INSIDER DEALING AND MARKET ABUSE: *THE FINANCIAL SERVICES AND MARKETS ACT 2000*

ESRC Centre for Business Research, University of Cambridge
Working Paper No. 222

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December 2001

This Working Paper forms part of the CBR Research Programme on Industrial Organisation, Competitive Strategy and Business Performance.

Abstract
The Financial Services and Markets Act 2000 (FSMA) provides the statutory framework for the new UK market abuse regime, which became effective on 1 December 2001. The FSMA market abuse regime provides new powers to the Financial Services Authority (FSA) to sanction anyone who engages in 'market abuse', that is misuse of information, misleading practices, and market manipulation, relating to investments traded on prescribed UK markets. It also applies to those who require or encourage others to engage in conduct that would amount to market abuse. FSMA's stated objective is to fill the 'regulatory gap' by giving the FSA substantial powers to punish unregulated market participants whose market conduct falls below acceptable standards, but does not rise to the level of a criminal offence. This paper analyses the major features of both the UK insider dealing legislation contained in Part V of the Criminal Justice 1993, the FSMA market abuse regime contained in section 118 of the Act, and the proposed European Union Directive on Market Abuse that represents a significant level of convergence in European securities regulation. The paper argues that an efficient price discovery process for securities markets can be facilitated only by a comprehensive regulatory regime that provides substantive standards and rules that ensure high standards of transparency and disclosure through effective enforcement.

JEL Codes: G2, G15, G19, K22, K33

Keywords: corporation and securities law; international financial markets; legal risk; cross-border securities trading; European Community law.

Acknowledgements
An amended version of this Working Paper appears in K. Alexander and L. Linklater *Market Abuse and Insider Dealing: The Financial Services and Markets Act 2000* (Butterworths, 2001). I would like to thank Jon Wheeler and Maxine Raggett at Butterworths for their careful editorial attention. I would also like to thank Lord Eatwell of Queens' College, Cambridge for his support, and the Ford and Rockefeller Foundations for providing generous financial support during the period this research was carried out. I bear sole responsibility for any mistakes or omissions.

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1. Introduction

The Financial Services and Markets Act 2000 (FSMA) provides the statutory framework for the new UK market abuse regime, which became effective on 1 December 2001. The FSMA market abuse regime provides new powers to the Financial Services Authority (FSA) to sanction anyone who engages in 'market abuse', that is misuse of information, misleading practices, and market manipulation, relating to investments traded on prescribed UK markets. It also applies to those who require or encourage others to engage in conduct that would amount to market abuse. FSMA's stated objective is to fill the 'regulatory gap' by giving the FSA substantial powers to punish unregulated market participants whose market conduct falls below acceptable standards, but does not rise to the level of a criminal offence. Moreover, the FSA has powers to regulate and discipline issuers of UK listed securities and their directors, and additional powers to impose fines for breaches of UK listing rules. The Market Abuse regime overlaps with, and extends beyond, the FSA's principles for business and statements of principles for approved persons and the disciplinary powers of other agencies such as the exchanges and the Takeover Panel.

The FSMA market abuse regime expands upon the criminal offence of insider dealing as set forth in Part V of the Criminal Justice Act 1993 by creating a far-reaching civil offence of market abuse for which unlimited fines can be imposed. Section 118 defines market abuse as 'behaviour (whether action or inaction) which is likely to be regarded by a regular user of the market who is aware of the behaviour as a failure on the part of the person or persons concerned to observe the standards of behaviour reasonably expected of a person in his or their position in relation to the market'.[1] The civil offence of market abuse is significant because it seeks to regulate market behaviour according to its impact on the market, and places less emphasis on the individual motivation of the behaviour in question.

This paper analyses the major features of both the UK insider dealing legislation contained in Part V of the Criminal Justice 1993 and the FSMA market abuse regime contained primarily in section 118 of the Act. The paper addresses three areas. First, the existing UK legislation that makes insider dealing a criminal offence will be analysed with the suggestion that its narrow application to cases of misuse of information either to gain a profit or avoid loss, its strictly territorial focus, and criminal evidentiary standard make it an ineffective regulatory tool to police market abuse in modern financial markets. Second, the FSMA Market Abuse regime defines market abuse broadly to include not only misuse of insider information but also various forms of market manipulation. The criminal offence of market manipulation under section 47 of the Financial Services Act 1986 has been replaced by section 397 of FSMA that makes misleading statements and misleading practices a criminal offence. Third, the proposed European Union Directive on Market Manipulation contains prohibitions on market abuse that are similar to UK insider dealing law and to FSMA's market abuse provisions. Although it appears to adopt a broader definition of market manipulation than what is provided under the UK law, the proposed Directive represents a significant level of convergence in the European Community regarding the recognition of the need to combat market abuse in EU financial markets.

2. Background To UK Insider Dealing Law

In the United Kingdom, insider dealing can be defined as trading in organised securities markets by persons in possession of material non-public information, and has been recognised as a widespread problem that is extremely difficult to eradicate. Some of the insider dealing is based on corporate information, that is, information about a company's finances or operations. In recent years, however, most of the important dealing cases have concerned mergers and acquisitions, due largely to the explosive growth in takeover activity during the past decade. The community of bankers, lawyers, public relations advisors, and others who receive advance knowledge of proposed takeovers, which invariably occur at a substantial premium over the existing market price of the acquired company's shares, face a strong temptation to make a quick profit from inside information.

The general criminal law has always sought to protect the integrity of public markets.[2] For example, section 47 of the Financial Services Act 1986 outlawed misleading statements and manipulative practices as unlawful interference with the proper operation of the markets.[3] Moreover, the crime of conspiracy to defraud was utilised to police the markets. In practice, however, these more general offences relating to interference with the market would not be applicable in cases of simple insider dealing, unless there had been manipulation and fraudulent conduct.

Until 1980, the restrictions on insider dealing in the United Kingdom were extremely limited. There was no statutory prohibition of the practice, nor did the common law make insider dealing actionable.[4] In the leading case of *Percival v. Wright*,[5] the Court of Chancery held that a corporate director owed a fiduciary duty only to the company and not to its individual shareholders, and that therefore the director was ordinarily not obliged to disclose information about the company to the shareholders before trading with them. Nevertheless, if a director expressly or impliedly becomes an agent for one or more shareholders in a particular transaction, the fiduciary duties arising out of the agency relationship may prevent him from realising a profit on the acquisition of securities to his own advantage. Although the City Panel on Takeovers and Mergers[6] and the London Stock Exchange[7] had adopted rules and guidelines that restricted insider dealing and the 'tipping' of inside information, these requirements were never strictly enforced.[8]

3. Companies Securities (Insider Dealing) Act 1985

After two unsuccessful legislative attempts to outlaw insider dealing in the 1970s,[9] Parliament in 1980 amended the Companies Act to make insider dealing a criminal offence.[10] These provisions outlawing insider dealing were consolidated in 1985 when the Companies Act was revised. The insider dealing provisions of the Companies Act 1985 became known as the Companies Securities (Insider Dealing) Act 1985.[11] These provisions were supplemented in 1986 by provisions in the Financial Services Act that strengthened the government's enforcement powers.[12]

The Insider Dealing Act 1985 prohibited persons who had access to material non-public information by virtue of their position with a company (including directors, officers, employees, and various kinds of agents of the company) from trading in the securities of the company while in possession of such information. These insiders were also prohibited from making selective disclosure of such information to others ('tipping'); and it prohibited their tippees from trading on basis of such inside information. The Act also prohibited persons in possession of non-public information about a proposed takeover of a company from trading in that company's stock.

The 1985 Insider Dealing Act established only criminal liability, and its prohibitions applied only to individuals who acted while knowingly in possession of inside information. Although the Insider Dealing Act was an important step in outlawing the offence of insider dealing, the scope and impact of the British legislation was rather narrow. In fact, despite the fact that insider dealing had been an offence since 1980, there were no convictions under the 1985 Act's provisions until the late 1980s.

