Wall crossing – Walking the regulatory tightrope

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CLIFFORD CHANCE

Wall crossing

Companies with listed securities and their advisers must ensure that there are tight controls on the handling of inside information and follow strict protocols if information is to be selectively disclosed ahead of general disclosure to the market. There is a tension between active shareholder engagement and the risks of committing market abuse through improper disclosure of inside information.

This briefing considers the meaning of "inside information", the circumstances in which inside information can be disclosed selectively, practical guidance on wall crossing, selective disclosure and wall crossing in the US, cleansing the market and what is in the pipeline under the EU Market Abuse Regulation.

Confidential pre-soundings and pre-marketing activities take place in advance of capital raisings, refinancing and other transactions prior to formal announcements to gauge interest in, or support for, a particular transaction (and its potential pricing, where relevant). As part of such activities, inside information is likely to be disclosed to market participants. Wall crossing is the act of making a person an "insider" by providing them with inside information.

Selective disclosure

The EU market abuse regime prohibits abusive behaviour relating to "qualifying investments" admitted to trading on a "regulated market" (extended to cover "prescribed markets" in the UK). Disclosure of inside information to another person otherwise than in the proper course of the exercise of one's employment, profession or duties is a form of market abuse (improper disclosure). The prohibition on improper disclosure of inside information is designed to limit the risk of misuse of such information (insider dealing). Criminal sanctions may also be imposed for improper disclosure. In the UK, the criminal regime is contained in the Criminal Justice Act 1993 and, in Europe, unlawful disclosure is one of the offences included within the Directive on criminal sanctions for market abuse which is required to be implemented into national law by July 2016 (the UK has opted out of this Directive).

Inside information: definition

"Inside information" is information of a **precise** nature which:

- is not generally available
- relates, directly or indirectly to one or more issuers of qualifying investments or to one or more of the qualifying investments, and
- 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

Information is **precise** if it –

- 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
- 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

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.

The term "**may reasonably be expected**" refers to future circumstances or events from which it appears, on the basis of an overall assessment of the factors existing at the relevant time, that there is a **realistic prospect** that they will come into existence or occur.

A "**realistic prospect**" is one which is more than "fanciful". The concept has not been quantified in terms of percentage chances of circumstances coming into existence or an event occurring, but the threshold is drawn at a relatively low level and it is not necessary for it even to be more likely than not that the circumstances will come into existence or the event will occur. Accordingly, even a less than 50 per cent likelihood can still be considered a "realistic prospect".

Information must be specific enough to enable a conclusion to be drawn as to the possible effect of facts or circumstances or an event on price. It is only necessary for an investor to be able to ascertain that, if the information were made public, the price of the financial instruments in question might move and, if it were to move, the movement will be in a known direction. 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.

Inside information: reasonable investor test

The "**reasonable investor**" is not necessarily synonymous with a typical investor to be found in the market – he does not necessarily have relevant knowledge of the particular market in which he is operating or the instrument in respect of which he is dealing. 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, for example, company shares, but is not expected to be an investment professional.

The "reasonable investor" test does not supplant the test of whether the information is "likely to have a significant effect on price". The price effect test must be borne in mind in applying the "reasonable investor" test as the reasonable investor would take into account information which would be likely to have a significant effect on price. On the flip side, the reasonable investor would not take into account information which would have no effect on price at all. The "reasonable investor" will take account of anything which is not "trivial".

Practical consequences

No-names or multiple names disclosure

Financial advisers risk committing market abuse if they disclose inside information without a reasonable and legitimate basis for doing so. The safest course (though potentially least practical) is to minimise the risk of disclosing inside information at all; for example, by conversing on a "no names" basis (where pre-sounding is conducted by reference to an industry sector or grouping) or multiple names approach (where the pre-soundings ask about a number of named companies, one of which is the relevant company). Care must still be taken, however, to ensure that it is not possible to deduce which company is in fact the subject of the transaction, particularly where there is sufficient information in the market to enable the recipient to assess the impact of a potential transaction on the company's securities.

Shareholder engagement

For some time enhanced shareholder engagement has been on the political agenda as a means of promoting good corporate governance. Companies with listed securities and their advisers have to take great care to ensure that there is a reasonable and legitimate basis for selectively disclosing inside information to some shareholders and that those shareholders are effectively wall crossed prior to disclosure. It is beneficial for companies and their advisers to have a clear idea as to which of their investors are generally prepared to be wall crossed as willingness varies. Institutional investors which are willing to become insiders must indicate as much in their stewardship statements pursuant to the Financial Reporting Council's UK Stewardship Code.

Wall crossing

The consent of the company must be obtained prior to the commencement of any pre-sounding activities. The company must have a legitimate basis for delaying announcement of inside information. Where the pre-sounding requires identification of the company and disclosure of inside information, it must be reasonable to make such disclosures, there must be a legitimate reason for doing so (for example, to enable a person to perform the proper functions of his employment, profession or duties, to facilitate a transaction or seek advice or a commitment or expression of support in relation to a transaction) and appropriate wall crossing procedures must be implemented.

