market makers, the dissemination of market information and permitted price stabilisation activities:

- Market Makers - such individuals are not guilty of insider dealing by virtue of dealing in securities or encouraging another person to deal if they show they acted in good faith in the course of their business as a Market Maker. A “Market Maker” is a person who holds himself out as willing to acquire or dispose of securities under the rules of the regulated market or an approved organisation and he is recognised as such.
- Market information – a person is not guilty of insider dealing:
 - by virtue of dealing in securities or encouraging another person to deal if he shows that the information he had as an insider was “market information” (defined very broadly as trading information, see above for the civil insider dealing offence) and that it was reasonable for a person in his position to deal in the security, despite having that information at the time of the dealing. In determining whether it is reasonable for an individual to have dealt in these circumstances, the content of the information, the circumstances in which he had the information and in what capacity and the capacity in which he acts shall be taken into account. This is broadly similar to the “legitimate business” exemption for the civil offence of insider dealing (see above).

- if he can show that he acted in connection with an acquisition or disposal (or a series of such), which was under consideration or negotiation, with a view to facilitating the accomplishment of the acquisition or disposal (or series of such) and that the information which he had as an insider was market information arising directly as a result of his involvement in the relevant acquisition or disposal (or series of such) (paragraph 3, Schedule 1, CJA – the “facilitation defence”).
- Price stabilisation – an individual is not guilty of insider dealing by virtue of dealing in securities, or encouraging another person to deal, if he shows he acted in conformity with the price stabilisation rules or the relevant provisions of the Buyback and Stabilisation Regulation (see above).

Misleading Statements

Under section 397(1), FSMA an offence is committed if a person:

- makes a statement, promise or forecast which he knows to be misleading, false or deceptive, in a material particular; or
- dishonestly conceals any material facts; or
- recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular;

for the purpose of inducing, or being reckless as to whether it may induce, another person (whether or not the persons whom the statement, promise or forecast is made or from whom the facts are concealed) to enter or offer to enter into, or to refrain from entering or offering to enter into, a relevant agreement or to exercise, or refrain from exercising any rights conferred by a relevant investment.

There are defences available in an action brought under section 397(1), FSMA (for example the exemptions for buyback programs and stabilisation of financial instruments discussed above).

An example of a misleading statement is where a company director of an issuer makes a public statement about the issuer (for example in relation to its profits) which induces a shareholder to sell shares where the company director making the statement knew (or was reckless so to whether) that statement was misleading.

In 2005, the FSA successfully prosecuted the former Chairman and Chief Executive and former Chief Financial Officer of the AIT Group plc for recklessly making statements to the market which were misleading. The FSA contended that AIT had made an announcement to the Stock Exchange in May 2002 incorrectly stating that the group’s profits and turnover would meet market expectations. The two directors were sentenced to 3 and a half and 18 months prison respectively: the custodial sentences were subsequently reduced on appeal to 18 months and nine months respectively. The case illustrates the severity of the offence and is the first time that the FSA has successfully prosecuted offenders under section 397(1), FSMA.

Market Manipulation

Under section 397(3), an offence is committed if any person does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any relevant investments if he does so for the purpose of creating that impression and thereby inducing another person to acquire, dispose of, subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by those investments.

The same defences available for misleading statements are available here and, as there is no “reckless” element, it is a defence for a person to show that he reasonably believed that the act would not create an impression that was false or misleading.

In December 2005, a former Daily Mirror journalist and a day trader were found guilty of conspiracy to contravene section 47(2) of the Financial Services Act 1986 (now replaced by section 397(3), FSMA) (this was a prosecution by the DTI rather than the FSA).

CONCLUSION

The actions the FSA may take under FSMA for suspected market misconduct are extensive. The FSA can take action not only against authorised persons (whether they are individuals or corporations) but also ordinary members of the public who engage in market abuse. Under FSMA, the FSA is given a broad range of powers which enable it to bring criminal or civil proceedings and enable it to adopt investigative methods more appropriately used by the Serious Fraud Office. Even where conduct is not caught by the civil offence of market abuse or the criminal law, the FSA can still take action if the firm or individual is regulated for breach of FSA Principles. Additionally, various other bodies have overlapping powers of investigation and prosecution. The guidelines agreed between the FSA and such other bodies (for example, the SFO or the DTI) do not necessarily preclude concurrent investigations by several bodies.

Market abuse is likely to remain one of the FSA's main wholesale enforcement priorities so it is likely that market abuse-related enforcement cases will continue to prominently feature over the course of the next few years. The FSA's powers have thus far been used primarily within the regulatory framework, rather than through the criminal courts, but the FSA has emphasised that, where it considers that behaviour justifies criminal rather than civil penalties, the FSA will be prepared to pursue such cases through the criminal courts. The prosecution of the former Chairman and Finance Director of AIT, under section 397, FSMA, is an example of the way in which the FSA may be heading.

For insider dealing and misleading-the-market related offences, the FSA has the choice whether to bring civil or criminal proceedings. Although the two regimes are similar, there are some subtle differences and both regimes must therefore be considered when analysing whether insider dealing or a market abuse may arise or has occurred. Although one might infer that compliance with the civil law guidance will give some comfort that there is no breach of the criminal law, no firm assurance can automatically be given that this is the case. The FSA has not issued or endorsed any guidance in respect of the criminal offence of insider dealing, for example, and has not issued any statements to the effect that compliance with the civil regime will result in a person not committing an offence under the criminal law. Similarly, the FSA has not issued guidance in respect of the criminal offences for market manipulation/misleading the market. For this reason, the position is somewhat unsatisfactory.

April 2006

Morgan Lewis

LON/JJG/RPF

A summary of the Financial Services Authority's market abuse regime in the United Kingdom

Schedule

Regulated Markets

Regulated markets, for the purposes of the CJA, is defined in the Insider Dealing (Securities and Regulated Markets) Order 1994 to mean any market established under the rules of the following investment exchanges:

Amsterdam Stock Exchange;
Antwerp Stock Exchange;
Athens Stock Exchange;
Barcelona Stock Exchange;
Bavarian Stock Exchange;
Berlin Stock Exchange;
Bilbao Stock Exchange;
Bologna Stock Exchange;
Bremen Stock Exchange;
Brussels Stock Exchange;
Copenhagen Stock Exchange;
the exchange known as COREDEALMTS;
Dusseldorf Stock Exchange;
the exchange known as EASDAQ;
Florence Stock Exchange;
Frankfurt Stock Exchange;
Genoa Stock Exchange;
Hamburg Stock Exchange;
Hanover Stock Exchange;
Helsinki Stock Exchange;
Iceland Stock Exchange;
The Irish Stock Exchange Limited;
Lisbon Stock Exchange;
LIFFE Administration & Management;
The London Stock Exchange Limited;
Luxembourg Stock Exchange;

Lyon Stock Exchange;
Madrid Stock Exchange;
Milan Stock Exchange;
Naples Stock Exchange;
The exchange known as NASDAQ;
The exchange known as the Nouveau Marché;
OMLX, The London Securities and Derivatives Exchange Limited;
Oporto Stock Exchange;
Oslo Stock Exchange;
Palermo Stock Exchange;
Paris Stock Exchange;
Rome Stock Exchange;
Stockholm Stock Exchange;
Stuttgart Stock Exchange;
The exchange known as SWX Swiss Exchange;
Trieste Stock Exchange;
Turin Stock Exchange;
Valencia Stock Exchange;
Venice Stock Exchange;
Vienna Stock Exchange;
virt-x Exchange Limited.

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