4. Criminal Justice Act 1993, Part V

The Criminal Justice Act 1993 ('CJA 1993')[13] replaced the Company Securities Act (Insider Dealing) Act 1985 and represented an extension of the basis of liability for the insider dealing offence. The CJA 1993 contains a wider definition of 'securities' and 'insider' than the 1985 Act and the nature of the inside information necessary to impose liability has been altered.

Part V of the CJA 1993 provides for the offence of insider dealing that seeks to prevent individuals from engaging in three classes of conduct in particular circumstances. First, the Act prohibits dealing in price-affected securities on the basis of inside information. Second, it prohibits the encouragement of another person to deal in price-affected securities on the basis of insider information; and, third, it prohibits knowing disclosure of insider information to another.[14] To prove an offence under section 52, it was necessary to demonstrate two elements: (a) the status of the person charged as an insider, and (b) the type of information in its possession to be inside information. Section 52 provides in relevant part:

> '(1) An individual who has information as an insider is guilty of insider dealing if, in the circumstances mentioned in subsection (3), he deals in securities that are price- affected securities in relation to the information.
>
> (2) An individual who has information as an insider is also guilty of insider dealing if –
> (a) he encourages another person to deal in securities that are (whether or not that other knows it) price-affected securities in relation to the information, knowing or having reasonable cause to believe that the dealing would take place in the circumstances mentioned in subsection (3); or

(b) he discloses information, otherwise than in proper performance of the functions of his employment, office or profession, to another person.

(3) The circumstances referred to above are that the acquisition or disposal in question occurs on a regulated market, or that the person dealing relies on a professional intermediary or is himself acting as a professional intermediary.'

Criminal liability for each offence may only attach to an individual, because the term 'individual' is defined to exclude corporations and other entities (eg. public authorities). The definition of individual did cover, however, unincorporated partnerships or firms comprising a collection of individuals. Although these offences could apply to certain business entities, it was a major weakness of the legislation that it did not apply to corporations. To this extent, the UK law was not in compliance with the 1989 European Community Insider Dealing Directive,[15] which applies to both natural and legal persons. The Market Abuse regime under FSMA remedies this gap, in part, by making the offence of market abuse applicable to most legal entities (including corporations) and natural persons.

5. Insider

To commit the offence of insider dealing, an individual must have information 'as an insider', which is defined in section 57 as follows:

'(1) . . .a person has information as an insider if and only if
(a) it is, and he knows that it is, inside information, and
(b) he has it, and knows that he has it, from an inside source.

(2) For the purposes of subsection (1), a person has information from an inside source if and only if –
(a) he has it through
(i) being a director, employee or shareholder of an issuer of securities; or
(ii) having access to the information by virtue of his employment, office or profession; or
(b) the direct or indirect source of his information is a person within paragraph (a).'

The CJA 1993, s. 57 created a distinction between a primary insider (a person who has direct knowledge of inside information) and a secondary insider (a person who learns inside information from an inside source). The primary insider usually obtains inside information through being a director, employee, or shareholder of an issuer of securities or any person who has information because of his employment or office. A secondary insider obtains inside information either directly or indirectly from a primary insider. Section 57 would impose liability on brokers or analysts as secondary insiders if they act on 'market intelligence' that comes from a primary insider.

The insider dealing offence, only in so far as dealing and encouragement are concerned, could only be committed if the acquisition or disposal of securities occurs on a regulated market, or if the person dealing relied on a professional intermediary or is himself a professional intermediary.[16] The CJA 1993 defines *professional intermediary* as a person who carries on a business of acquiring or disposing of securities (whether as principal or agent) or a business of acting as an intermediary between persons taking part in any dealing in securities.[17] An individual employed by such a person to carry out these activities are also defined as *professional intermediaries*. The definition of professional intermediary does not include a person whose activities are merely incidental to other activities or if those activities are only conducted occasionally.[18]

6. The Encouragement Offence

The encouragement offence is found in section 52(2)(a) of the Criminal Justice Act 1993 (CJA 1993) and it prohibits a person from encouraging another person to deal in securities based on knowing or having reasonable cause to believe that the person receiving the encouragement would deal in securities in the circumstances covered by the dealing offence.[19] It is not a requirement of the offence for the individual who has information as an insider to pass information to the other person, nor is it necessary that the other person should know that the securities it is encouraged to buy are price-affected securities. The offence covers the classic situation where a tip is given by an insider to another to sell, for example, 'as many shares of Marconi as you can before tomorrow's profit report'. Naturally, this could occur in a number of other situations.

If the insider knows or has reasonable cause to believe that the other person will deal on a regulated market or through a professional intermediary the offence will be committed even if, in fact, the other person does not undertake an insider dealing transaction. In practice, however, a successful criminal prosecution will likely require a deal or transaction to ensure a conviction. A deal in securities is relevant not only to the dealing offence but also to the encouragement offence insofar as the encouragement has to be targeted at a particular transaction. Although not of direct relevance to the form of the disclosure offence, a defence is available where no dealing was expected.[20] This is because the type of dealing with which the CJA 1993 is concerned is limited. [21]

The encouragement offence can also create intermediary liability. For example, if deals in securities do not occur on a recognised investment exchange, they will only be within the insider dealing legislation if the person dealing relies on a professional intermediary or is himself a professional intermediary. A person will rely on a professional intermediary only if the professional intermediary either acquires or disposes of securities (whether as principal or agent) in relation to the dealing or acts as intermediary between persons taking part in the dealing.[22] Therefore, if the securities dealt in fall within the above categories, the insider dealing offence will be relevant unless the transaction is truly a private deal off the market without the intervention of a market professional.[23]

Under this definition, a person will rely on a professional intermediary only if the professional intermediary *either* acquires or disposes of securities (whether as principal or agent) in relation to the dealing *or* acts as intermediary between persons taking part in the dealing.[24] If deals in securities do occur on a regulated market (i.e., investment exchange), the insider dealing offence will be relevant unless the transaction is truly a private deal off the market without the intervention of a market professional.

In addition, the offence of insider dealing cannot apply to anything done by an individual acting on behalf of a public sector body in pursuit of the government's economic policies (e.g. managing monetary policy through the adjustment of exchange rates, interest rates, or the public debt or foreign exchange reserves).[25] The purpose of these exclusions is to permit government policymakers to have sufficient discretion to manage the economy in the public interest. These exclusions, however, would not apply to the government's sale of shares in a privatisation.

7. The Elements of the Dealing Offence

The two essential requirements for the dealing offence are that: (a) an individual must have information as an insider; and (b) the insider must deal in securities that are price-affected securities in relation to the information.[26] With respect to inside information, the prices of price-affected securities will likely be significantly affected if information related to such securities is made public.[27] Accordingly, if an insider has inside information he must not deal in the securities to which that information relates. The CJA 1993 adopts a broad definition of 'dealing in securities' to cover any acquisition or disposal of a security, including an agreement to acquire or dispose of a security and the entering into a contract which creates the security or the bringing to an end of such contract.[28] Moreover, such acquisitions or disposals are within the definition irrespective of whether they are made by an individual as principal or as agent.

The securities to which the Act applies are price-affected securities which are defined in Schedule 2. They include shares and debentures in companies as well as their derivatives. They also include gilts and local authority stock (even of foreign public bodies) and their derivatives. Contractual rights of differences (*e.g.*, derivatives) are also included.[29] The list conforms to the EC Directive on Insider Dealing,[30] so that not only corporate securities and instruments based on such securities are included but also that other contractual rights in other futures and derivatives markets are covered.

The relevant time at which to consider whether or not an offence has been committed would appear to be at the time of agreement to acquire or dispose of the security. At that time, if the individual had inside information about these securities he will have committed an offence. However, if he received inside information only after making the agreement he will probably not have violated the provision if he completes the deal and actually acquires or disposes of the securities.[31] On the other hand, if the individual had the inside information at the time when he agreed to acquire or dispose of the security it would seem that he will still have committed an offence, even if he does not complete the bargain.

