KEY FACTS COMPANY LAW

4th edition

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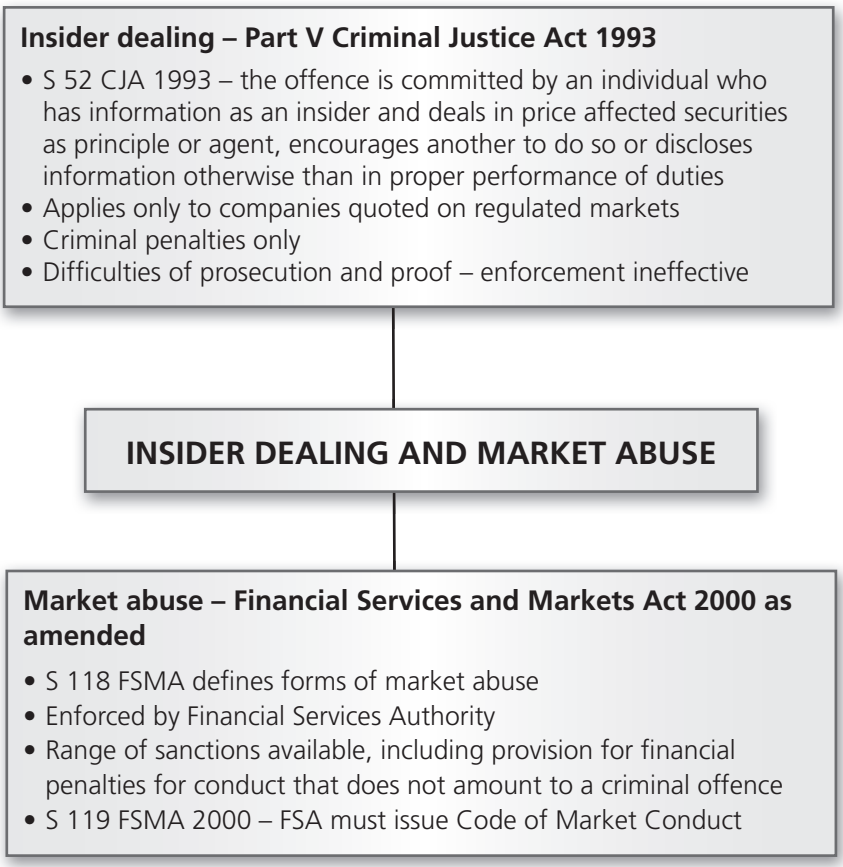
HODDER EDUCATION

13

Insider dealing and market abuse



13.1 Introduction

1. Insider dealing is an offence under the Criminal Justice Act 1993 (CJA 1993). The offence may be committed by an individual who uses unpublished information about the company, acquired by virtue of his position, to deal in price sensitive securities so as to make a profit or avoid a loss.
2. In recent years such conduct has been seen as a breach of trust by a person in a fiduciary position and as a fraud on other investors. Since 1980, it has been a criminal offence. The law was revised in the Company Securities (Insider Dealing) Act 1985 and amended by the Financial Services Act 1986.
3. In 1989, an EC Directive (89/592/EEC) was adopted. This was designed to ensure that regulation of insider dealing was co-ordinated across member states and required that certain changes be made to the United Kingdom law. The law, now more focused on control of securities markets than on abuse of confidential information, is contained in the Criminal Justice Act 1993.
4. Some commentators argue against the criminalisation of insider dealing. Professor H.G. Manne in particular has put up a defence of the practice on the grounds that:
   - insider dealing should be seen as a legitimate benefit of management and a reward for entrepreneurial ability;
   - it is a 'victimless crime' since the fact that one party may have had inside information was irrelevant to the other party's decision to buy or sell;
   - it brings information to the market quickly;
   - it is notoriously difficult to prove and enforce and it is therefore futile to have the offence on the statute book.
5. These arguments have not been widely accepted and it is argued on the other hand that insider dealing:
   - involves an improper use of confidential information;
   - is contrary to the basic notion of market fairness as it places the insider at an unfair advantage.

   This view has prevailed in Europe.
6. However, there has been widespread criticism of the law as set out in the Criminal Justice Act 1993:
   - the Act provides for criminal penalties only;

- it applies only to companies quoted on regulated markets;
- prosecution under the Act has proved to be difficult and as a result there have been few prosecutions, so enforcement of the law has not been very effective.

