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Briefing note 9 June 2014

Eight things we now really know about market abuse

On 28 May, the UK Upper Tribunal handed down its long-awaited judgment in relation to the FCA's case against Ian Hannam for market abuse. The Financial Conduct Authority ("FCA") had found, and the Upper Tribunal has now held, that he engaged in market abuse by improperly disclosing inside information. The FCA is seeking to impose a financial penalty of £450,000, although the Tribunal is yet to determine the appropriate penalty.

The FCA's action was based on two emails sent by Mr Hannam in September and October 2008 whilst he was advising an oil exploration company. The emails, sent to a representative of a potential purchaser, referred to positive exploratory drilling results and indicated that an offer would imminently be made by another interested party.

The Tribunal's findings do not break new ground. However, its lengthy and thorough judgment does provide some lessons for those involved in handling inside information and pre-sounding activities in advance of transactions.

The confirmation it provides in relation to the meaning of "inside information" (under section 118C of the Financial Services and Markets Act ("FSMA")) will be of particular importance for issuers considering whether it is necessary to make announcements. Likewise, it provides useful clarification to advisers and other market participants who must decide whether and how information can be disclosed and whether they are free to deal in securities even though they have received non-public information.

The Tribunal's views on what is inside information will continue to be important under the new Market Abuse Regulation, scheduled to replace the existing UK law in mid-2016. The Regulation uses similar tests of what constitutes inside information and improper disclosure, although it includes a more formal set of requirements for market soundings by issuers and their advisers.

Key lessons

1. When will information be "likely to have a significant effect on price"?

Non-public information is inside information if it would be "likely to have a significant effect on price", but section 118C(6) FSMA states that information is likely to have a significant effect on price if but only if it is information of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions. The relationship between these two tests has been an area of fertile and longstanding debate in the UK and will continue to be important under the new EU Market Abuse Regulation scheduled to apply from mid-2016.

However, the FCA accepted that the "reasonable investor" test did not altogether supplant the test of whether the information is "likely to have a significant effect on price". The Tribunal held that the "likely to have a significant effect on price" test must be borne in mind in construing or must inform the meaning of the "reasonable investor" test as the reasonable investor is an investor who would take into account information which would be likely to have a significant effect on price. Conversely, he is an investor who would not take into account information which would have no effect on price at all or, as the FCA itself argued, information which would have no prospect of significantly affecting the price of the investment.

The Tribunal made clear that the "reasonable investor" will take account of anything which is not "trivial". As other courts and tribunals considering this issue have, it stopped short of seeking to quantify "significant" in numerical terms.

2. Is intent necessary for a finding of improper disclosure?

No. It was common ground throughout the proceedings that Mr Hannam did not intend to engage in market abuse. Instead, arguments focused on whether he should have known that the disclosures would amount to market abuse.

The FCA has been careful from the outset of its action not to seek to impugn Mr Hannam's honesty and integrity and has not taken action under any other provisions of the Handbook or FSMA. However, this should not be seen as an indication that it is softening its line on approved persons who engage in market abuse (whether deliberately or otherwise). Other cases (such as the fine of £662,700 and prohibition order imposed on Mark Stevenson in March 2014 for market manipulation) illustrate its readiness to take action using the full array of tools available to it in this area.

3. Can information be "inside information" even if it is inaccurate?

Yes. The key issue is how information is perceived by the recipient. As in this case, statements containing factual inaccuracies may be considered to be accurate by the person receiving them, and may inform the actions subsequently taken by them. The Tribunal confirmed that, provided a particular piece of information indicates some circumstances or events which actually exist or have occurred or which may reasonably be expected to come about or occur, it may still be "inside information" even if it contains inaccuracies. The Tribunal also stated that the fact that a communication, or even a particular sentence, may contain some inaccurate information does not prevent other information contained in the same communication or sentence from being "inside information" provided "the correct facts are still recognisable despite the inaccuracies".

4. When is there a "realistic prospect" of circumstances coming into existence?

The question of whether there is a "realistic prospect" of circumstances coming into existence or events occurring in future is important to whether information is "precise" and therefore whether it can constitute "inside information". Adding some colour to existing European case law and guidance, the Tribunal indicated that there is a "realistic prospect" where that prospect is more than "fanciful". It declined to quantify the concept in terms of percentage chances of circumstances coming into existence or an event occurring, but made clear that the line is drawn at a relatively low level and that it is not necessary for it even to be more likely than not. Accordingly, even a less than 50 per cent likelihood of an event occurring can still be considered a "realistic prospect".

What is "inside information"?

"*Inside information*" is defined for the purposes of the UK civil market abuse regime by section 118C(2) of FSMA, by reference to particular "qualifying investments" as:

"*information of a precise nature which -*

(a) is not generally available

(b) relates, directly or indirectly to one or more issuers of the qualifying investments or to one or more of the qualifying investments, and

(c) would, if generally available, be likely to have a significant effect on the price of the qualifying investments or on the price of related investments"

Section 118C(5) of FSMA adds:

"*Information is precise if it –*

(a) indicates circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur, and

(b) is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of qualifying investments or related investments"

Section 118C(6) of FSMA further adds:

"*Information would be likely to have a significant effect on price if and only if it is information of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions*".

5. Is it necessary to know how information will affect price?

Yes, although the threshold for information to be regarded as "specific enough to enable a conclusion to be drawn as to the possible effect of … facts or circumstances or [an] event on…price" is also relatively low. The Tribunal held that it is only necessary for an investor to be able to ascertain that, if the information were made public, the price of the instruments in question "might move and, if it [were to move], the movement will be in a known direction". In other words, it is only necessary to know that the information may either cause the price to increase or that it may cause the price to decrease. It is not necessary to know by how much the price would change or even for the investor to have a high degree of confidence that the price will in fact move.

6. What are the characteristics of the "reasonable investor"?

It is now clearer what the mythical "reasonable investor" looks like. The Tribunal has made clear that the term is not necessarily synonymous with the typical investor to be found in the market (or in other words "the regular user of the market"), and that the "reasonable investor" does not necessarily have relevant knowledge of the market in which he is operating or the instrument in respect of which he is dealing. Instead, a "reasonable investor" is assumed to know all publicly available information, and to be a rational and economically motivated investor with some experience of investing in company shares, but not an investment professional.

7. Can you "improperly disclose" information to someone who already knows it?

Yes. Reiterating that the focus of "improper disclosure" must be on the actions of the person disclosing information rather than the state of knowledge of the recipient of that information, the Tribunal confirmed that information can be "improperly disclosed" to a recipient who already knows that information from a separate source. In this case, information was held to have been "disclosed" in emails because it added materially to that already provided at previous meetings.

8. Can one act in the client's best interests but not "in the proper course of the exercise of employment, profession or duties"?

Yes. Although it accepted that he intended to act in his client's best interests, the Tribunal was clear in its conclusion that Mr Hannam was not acting "in the proper course of the exercise of his employment, profession or duties" as he did not impose any confidentiality requirements on the recipient of the information he disclosed. Although it did not provide detailed indications of the steps to be taken to avoid improper disclosure, the Tribunal did indicate its view that "it could never be in the proper course of a person's employment for him to disclose inside information to a third party, where he knows that his employer and client would not consent to the public disclosure of that information, unless he knows that the recipient is under a duty of confidentiality and that he knows that the recipient understands that to be the case."

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