The acquisition or disposal may be made by an individual acting either as principal or agent. Accordingly, if an agent has inside information, he will be within the scope of the offence if he deals in the relevant securities even though, in a direct sense, he will not gain from the transaction. This has special relevance to a trader who is engaged in a transaction as agent to benefit his principal. The fact that the individual deals as agent and not principal is irrelevant. However, where the agent deals on an execution basis only, such an approach hardly seems justified and is unfair to the principal who gave the instruction if the agent then feels inhibited from processing the order. Fortunately, it appears that a defence in this situation would allow the agent to act on instructions notwithstanding that, incidentally, he has inside information.[32]

A person is also regarded as dealing in securities if he procures, directly or indirectly, an acquisition or disposal of the securities by another person.[33] Such procurement may occur in a number of ways including where the person who actually acquires or disposes of the security is acting as an agent, nominee or at the direction of another in relation to the acquisition or disposal of a security.[34] This aspect of the definition of 'dealing in securities' is designed to cover transactions through an agent or nominee where the principal has relied on inside information without purchasing or selling the securities himself. Transactions are also covered that are undertaken at the direction of a sole shareholder who uses its influence over a company to deal in its shares.[35]

The broad scope of the procurement prohibition was recognised in debates in the House of Commons Standing Committee during passage of the Criminal Justice Bill in which the phrase 'a person who is acting at his direction' may likely result in liability for a principal who has inside information but whose investment portfolio is handled by someone else on a discretionary basis. For example, this might occur in the case of a fund manager who had the authority to deal in a discretionary manner in securities to which his principal's insider information relates, thus resulting in liability for the principal, despite the principal's lack of knowledge of the specific transaction.

The Government's Economic Secretary responded by stating that whilst it was possible for a person who had transferred its holdings of a portfolio to an investment manager to be exposed to liability as a procurer, 'it may well be that'[36] a person who gives a general direction to another to manage its affairs would not be considered to have directed and, therefore, to have procured dealings in securities which was undertaken by the person with responsibility for managing the fund. Moreover, the Minister stated that in cases where there were circumstances to suggest that a person had procured a transaction, the holder of the shares would have a statutory defence if the holder had not genuinely influenced the dealing.[37]

8. The Characteristics of Insider Information

Each of the three offences provided for in the CJA 1993 requires that insider information be an essential element of the offence. Commentators have acknowledge, however, that notwithstanding the statutory definition, inside information is a difficult concept to define in practice. For example, at any one time, a substantial amount of information will be generated within a company and be available to its directors, employees, and advisers. Much of this information will be confidential, and may have some impact on share prices. Generally, insider dealing law should not be concerned with this type of information, but rather it should focus on information that is essentially extraordinary in nature and which is reasonably certain to have a substantial impact on the market price of securities.[38] Indeed, during debate over the original UK insider dealing law, ministers acknowledged that the kind of knowledge they were concerned with was that of dramatic events and major occurrences that would transform a company's prospects.[39]

The CJA 1993 assesses the quality of information to determine whether it is inside information by use of criteria that seek to ascertain whether or not information has a ‘significant effect’ on the market price of the security. The CJA 1993 defines inside information by reference to four characteristics as provided in section 56:

CJA 1993, s. 56 defines inside information as follows:

> ‘(1) . . . inside information means information which—
>
> (a) relates to particular securities or to a particular issuer of securities
> or to particular issuers of securities and not to securities generally
> or to issuers of securities generally;
> (b) is specific or precise;
> (c) has not been made public; and
> (d) if it were made public would be likely to have a significant effect on the price of any securities.
>
> (2) . . . securities are ‘price-affected securities’ in relation to inside information, and inside information is ‘price-sensitive information’ in relation to securities, if and only if the information would, if made public, be likely to have a significant effect on the price of the securities’.[40]

It is important to note that the FSMA has adopted this meaning of the term ‘inside information.’ The characteristics and elements of inside information are such that they should cover information which relates to a specific sector as well as to a specific security, while excluding general information. Under FSMA, general information has been defined as information which can be obtained by research or analysis conducted by or on behalf of users of a market.[41]

9. *'Made Public'*

For purposes of defining inside information under section 56 another characteristic of it is that it has not been made public.[42] Under section 58(2) & (3), Inside information is made public or is to be treated as made public in the following circumstances:

(a) if the information is published in accordance with the rules of a regulated market for the purpose of informing investors and their professional advisors;
(b) if the information is contained in records which, by virtue of any enactment are given to inspection by the public;
(c) if the information 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; or
(d) if the information is derived from information which has been made public.

In addition, the CJA 1993 provides five circumstances when information may be treated as having been made public, even though it has not.[43]

These are where information:

(a) can be acquired only by persons exercising diligence or expertise;
(b) is communicated to a section of the public and not to the public at large;
(c) can be acquired only by observation;
(d) communicated only on payment of a fee; or
(e) is published only outside the UK.[44]

The above definitions state that information may be treated as public, even though further efforts have to be made to obtain the information. This accords with the broad scope of the definition of 'made public' in the EC Directive 89/592, which provides that information derived from publicly available data cannot be regarded as inside information and any transaction executed on the basis of such information would not constitute insider dealing under the broad definition of the Directive.

10. Information published according to the rules of a regulated market

Publication of insider information will not necessarily deprive insiders of their advantages because markets often take time to absorb information. It is generally accepted in financial markets that prices of securities do not always adjust immediately upon the release of material information. Accordingly, US securities law recognises this market reality by imposing liability on insiders for transactions undertaken before the market has assimilated the information.[45] Similarly, before the CJA 1993, the UK Companies Securities (Insider Dealing) Act 1985 probably would have prohibited insiders from immediately dealing on insider information after announcement until prices had adjusted to the information. The insiders were thus required to wait for the market to assimilate the information. The EC Directive on Insider Dealing has also been given this interpretation.[46]

The 1993 CJA clarifies the procedure for insiders to know when they can trade on information just released to the market. It adopts a procedure for notifying information to The Stock Exchange[47] that contains the following requirements. The information which issuers wish to release to the public must be delivered in the form of an announcement to the Company Announcements Office. The Stock Exchange then arranges for the prompt publication of announcements through its Regulatory News Service. At this point, for example, there could be an announcement on TOPIC that the information will be ‘made public’ for the purposes of the CJA 1993.

In recent years, the Regulatory News Service operates between 7.30 am and 6.00 pm and announcements notified up until 5.30 pm are released on the day of receipt. The FSA Listing Rules provide that no information may be released to a third party before such information is released to the Company Announcements Office. If announcements are made outside the operational hours of the Regulatory News Service, however, the information must be given to two or more UK national newspapers and to two news services to ensure adequate coverage. This information must also be lodged with the Company Announcements Office no later than it is given to the other parties. In these circumstances, the information would appear to have been made public on publication of the newspapers.

11. Information contained in public records

Information will be regarded as being made public if it is contained on records which, by virtue of any enactment, are open to inspection by the public. This covers registers set up under the statute, such as companies' or patents' registers or in publications such as the Official Gazette.[48]

Information is considered 'public' when it can readily be acquired by those likely to deal in any securities to which or to whose issuer the information relates.[49] The phrase 'likely to deal' in securities is a term of art having its origin in the Company Securities (Insider Dealing) Act 1985, which defined it as 'unpublished price-sensitive information'.[50] Although it could be argued that the phrase only embraces the market professionals who deal in securities, such as market makers who are clearly 'likely to deal', it is also possible that it refers to the market in the shares itself. If information can readily be acquired by the market, that information is already likely to have made its price impact and is, therefore, not properly to be regarded as inside information. Thus, it is treated as having been 'made public'.