7. The provisions introduced by the Financial Services and Markets Act 2000 (FSMA 2000) and strengthened by EC Directives, discussed at section 13.4 below, have sought to address some of these issues. The focus has moved in recent years from the criminal law of insider dealing to the regulation of market abuse and market manipulation under the FSMA 2000.

13.2 Insider dealing

13.2.1 The offence

1. The offence itself is set out in s 52 CJA 1993, and the terms used in s 52 are defined in ss 54–60. Section 53 provides for a range of defences.
2. Under s 52 an individual, who has information as an insider, may commit the offence in three ways:
   - s 52(1) dealing in price affected securities as principal or agent;
   - s 52(2)(a) encouraging another to do so;
   - s 52(2)(b) disclosing information otherwise than in the proper performance of his functions.
3. The offence extends only to regulated markets, or in circumstances where the person dealing relies on a professional intermediary or is himself a professional intermediary.

13.2.2 Definitions

1. Section 54 defines **securities** widely, to include certain options and futures as well as shares and debt securities.
2. Section 55(1) provides that a person **deals** if he or she:
   - acquires or disposes of the securities (whether as principal or agent), or
   - procures, directly or indirectly, an acquisition or disposal of the securities by any other person.
3. Under s 56, **inside information**:
   - relates to particular securities or to a particular issue of securities, not to securities generally;

- is specific or precise;
- has not been made public;
- would be likely to have a significant effect on the price of the securities if it were made public.

13.2.3 Who can commit the offence?

1. Under s 57 the offence can be committed only by an individual who has information as an insider.
2. An insider is defined as:
   - an individual who obtains information through being a director, employee or shareholder of the issuer of securities, or
   - an individual who has access to information by virtue of his employment, office or profession, whether or not his employment is with the issuer of securities, or
   - those who have inside information 'the direct or indirect source of which is a person falling into either of the first two categories'.
3. There is an exemption for market makers in relation to dealing or encouraging others to deal by s 53(4), as long as they act in good faith and in the normal course of business.

13.2.4 When is information made public?

1. Under s 58(2) information is made public if:
   - it is published in accordance with the rules of a regulated market for the purpose of informing investors and their professional advisers;
   - it is contained in records which are open to inspection by the public;
   - it can be readily acquired by those likely to deal in any securities to which the information relates, or of an issuer to which the information relates;
   - it is derived from information which has been made public.
2. Section 58(3) is also relevant and provides that information may be treated as made public even though:
   - it can only be acquired by persons exercising diligence or expertise;
   - it is communicated to a section of the public and not to the public at large;
   - it can be acquired only by observation;
   - it is communicated only on payment of a fee;
   - it is published only outside the United Kingdom.

13.2.5 Defences

1. Section 53 provides the following defences in relation to both dealing and encouraging:
   - that the defendant did not expect the dealing to result in a profit (or avoid a loss) attributable to the fact that the information was price sensitive;
   - that he or she reasonably believed that the information had been disclosed;
   - that he or she would have done what they did even if they had not had the information.
2. In relation to disclosing, the defences are:
   - that he or she did not expect any person to deal in the securities because of the disclosure;
   - that he or she did not expect the dealing to result in a profit attributable to the fact that the information was price sensitive.

13.2.6 Penalties

1. The offence is triable either way.
2. The maximum penalty on conviction on indictment is seven years imprisonment and/or a fine on which there is no limit, s 61(1). *R v Collier* (1987, unreported) is one of the few convictions leading to imprisonment.
3. Any transaction entered into in contravention of the act will stand – s 63, but will usually not be enforced by the courts (*Chase Manhatten v Goodman* (1990)).

13.2.7 Procedure

1. A prosecution can be instituted only by or with the consent of the Secretary of State for Business Innovation and Skills or the Director of Public Prosecutions (DPP). Suspected cases may be referred to the Department of Business Innovation and Skills from the Stock Exchange, which monitors the market.
2. The Financial Services Authority (FSA) may institute proceedings under s 402 FSMA (2000).

13.3 United Kingdom Listing Authority Model Code

1. Listed companies in the United Kingdom must have internal rules to govern dealings in securities by its directors, which must be at least as rigorous as the UKLA Model Code.
2. The Code lays down a number of principles to be followed by directors when dealing in their companies' securities, including the following:
   - A director of a listed company must notify the chairman (or another designated director) in advance of dealing in the company's securities. Dealings by the chairman or designated director must be notified to the board. A record of notifications and clearances must be kept.
   - A director of a listed company must not buy the company's securities during a 'close period', that is the two months before the preliminary announcements of its half-yearly and annual results or the month before the announcement of its quarterly results.