12. Information derived from information made public

Information is considered public if it originates from information which has been 'made public'.[51] Although this may seem obvious, expert analysis of information may still have regard to many other factors, including the exposure of facts that had not been in the public domain. The CJA 1993 addresses the problem posed by an analyst who has knowledge of the company and industry and who can put together seemingly inconsequential data with public information into a mosaic which reveals material non-public information. Whenever managers, advisers and analysts meet in non-public places, there will be a risk that the analysts will take away knowledge of material information which is not publicly available. This should not be a violation of UK law so long as the mosaic, which contains inside information, is derived from information which has been made public.

13. Price Sensitivity

The final aspect of the definition of 'insider information' is the price sensitivity of the information. The test is that if the information was made public it would be likely to have a significant effect on the securities. This is the most essential feature of the statutory definition of inside information. This criterion, rather than the issue of how qualitative the information actually is, which really matters and which, ultimately, will be the determining factor when a jury considers whether information is inside information.

Price sensitivity can only be determined at the moment of the deal when, by definition, the information is not known to the public and can have no impact on the price.

14. Territorial Scope of the Offence

The jurisdictional provisions of the CJA are contained in section 62, which requires that some element of the offence under section 52(1) or (2) must take place in the United Kingdom or the dealing was on a UK regulated market, or the broker or investment firm was carrying on business in the UK. The statute is narrowly aimed at insider dealing that takes place in the United Kingdom, and will not apply if an essential element of the offence takes place outside UK territory.[52]

The prohibitions contained in these provisions are subject to territorial restrictions, though the restriction 'regulated markets' included all of the major stock markets of the European Community and any other designated by order.[53] It is important to note, however, that purely private deals, even involving securities covered by the CJA, fell outside the scope of the offence. By contrast, the FSMA market abuse regime covers both transactions by regulated persons and dealing by private persons off regulated exchanges.

Generally, an offence will be committed under the following circumstances: if the insider is in the United Kingdom when he deals, or when the dealing takes place on a UK-regulated market, which operates in the United Kingdom, or if the person dealing in the price-affected securities relies on a professional intermediary on a regulated UK market or is himself a professional intermediary.

By contrast, the FSMA will have extraterritorial reach. It applies to misleading practices and manipulative conduct outside the UK that might have an effect on UK markets. In relation to misuse of information, it is not necessary to show any nexus with the UK at all, other than that the behaviour relates to a UK traded investment in the broad sense described below. It will not necessarily be a defence for a person in a foreign jurisdiction to plead that they have conformed with the rules or standards of a local jurisdiction. This expansive application of jurisdiction enables the UK authorities to regulate activity that takes place in a foreign jurisdiction that affects UK financial markets.

15. The Financial Services and Markets Act: The Market Abuse Regime

The Criminal Justice Act 1993 imposes criminal liability for insider dealing, but did not provide a civil remedy for the company or unsuspecting outsider. Prosecutions for insider dealing were rare because of the high evidentiary requirements to prove beyond a reasonable doubt that the behaviour in question was undertaken to make a profit or to avoid a loss. Although the possibility existed for civil remedies for insider dealing on the basis of constructive trusteeship, fiduciary accountability or breach of confidence, it was generally accepted that no comprehensive regime for civil liability was availability for those investors who had suffered a diminution in value of their securities as a result of dealing on the basis on inside information. The Financial Services and Market Act 2000 (FSMA)[54] represents an important extension of the powers currently available to regulators to combat market abuse and insider dealing. The UK's position as a leading international financial centre depends not only on the openness and competitiveness of its markets but also on its reputation as clean and fair place to do business. Market confidence will be undermined where participants and users believe markets are susceptible to abuse. This reduction in market confidence will impair market efficiency, thus disadvantaging market participants. To this end, section 118 of FSMA defines and prohibits market abuse. In addition, section 123 (1)(b) creates a separate offence of encouraging or requiring another person to commit market abuse. These offences will be discussed in turn.

The Act's legal framework complements the existing criminal offence of insider dealing under the Criminal Justice Act 1993. The Act confers on the FSA broad powers to combat market abuse, in particular to fill the gap that had existed in previous legislation. The FSA is also empowered to prosecute the criminal offence of market manipulation as defined under section 397 and the offence of insider dealing under section 402. Although these particular offences cover a relatively narrow range of very serious misconduct where there is an intention to abuse the market and other users, it is also recognised that market confidence, integrity and efficiency can also be damaged by a broader range of misconduct and by the effects of that misconduct on the markets. It is this broader range of conduct that was not covered by previous legislation. Such misconduct was only addressed by the regulatory framework (including the rules of the RIEs), in particular the FSA's *Principles for Business* which required authorised firms and registered individuals to observe high standards of market conduct.

16. What is Market Abuse?

Part VIII of FSMA contains the provisions relating to market abuse and section 118 (1) defines the specific offence of market abuse to occur when a user of the market has been unreasonably disadvantaged (whether directly or indirectly) by others in the market who have: (1) used to their own advantage information which is not generally available; or (2) created a false or misleading impression; or (3) undertook activities that distort the market. Part VIII of the Act contains provisions relating to market abuse. Market abuse is defined[55] in section 118(1) of the Act as behaviour (whether by one person alone or by two or more persons jointly or in concert) –

> (a) which occurs in relation to qualifying investments traded on a market to which this section applies;
>
> (b) which satisfies any one or more of the conditions set out in subsection (2); and
>
> (c) which is likely to be regarded by a regular user of that market which is aware of the behaviour as a failure on the

> part of the person or persons concerned to observe the standard of behaviour reasonably expected of a person in his or their position in relation to the market.

The three conditions set forth in subsection two are:

> (a) the behaviour 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 or would be likely to be regarded by him as relevant when deciding the terms on which transactions in investments of the kind in question should be effected;
>
> (b) the behaviour is likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for, or as to the price or value of, investments of the kind in question;
>
> (c) a regular user of the market would, or would be likely to, regard the behaviour as behaviour which would, or would be likely to, distort the market in investments of the kind in question.

Based on the above language, three tests must be satisfied in order to determine whether behaviour is market abuse: (1) that the behaviour must occur in connection with a qualifying investment traded on a prescribed market (i.e. recognised investment exchange); (2) one or more of the following: 'misuse of information', 'false or misleading impressions', or 'market distortion'; and (3) the behaviour must fall below the standard of behaviour that a regular user of the market would reasonably expect of a person in the position of the person in question. Behaviour will amount to market abuse *only* if it satisfies all three these tests. The FSA considers these descriptions to cover behaviour which, in its view, constitutes market abuse. Therefore, for such behaviour to be considered market abuse, it must correspond to one of these three elements and be likely to be regarded by a regular user of the market as a failure on the part of the person or persons concerned to observe the standard of conduct reasonably expected of a person in his or their position in relation to the market.

17. The Code of Market Conduct's Definition of Market Abuse

Section 119 of FSMA requires the Financial Services Authority (FSA) to issue a Code of Market Conduct (the Code) that provides guidance for determining whether behaviour amounts to market abuse.[56] The Code sets out in more detail the standards that should be observed by everyone who uses the markets. Section of FSMA defines three broad categories of behaviour which may amount to market abuse: misuse of information that is not generally available to users of the market; the dissemination of false or misleading information; and market distortion.[57] The Code defines these categories of behaviour in more specific terms. Misuse of information is similar to the insider dealing offence because it involves behaviour (action or inaction) that is based on information which is not generally available but which would be relevant to an investor's dealings in a particular investment and which is ordinarily disclosed to the market. For example, a person who learns from a friend that the friend's spouse's company is about to be the subject of a takeover would commit misuse of information if the person buys shares in the spouse's company in anticipation of making a profit on the rise in the share price once the takeover is announced.

The second category is the creation of false or misleading impressions. This is behaviour likely to give rise to a false or misleading impression as to the supply or demand, price or value of an investment. The FSA has used the example of internet bulletin boards, where messages can be posted outlining the benefits of a number of investments. This can be a source of market manipulation if they contain false or misleading statements about a companies’ activities or profitability. For example, an individual who buys shares in a company, then posts untrue messages and afterwards, when unwary investors buy the shares (driving the price higher), sells at a profit, thus leading the price to collapse. This is known as a ‘pump and dump’ scheme, which often leads innocent investors to lose money on their investment.

The third category is ‘distorting the market’ which involves behaviour that interferes with the normal process of supply and demand, and therefore manipulates the market price of an investment. This would involve a person buying large amounts of a particular share near the end of the day with the purpose pushing the stock price higher to improve investor performance. Because the market price is driven to a distorted level, investors receive a false impression of the share price or the value of any portfolio or fund which holds that stock. Investors are thus encouraged to make the wrong investment decisions.

These three categories of market abuse will have the effect of reducing confidence in the market and impairing its efficiency. Under the statute, market confidence will be undermined if markets user feel unreasonably disadvantaged – either directly or indirectly – by others in the market who have *used to their own advantage information which is not generally available*, *created a false or misleading impression*, or *distorted the markets*.

18. The Effect of the Market Abuse Regime?

The Act’s market abuse regime extends the current regulatory scheme in two important respects: (1) extends its scope of coverage to unauthorised persons as well as to authorised persons; and (2) introduces greater transparency and clarity in the area of market conduct than was currently available to the regulated community. The insider dealing provisions of the Act are significant because they apply not only to authorised persons, but also to all those who deal in investments traded on certain prescribed markets. These prescribed markets are expected to be those operated by the seven UK recognised investment exchanges (RIEs). With respect to clarity and transparency, the Act requires the FSA to publish a Code of Market Conduct ('the Code') to supplement the statutory provisions defining market abuse and insider dealing in the Act. The Code is intended to give guidance to those who may determine whether or not behaviour amounts to market abuse, as required by the Act. This section will analyse the three main elements of the new market abuse and insider dealing regime, that is, the *misuse of relevant information that is not generally available to other market users*, *the giving of false or misleading impressions*, and *market distortion*.

The Market Abuse Regime covers both unauthorised and authorised persons and, through the Code, introduces greater transparency and clarity than existed under the previous legislation and regulations in determining what behaviour is acceptable or not. It is intended that those who use the markets will have a clear benchmark against which to measure their standards of behaviour. The benchmark is based in market standards that were developed through the consultation process and through the 'regular user' test. The 'regular user' test is an essential element in the definition of market abuse and will be discussed below.

19. Regular User Test

The definition of the term 'regular user' plays an essential role in defining 'market abuse'. Market abuse is defined in reference to standards of behaviour that a *regular user* would reasonably expect of a person in the position of a person concerned. A regular user is defined in section 118(10) of the Act as 'in relation to a particular market, a reasonable person who regularly deals on that market in investments of the kind in question'. The Code describes how the FSA will apply the 'regular user' test by making clear that the 'regular user' is, in legal terms, a hypothetical user of the market, rather than a particular or actual user. Behaviour will not, therefore, amount to market abuse unless it falls short of the standards of behaviour which the hypothetical regular user of the market in investments of the kind in question would be likely reasonably to expect from a person in the position of the person concerned; that is, unless the behaviour in question falls short of acceptable standards of *behaviour* in the particular context.

In addition, the Code recognises that, although the actual standards of conduct which prevail in a particular market at a particular time are relevant to the decision as to whether conduct meets or falls short of the standards expected by the regular user, these standards are not defined by the Code. The rationale is that there may be occasions when regular users of the market may not deem the standards which are acceptable by actual users of the market to be objectively acceptable. This may occur in a situation where the actual user of a market would tolerate the misuse of information, whereas the objective reasonable regular user would not find such behaviour acceptable.

Although the regular user test is based on a hypothetical user, it will not operate in a vacuum, unaffected by the standards that do prevail in markets. The regular user will take into account compliance with the rules of a RIE or other rules or codes of conduct and good practice when deciding whether behaviour amounts to market abuse because it falls short of reasonably expected standards. Moreover, the rules of a RIE will include the rules and standards of overseas markets when conduct on those markets is relevant to determining whether or not there has been an abuse of the standards of a prescribed UK market. Similarly, it should also be pointed out that there may be consequences for market participants who operate in different national markets where standards of conduct may vary across different national markets. Specifically, it is possible that conduct which is tolerated in one jurisdiction may be considered as behaviour which amounts to market abuse if that behaviour has an adverse effect on a UK prescribed market. The Code recognises that the local rules, practices, and conventions prevailing in a non-UK market will be an important factor in determining the standards that the regular user will expect of a person dealing from that market onto a prescribed market. However, compliance with local rules will not automatically insulate a market user from liability since such conduct may still fall below the standards expected by the regular user. An analogy can be provided by the FSA's *Price Stabilising Rules*[58], which will only recognise non-UK financial authorities' stabilisation rules if they provide broadly equivalent protection to the FSA's rules. Where such foreign stabilisation rules provide equivalent protection, a person's compliance with those rules entitles it to benefit from a safe harbour; but where such foreign rules do not provide similar protections, then there is no safe harbour protection.

The FSA has stated, as a general proposition, that 'normal market practices' will not amount to market abuse, provided that the behaviour in question meets the standards reasonably expected by the reasonable user. There may be circumstances, however, when it becomes clear that, although a market, or class of users in a market, accepts a particular practice, that practice may still not rise to the standard reasonably expected by the regular user, as defined in the Act. The FSA does not expect such circumstances to arise frequently, but it should be noted that such a case arose in 1991 concerning trading in property futures contracts on the London FOX market. In this case, the Securities and Futures Authority (SFA) took disciplinary action against five firms which admitted carrying out transactions for the purpose of creating a false appearance of increased activity and liquidity in property futures contracts. Moreover, senior officials of the London FOX (which was, at the time, a RIE) directed and encouraged that such transactions be carried out. This is an example of conduct that was accepted by market participants and senior officials of the exchange but which fell beneath the standards that were acceptable to the regular user.[59]

The focus of the market abuse regime remains centred on the effects of behaviour, and not on the intentions behind such behaviour. Accordingly, to impose civil liability, it is not necessary for any intention or purpose to be demonstrated in order for the regular user to conclude that behaviour amounts to market abuse. Notwithstanding, there will be some situations where the purpose of the person responsible for the behaviour will be relevant to the regular user's conclusions as to whether the behaviour falls below that of expected standards. In order to determine acceptable standards of behaviour for a person, the regular user must take into account that person's position in relation to the market. The Code prescribes no universal standard. Rather, the standards expected of the regular user will vary according to, *inter alia*, a person's skill, level of knowledge and experience. For example, the standards expected of a professional market participant will be more demanding in many instances than those of a retail investor who trades infrequently. Because the Code does not seek to set forth the standards of behaviour expected for every conceivable type of market participant, the FSA has determined that it will apply the appropriate differentiation on a case-by-case basis.

The FSA has stated that it will assess behaviour in the light of the circumstances which applied at the time of the transaction. There will likely be cases where, with the benefit of hindsight, conduct that was previously accepted in a particular market becomes regarded as market abuse. If the behaviour was reasonable at the time, however, taking account of all circumstances, then the regular user will not consider the person as having engaged in market abuse at that time.

20. The Prescribed Markets and Qualifying Investments Order

The market abuse regime applies to behaviour in connection with qualifying investments traded on a market to which section 118 will apply. The HM Treasury has the power to prescribe the markets to which section 118 will apply and the investments which are qualifying investments in relation to those markets. The Prescribed Markets and Qualifying Investments Order specifies which investments and markets will be subject to the statute. Article 2 of the Order prescribes the markets to which section 118 will apply as any market established under the rules of the UK RIEs. These UK RIEs include: the London Stock Exchange Ltd, London International Financial Futures and Options Exchange Administration and Management, the London Metal Exchange Ltd, the International Petroleum Exchange of London Ltd, OM London Exchange Limited and Tradepoint Stock Exchange. Article 3 of the draft Order prescribes as qualifying investments any investment of a kind which, at the time the Order is made, is admitted to trading under the rules of any of the prescribed markets.