13.4 Market abuse

1. Since 1980 insider dealing has been a criminal offence in the United Kingdom. But it has been subject to criticism because of the difficulties in enforcing the law and the fact that it does not give rise to civil liability as well as criminal sanctions.
2. Directive 2003/6/EC (the Market Abuse Directive) applies to regulated markets in the EEA. The Financial Services and Markets Act 2000, as amended by the Directive, creates a statutory framework for the control of certain kinds of behaviour deemed to be unacceptable to the market, but falling short of criminal liability.
3. The purpose of the Directive is to:
   - preserve the integrity of financial markets, and
   - to enhance investor confidence.

   See *Spector Photo Group and Van Raemdonck v Commissie voor het Bank-, Financie- en Assurantiewezen* (2009) where the European Court of Justice (ECJ) was required to interpret the Directive in a case referred by the Brussels Court of Appeal.
4. The Act makes provision for financial penalties in cases involving market abuse, although this does not amount to a criminal offence.

5. As required by s 119 FSMA 2000, the Financial Services Authority has issued a detailed Code on Market Conduct.

13.4.1 What is market abuse?

1. Market abuse is defined in s 118 FSMA 2000, amended by SI 2005/381. Three forms of insider trading are defined as market abuse, along with six forms of market manipulation. The section describes conduct in relation to 'qualifying investments', which include company shares and debt securities, traded on a 'prescribed market'.
2. Insider trading as market abuse:
   - s 118(2) Insider dealing: where an insider deals, or attempts to deal, in a qualifying investment or related investment on the basis of inside information relating to the investment.
   - s 118(3) Improper disclosure: where an insider discloses inside information to another person otherwise than in the proper course of his employment, profession or duties.
   - s 118(4) Misuse of information: where the behaviour of a person is based on information not generally available and fails the regular user test; that is, the conduct would be regarded by a regular user of the market as a failure to observe the standard of behaviour of a person in that position.
3. Section 118B defines the term 'insider' as a person who has inside information:
   - as a director;
   - as a shareholder;
   - as a result of exercise of his employment, profession or duties;
   - as a result of criminal activities;
   - which was acquired by other means but he knows, or could reasonably be expected to know, that it is inside information.
4. Section 118C defines inside information in relation to qualifying investments as information of a precise nature which is:
   - not generally available;
   - relates, directly or indirectly, to issuers of the qualifying investments or to the qualifying investments;
   - would, if generally known, be likely to have a significant effect on the price of the qualifying investments or on the price of related investments.

5. Market manipulation as market abuse:
   (a) Effecting transactions which give, or are likely to give, a false or misleading impression as to the supply of, the demand for or price of qualifying investments (s 118(5)(a)).
   (b) Effecting transactions or orders to trade which secure the price of qualifying investments at an abnormal or artificial level (s 118(5)(b)). In the case of both (a) and (b) the behaviour is not market abuse if it is for a legitimate reason and in conformity with accepted market practices on the relevant market.
   (c) Effecting transactions or orders to trade which use fictitious devices or any other form of deception (s 118(6)).
   (d) Disseminating information which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knows or may reasonably be expected to know, that the information is false or misleading (s 118(7)).
   (e) Behaviour which is likely to give a regular user of the market a false or misleading impression as to the supply of, demand for or price of a qualifying investment which fails the regular user test (s 118(8)(a)).
   (f) Behaviour which would be, or 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 a qualifying investment and which fails the regular user test (s 118(8)(b)).

13.4.2 Enforcement

1. Enforcement of the market abuse provisions is the responsibility of the Financial Services Authority (FSA).
2. A range of sanctions is available to the FSA, from prosecuting through the courts for insider dealing (s 402 FSMA) to imposing its own sanctions, including a fine or a public reprimand.
3. The standard of proof is the civil standard (balance of probabilities) but this is subject to the principle that the more serious the allegation the stronger the proof must be: *Mohammed v Financial Services Authority* (FS&M Tribunal, 29 March 2005).
4. Under s 381 FSMA 2000 the FSA may apply to the High Court to issue an injunction restraining market abuse and, if satisfied that the person concerned was or may have been engaged in market abuse, a freezing injunction restraining the use of that person's assets may be issued by the court.

5. The FSA may make a restitution order against a person who has profited as a result of market abuse or where one or more people have suffered loss as a result. The FSA may also apply to the High Court for it to make an order.