21. The Encouraging or Requiring Offence

The FSMA also prohibits those persons who encourage or require others to engage in market abuse. Indeed, section 123 (1)(b) creates a separate offence of requiring or encouraging another person to commit market abuse by authorising the FSA to impose a penalty on a person if it is satisfied that that person, by taking or refraining from taking any action, has required or encouraged another person or persons to engage in behaviour which, if engaged in by the encourager, would amount to market abuse. To commit this offence, section 123 (1)(b) requires the following to be shown: (a) that the behaviour would have amounted to market abuse if carried out by the person who requires or encourages; and (b) that the person, by action or inaction, required or encouraged another to engage in the behaviour in question.[60]

The purpose of section 123 (1)(b) is to prevent persons from circumventing the market abuse prohibition by prohibiting behaviour that encourages or requires other persons to engage in market abuse. It is not necessary to show that the person who encouraged or required has in fact benefited from the action of the person who was required or encouraged to commit the conduct in question.[61] The FSA is authorised to undertake a civil *and*/or criminal enforcement action against persons who breach the encouragement or requirement standard. The FSA will likely apply a test that assesses whether the conduct undertaken by the person who was encouraged or required amounts to market abuse *and* whether such conduct would also have amounted to market abuse if committed by the person who purportedly did the encouraging or requiring.

Under section 123 (1)(b) of FSMA, the FSA may determine if the behaviour of another person amounts to market abuse if such behaviour had been engaged in by the encourager. In deciding this question, the FSA will apply the general principles set out in the Code of Market Conduct ('Code').[62] The Code provides guidance to the extent that in determining whether a person's behaviour falls short of expected standards (so that it would have amounted to market abuse if engaged by that person), consideration will be given to the knowledge, skill and experience to be expected of a person in the position of the alleged encourager. This is an objective reasonable person standard to be applied to the person whose conduct has allegedly encouraged or required another to undertake conduct that amounts to market abuse as defined in the statute and the Code.

The Code also provides that whether a person's taking or refraining from taking action might be regarded as requiring or encouraging others will depend on circumstances such as acceptable market practices, the expertise of the person concerned, and the control or influence the person has in relation to the person who engages in the behaviour in question. In the case of intermediaries, the primary focus will be on the originator of any abusive behaviour or transaction, including when the originator uses an intermediary to execute the transaction. For example, the mere execution of a customer's order by an intermediary will not result in liability for *requiring or encouraging* the customer to engage in behaviour which amounts to market abuse if the contact between the intermediary and the customer is limited to the placing of the order with no indication that the transaction in question is an abusive transaction.

There may be circumstances, however, in which an intermediary executes a transaction when it knows, or has reason to know based on an objective standard, that the effect of the transaction on the market will be to abuse the market and allows the transaction to proceed.[63] Under these circumstances, the intermediary's behaviour will amount to market abuse under section 118 of FSMA, but liability will not be based on the intermediary *requiring or encouraging* the customer to engage in abusive behaviour. To demonstrate liability in this context, it will be necessary to show that the intermediary failed to observe the standard of behaviour reasonably expected of a person in the intermediary's position. The relevant considerations for determining this will be, *inter alia*, the extent to which the intermediary had followed the rules of the relevant recognised investment exchange, and the extent to which the intermediary had made (or should have made) some assessment of the abusive nature of the customer's behaviour.

The Code of Market Conduct discusses several examples in which a person may require or encourage another person to engage in behaviour which, if engaged in by the former, would amount to market abuse. The Code provides some examples where liability might arise under section 123 (b)(1).

> Examples:
> a company director who is in possession of information which is both relevant and disclosable (other than trading information) and which is not generally available to market users, instructs a company employee to *deal* in qualifying investments or relevant products in respect of which the information is relevant information.

> If A recommends or advises B to engage in behaviour which, if engaged in by A, would amount to market abuse, or if A seeks to persuade or otherwise entice B to engage in such behaviour.

FSA consultation paper 59 specified an example of employer liability arising where the employer is aware that one of its employees, or any other person under its authority or control, is engaged in market abuse, and then permits that person to continue to engage in the relevant behaviour.[64] After consultation, however, the FSA did not list this type of employer liability in its list of examples in consultation paper 76, thus providing no guidance for employers in this area. Another important issue not addressed by the FSA in its consultation papers concerns the issue of vicarious liability, or *respondeat superior*, for an employer whose employees or agents commit market abuse whilst performing within the course and scope of their responsibilities. These issues of employer liability should be clarified.

In considering whether a person's behaviour falls below certain standards of conduct with respect to market abuse, it will be necessary to inquire as to the knowledge, skill, and experience of not only the person who actually committed the offence, but also the person who is alleged to have *required* or *encouraged* the offence. Another important factor in determining whether the person taking or refraining to take action might be regarded as requiring or encouraging others will depend on circumstances (e.g. acceptable market practices), the expertise of the person concerned, and the control or influence the person has in relation to the person who has engaged in the misconduct. Unlawful requiring or encouraging may also occur where a person disclosed information which a *regular user* would expect market users to have on an equal basis, other than in accordance with the rules of a prescribed market, in order to manipulate market prices. For example, unlawful encouragement or requiring would occur where a potential bidder selectively disclosed certain information prior to dissemination of that bidder's intention, except as permitted according to the rules of a prescribed market or recognised investment exchange.[65]

The FSA has stated in the Code that it will not regard a person as requiring or encouraging others to deal if he passes information which is relevant information and not generally available to the following:

1) his employees (or, where appropriate, his fellow employees) for the purpose of enabling them to perform their functions in circumstances where the possession of the information in question is necessary for the proper performance of those functions; or
2) his professional advisers, and/or the professional advisers of any persons involved or who may be involved in any transaction or takeover bid with or involving him, for the purpose of obtaining advice; or
3) any person with whom he is negotiating, or intends to negotiate, any commercial, financial or investment transaction (including prospective underwriters or places of securities) for the purposes of facilitating the proposed transaction; or
4) Representatives of his employees or trade unions acting on their behalf in fulfillment of a legal obligation; or
5) Any government department, the Bank of England, Competition Commission or any other statutory or regulatory body or authority for the purposes of fulfilling a legal or regulatory obligation or otherwise in connection with the performance of the functions of the body to which the information has been passed.[66]

The above list does not cover all the circumstances where liability may arise because of a person passing information which is relevant information and not generally available to the public, and the FSA will assess the facts of each case on an individual basis.

Regarding a takeover bid, a person will not be regarded as having required or encouraged another person to engage in behaviour that amounts to market abuse in the following circumstances: (a) where A is an advisor to B, and B is an actual or potential offeror in a takeover bid; and (b) where A advises B to acquire an equity stake in a target company for the purposes and in the manner specified.[67]

In summary, the Act defines market abuse as the misuse of relevant information that is not generally available to other market users, the giving of false or misleading impressions, and market distortion. The first element, 'the misuse of information', applies to behaviour based on information not generally available to those using the market, but which, if it were available to a regular user, would be regarded by him as relevant in making investment decisions. The rationale is that market users expect certain classes of information to be made available to all market users on an equal basis. Trading on the basis of such insider information will undermine confidence in the integrity of the market if certain market participants have access to such information before it becomes generally available and can trade on it to their own advantage.

The second element involves behaviour which is likely to give a regular user a 'false or misleading impression' as to the supply of, or demand for, or price or value of investments. Market users who trade on the markets covered by the Act can reasonably expect to rely on the accuracy of certain types of information and transactions that are reported to the wider market. The third element of market abuse concerns 'market distortion', in which the behaviour of a person impeding the proper operation of market forces and the interplay of demand and supply would be regarded by the regular user as distorting the market.

22. Developments in the European Community

As part of its Financial Services Action Plan, the European Commission has proposed a Directive on Insider Dealing and Market Manipulation (referred to as the 'Market Abuse Directive') that is intended to serve as part of a broader and more integrated European Union financial services and capital market. The Commission initially consulted the newly-constituted European Securities Committee (established as part of the Lamfalussy Committee programme) and then was submitted as a 'technical' directive to the European Parliament (as opposed to a 'framework' directive). Under the so-called 'Lamfalussy Stockholm Format', 'technical' directives face a streamlined procedure for approval in the European Parliament before being sent to the European Council. This streamlined form of lawmaking is considered necessary for regulators to respond promptly to rapid changes in financial markets, and will be adopted for most new legislation on financial services and cross-border capital movement.

The Market Abuse Directive will replace the existing Directive on Insider Dealing[68], which applied only to the offence of insider dealing, and not to the wider offence of market manipulation. The proposed Market Abuse Directive will expand the proscribed offence to include both insider dealing and market manipulation, thus creating a common legal regime for these offences and a more harmonised EU approach for corporate and securities regulation. The Lamfalussy Committee proposal intends to establish a streamlined administrative structure at the EU level that would facilitate and coordinate enforcement and supervision efforts by national authorities and to harmonise regulatory efforts in these areas.

23. Market Abuse Under the Proposed Directive

The proposed Directive's definition of market abuse falls into three categories. First, the use of information that is not publicly available for the benefit of certain persons. Second, transactions to trade or orders to trade that distort market conditions by giving rise, or likely to give rise, to false or misleading signals as to the supply, demand or price of one or several 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. Third, the creation of false or misleading signals through the dissemination of information in the media (including the internet) that is likely to affect the supply, demand or price of financial instruments, including the dissemination of rumours and false or misleading news.

These definitions of market abuse are generally similar to the definitions of market abuse provide in section 118 of FSMA. Regarding misuse of information, Article 2 of the Directive restates the prohibition on insider dealing provided under the 1989 Insider Dealing Directive by requiring member states to prohibit any natural or legal person who possesses inside information from taking advantage of that information by acquiring or disposing of financial instruments to which that information relates, either directly or indirectly, for his own account or for the account of a third party. Although the prohibition on misuse of information in section 118 of FSMA corresponds with the Directive's definition of information, its scope is narrower because it applies only to the civil offence of misuse of information. The UK definition is narrower because it applies only for the civil offence, and not as a criminal offence as under the Directive. Because Part V of the Criminal Justice Act was enacted in order to implement the 1989 Directive, UK law essentially complies with the requirement in Article 2.

Article 1(2) however goes beyond the insider dealing offence by creating two categories of market abuse that could be broadly defined as market distortion and creating false or misleading impressions in the market. These two categories provide a general definition of 'market manipulation'. The Directive recognises that market manipulation can occur in four different situations. First, trading activities intended to create a false impression of activity, which would include transactions such as ‘wash sales’ in which there is no genuine change in the actual ownership of the financial instrument in question. This would also apply to transactions where both buy and sell orders are entered at the same time, involving different parties who collude to maintain the same prices and quantity (‘improperly matched orders’). Parties are also prohibited from becoming involved in a series of transactions that are reported in a public display facility from giving impressions of price movements in a financial instrument (ie. ‘painting the tape’). It would also impose penalties on persons who act in collaboration to ‘pump-up’ the price of a financial instrument on a market to an artificially inflated value, and then immediately sell it (pump and dump).

Second, trading activities intended to create a shortage, such as ‘cornering’ or ‘abusive squeezes’, are also prohibited under the proposed Directive. ‘Cornering’ occurs when a person seeks to exploit a dominant position in a derivative or underlying asset by securing control of the bid or demand-side of the derivative and/or the underlying asset in order to manipulate its price. ‘Abusive squeezing’ occurs when a manipulator has a significant position in the market and then seeks to use its control or influence to cause a shortage and thereby to create artificial prices.

Third, time specific trading activity can involve manipulation where the manipulator buys or sells at the close of the market in order to alter the closing price of the financial instrument, and thus to mislead those who act on the basis of closing prices. This is known as ‘marking the close’. A trader might also seek to manipulate the market by trading specifically to interfere with the spot or settlement price of derivative contracts, although many experts recognise it would be very difficult to prove this.[69]

Fourth, manipulative trading activity may involve the spreading of false rumours to induce buying or selling by others or the making of untrue statements of material fact. Further, what is known as ‘scalping’ may also breach the Directive when a person purchases a financial instrument for his or her own account before recommending it to others and then selling it at a profit after the price rises following the recommendation.

In addition, Article 6 of the proposed Directive requires member states to impose third party liability on professional intermediaries who fail to refrain from entering, facilitating, or assisting transactions if it reasonably suspects that a transaction would be based on inside information or would constitute market manipulation. Article 6 requires professional intermediaries to reject orders on behalf of clients if a reasonable person could surmise that such transactions are based on inside information or market manipulation. This is a controversial provision that places the burden for preventing market manipulation on third party advisers and intermediaries who actively facilitate a transaction. Under UK law, this third party responsibility is similar to that which exists for banks, financial institutions and other professionals regarding money laundering. Various issues will arise concerning such things as what constitutes reasonable suspicion of market abuse, the burden of proof, and imputing liability through the corporate veil to senior managers and directors.

If the proposed Directive is approved by Parliament and Council, each member state will be required to implement it into its own legal system, and the principles of civil and criminal liability in national legal systems will prevail in determining the type of liability to be imposed for breach. It is likely that each member state would impose divergent sanctions, and there would be the possibility that a market abuser would be subject to a serious criminal penalty in one state, while being exposed to a less-stringent fine in another. The EU has no legal competence to legislate a specific civil or criminal sanction in each member state. One might conclude that such divergent application of sanctions for breach of the Directive would undermine the notion of harmonisation in the European Community and would lead to a less effective EU regulatory system for financial services. A possible solution might involve linking a member states general obligation under EU law to adopt effective and proportionate sanctions to implement directives with the obligation under Article 14 of the proposed Directive to ensure effective prohibition against market abuse.

24. Conclusion

Insider dealing is a form of misuse of information. Traditionally, UK law viewed the problem of misuse of market information in a very narrow context as it related to the fiduciary relationship between the company director and the shareholder. More sophisticated financial analysis now suggests that misuse of information (including insider dealing) obstructs the efficient pricing of securities (Bhattacharya & Daouk 1999) and should be an issue of broader concern for the investing public. Therefore efficient financial regulation must regulate the mode of disclosure of relevant price sensitive information in order to maintain the efficient pricing and integrity of securities markets.

This paper provides a general analysis of the various legal provisions that seek to protect investors against insider dealing and market abuse in the financial markets. The two major pieces of legislation are the provisions against insider dealing in the Criminal Justice Act 1993 and the market abuse provisions of the Financial Services and Markets Act ('FSMA') 2000. The FSMA market abuse regime represents an important extension of the powers currently available to regulators to combat market abuse. To prove market abuse, the FSA need only demonstrate the impact of the behaviour in question on the market (the regular user test). Moreover, the new market abuse regime applies to all market participants, and not merely to authorised persons as was the case under the 1986 Act. The Code of Market Conduct is intended to provide clarity and guidance to the high level of conduct that is considered acceptable behaviour for the regular user of the market. The FSA is concerned to ensure that the Code is effective in helping address market abuse so as to maintain confidence in the standards of UK markets and thereby to promote the UK competitive position in global financial markets.[70]

The FSA's broad powers to undertake investigations and to impose unlimited fines for market abuse is expected to chasten the behaviour of those insiders who have frequently engaged in sharp practices and market distortion. The FSA will likely use these powers to focus on market conduct issues. Senior management of companies, directors and all other market participants should re-examine their procedures in disseminating market sensitive information in order to minimise their liability exposure under the new regime.

In addition, the Commission of the European Communities in May 2001 released a proposed European Communities Directive in *Insider Dealing and Market Manipulation* which, if implemented, will substitute for the current 1989 EU Insider Trading Directive. The proposed Directive contains many of the features of the 1989 Directive, including the rationale that those persons who trade on the basis of insider information have an unjustified economic advantage over other market participants, and that insider trading laws are necessary to enhance investor confidence. The proposed Directive, however, contains important differences from the 1989 Directive that includes its coverage not only of securities but also of all other financial instruments, including derivatives over commodities. The proposed Directive would also require all member states to impose criminal sanctions for insider trading and market manipulation on 'any natural person or legal person'. The proposed Directive would likely create a significant degree of convergence in the regulation of market abuse and insider dealing throughout the European Community. It also approximates the scope of coverage of the new FSMA market abuse regime, despite the contention that the proposed Directive goes beyond the scope of coverage of UK law. The proposed Directive is an important step in bringing about convergence of European financial regulation and will enhance the efficiency of the price discovery process for securities in European financial markets.

Notes

1 FSMA sec. 118 (10)

2 See B.A.K. Rider & M. Ashe, *Insider Crime* (Jordans, 1993) p. 20.

3 Financial Services Act 1986, s. 47 (1) & (2).

4 By contrast, the United States enacted anti-market manipulation legislation in 1934 in the form of section 10(b) of the Securities and Exchange Act of 1934.

5 [1902] 2 Ch. 421.

6 City Code on Take-overs and Mergers, Rule 4.1.

7 LSE, Model Code for Securities Transactions by Directors of Listed Companies (Yellow Book), 5.43-5.48 (1987).

8 See Hull and Bridges, 'End of the Line for Insider Traders?' (1981) 14 *Brackton L. Rev.* 13, 17.

9 In 1973, the Conservative government published a Companies Bill that would have outlawed insider trading, but it failed when the government was defeated in the February 1974 general election. The Companies Bill that was proposed by the Labour government in 1978 suffered a similar fate after that government went down to defeat in the May 1979 general election.

10 Companies Act 1980, sections 68-73.

11 Company Securities (Insider Dealing) Act 1985 (hereinafter the Insider Dealing Act).

[12] Financial Services Act 1986, sections 173-178.

[13] Part V of the CJA 1993 came into force on 1 March 1994 together with two ancillary statutory instruments (both reproduced in the 'Rules and Regulations'): the *Insider Dealing (Securities and Regulated Markets) Order* 1994 and the *Traded Securities Disclosure Regulation* 1994. The relevant provisions are in the 'Ancillary Acts'.

[14] CJA 1993, Part V, s. 52(1) & (2).

[15] EC 89/552 (1989).

[16] Ibid s. 52 (3).

[17] Ibid s. 59(1)(a).

[18] Ibid s. 59(3)(a)-(b).

[19] CJA 1993, s. 52(2)(a).

[20] Ibid, s. 52(3).

[21] Defences under the CJA and the new Financial Services and Markets Act will be discussed in Chapter 9.

[22] Ibid s. 59(1)(a).

[23] CJA 1993, s. 59 defines professional intermediary as follows:

'(1) . . . a professional intermediary is a person –

(a) who carries on a business consisting of an activity mentioned in subsection (2) and who holds himself out to the public or any section of the public (including a section of the public constituted by persons such as himself) as willing to engage in any such business; or
(b) who is employed by a person falling within paragraph (a) to carry out any such activity.
(2) The activities referred to in subsection (1) are –
(a) acquiring or disposing of securities (whether as principal or agent); or
(b) acting as an intermediary between persons taking part in any dealing in securities.'

24 Ibid s. 59(4).

25 Ibid, s. 63(1).

26 Ibid, s. 52 (1).

27 Ibid, s. 56(2).

28 Ibid s. 55(3)(b).

29 The list contained generally most of the investments that had been designated under Schedule 1, Part I of the Financial Services Act 1986.

30 Council Directive (89/552)/EEC), Art. 1 (2).

31 See discussion of Defences under s. 53(1)(c) in Chapter 9 for an alternative approach.

32 CJA 1993, s. 53(1)(c).

33 CJA 1993, s. 55 (1)(b).

34 Ibid, 55(4).

35 See Parliamentary Debates, HC, Standing Committee B, 10 June 1993, col. 171 (per Economic Secretary).

36 Ibid cols 171 and 172 (per Peter Ainsworth).

37 See CJA 1993, s 53(1)(c).

38 See Rider *et al Insider Dealing* p. 29 (citing US Supreme Court case *SEC v. Texas Gulf Sulfur* 401 F.2d 833, 848 (2nd Cir. 1968).

39 Parliamentary Debates, HC, Standing Committee A, (debates on the Company bill), col. 394, 6 December 1979.

40 CJA 1993, s. 56. Under the Company Securities (Insider Dealing) Act 1985, inside information was referred to as 'unpublished price-sensitive information' that contained the following elements:

1. The information had to relate to specific matters relating or of concern (directly or indirectly) to the company whose securities were dealt in, which was not of a general nature, or of concern to the company.
2. The information was not generally to be known to those persons accustomed or likely to deal in the company's securities.
3. The information should be likely to affect the price of the securities.

4. The information was such that it would be reasonable to expect a primary insider not to disclose it, except in the proper performance of its functions.

41 FSMA 2000 s. 118(7).

42 The original drafts of the Criminal Justice Bill that was introduced in the House of Lords provided no guidance for defining what was meant by the phrase ‘made public’. See BAK Rider & M. Ashe, (1993) *Insider Crime* (London: Jordans) pp. 34.

43 CJA 1993, s. 58(2).

44 Ibid, s. 58(3).

45 *SEC v Texas Gulf Sulfur Co.*, 401 F.2d 833 (2nd Cir. 1968); *SEC v. MacDonald*, 699 F.2d 47 (1st Cir. 1982).

46 See Klaus J. Hopt, ‘The European Insider Dealing Directive’ (1990) 27 CMLR 51. The recital to the Directive states that investors should be ‘placed on equal footing’.

47 The Listing Rules, ch. 9.

48 Parliamentary Debates, House of Commons, Standing Committee B, 10 June 1993, col. 184 (per the Economic Secretary).

49 CJA 1993 s. 58 (2)(d).

50 Company Securities (Insider Dealing) Act 1985, s 10(b).

51 CJA 1993 s. 58(2)(d).

[52] CJA 1993, s. 79(2) & s. 62 (discussing scope of the offence).

[53] CJA 1993, s. 62 (discussing territorial scope). A full list of proposed regulated markets appears in Appendix 2, Schedule, Regulated Markets, Part I.

[54] Financial Services and Markets Act 2000 c.8 (hereafter 'FSMA')

[55] It is important to note that all definitions must be consistent with the Regulated
Activities Order, The Prescribed Markets and Qualifying Investments Order, the Interpretation Act, and other FSA final rules and regulations.

[56] FSA Handbook, Code of Market Conduct (19 July 2001).

[57] Ibid.

[58] See FSA Consultation Paper #40, sec. 2.24.

[59] See SFA Board Notice 58, (17 Dec 1991).

[60] Code of Market Conduct, 1.8.2.

[61] Ibid.

[62] See Code of Market Conduct, 1.9 Requiring or encouraging.

[63] Code of Market Conduct, 1.8A1.

[64] Ibid, 1.9.3.

[65] Ibid, 1.9.5

[66] Ibid, 1.9.6.

[67] Ibid , 1.9.8.

[68] 89/555 EC (1989).

[69] See discussion in J.C.T. Chuah, 'EC Legal Developments: A Proposal To Deal with Insider Dealing and Market Manipulation' *Finance and Credit Law* (July/August 2001).

[70] The FSA will do so by endeavouring to respond promptly to reasonable requests for further guidance on interpretations of Code.

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