The number of recipients and the extent of disclosure should be kept to a minimum and the sounding should take place as close as possible to the launch of the transaction.

As part of the wall crossing process, proposed recipients must be made aware that:

- they will be given potentially inside information;
- they have obligations of confidence in respect of that information; and
- they must not deal or otherwise act on the basis of that information until the information has been cleansed or it otherwise no longer constitutes inside information (see “When can a recipient start trading?”).

If a shareholder refuses to be wall crossed but requests an "open" conversation with management, this should sound alarm bells. If possible, the request should be deferred until such time as potential inside information has been cleansed. If a deferral is not practicable, any "open" conversation should be kept to a pre-vetted script.

When is wall crossing necessary?

Has the company consented to pre-soundings?

Yes →

Is there a reasonable and legitimate basis for disclosing information to recipients?

Yes →

Before disclosing information that identifies the company have the recipients agreed to being wall crossed?

Recipients must understand that:

- they may receive inside information
- the information must be kept confidential
- they will be restricted from dealing on the basis of the information until it is no longer inside information

Yes →

Has the recipient signed a non-disclosure and standstill agreement or have follow-up written confirmations regarding confidentiality and no dealing been provided to recipients?

Yes →

DISCLOSURE

Details of transaction can be disclosed to recipients:

- record conversations (if possible) for evidential purposes
- keep internal records of disclosures
- update insider lists
- prepare leak announcement
- monitor dealings in company's securities
- inform compliance and legal teams of all pre-sounding activities
- notify compliance team of any suspicious trades
- make suspicious transaction report in relation to any such trades arranged or executed by the firm

No ↓ (each question)

NO DISCLOSURE

What's in a name?

There is some debate as to whether an invitation for someone to be wall crossed can refer to the name of the company, on the basis that, if no further information is provided, no inside information about the company has been disclosed. Disclosure of the company's name prior to formal wall crossing is not completely ruled out, but such conversations are regarded with anxiety by the UK regulator, and market practice has moved away from such an approach. In practice, whether disclosure of the name will amount to a disclosure of inside information will depend on other factors such as what other information is already available in the market on the company and what other information is disclosed as part of the conversation. However, advisers should approach conversations involving disclosures of the name with caution and bear in mind that such disclosures will leave them open to greater scrutiny from the FCA.

There is a tension here as market participants have a legitimate wish to be provided with sufficient information to make an informed decision about whether to agree to be wall crossed or not. They might expect to be provided with details of:

- the company;
- the type of transaction; and
- the likely standstill period.

Accordingly, depending on the context, disclosing information that identifies the company prior to wall crossing may be sufficient to constitute a disclosure of inside information as a wall crossing request will suggest a significant transaction is imminent since wall crossing is generally only initiated in the advanced stages of major transactions.

Wall crossing requests must be handled very carefully. On the sell-side, advice should be sought from compliance and legal teams at a preliminary stage to determine:

- whether there is a reasonable and legitimate basis on which to wall cross the proposed recipient(s); and
- what can be said during the wall crossing request.

Financial advisers must be very careful to follow and record that advice in order to put themselves in the best position to rebut any allegation of improper disclosure of inside information or that they have acted in breach of other regulatory requirements (see "What defences work?"). It is good practice to script calls, including answers to difficult questions that might arise, to avoid the risk of inadvertent disclosure of inside information during the request conversation.

What happens if things go wrong?

Inadvertent disclosure of what may be inside information to a non-wall crossed recipient should be immediately escalated to the compliance and legal teams and potentially senior management

If there is evidence of a trade by a wall crossed recipient in the securities of the relevant issuer, the compliance team should be informed. Where the trade has been arranged or executed by the firm, a suspicious transaction report should be made

The FCA remains committed to the "credible deterrence" enforcement agenda that has seen the imposition of substantial penalties on firms and individuals for market misconduct in recent years. Levels of financial penalties are expected to continue to rise

When can a recipient start trading?

On the buy-side, a wall crossed recipient will cease being an insider once an announcement is made disclosing the proposed transaction. At that stage, the restrictions imposed upon the recipient fall away.

The position is more complex where the transaction does not proceed. It is not considered market practice for issuers to make cleansing announcements if a proposed transaction is no longer on the table. In these circumstances, financial advisers must be very careful when informing recipients that a transaction is not being pursued particularly where a reason is given as this information may itself constitute inside information.

From the recipient's perspective, they may be left between a rock and a hard place possessing information regarding an aborted proposal but which has not been cleansed and which therefore may or may not remain inside information. In these circumstances legal advice should be taken by the recipient to ascertain whether the disclosures still represent inside information or whether it has become stale due to the effluxion of time or a change of circumstances.

Dispelling the myths around improper disclosure

It must be remembered that the FCA will always judge any potential disclosure with the benefit of hindsight. This must be factored into any advice given in respect of wall crossing protocols and procedures.

Myth:	**Reality**:
✘ The disclosing party believed that the recipient was under a duty of confidentiality	✔ Effective wall crossing procedures <u>must</u> be put in place before the recipient is made an insider
✘ Disclosing inside information as part of a corporate advisory mandate can never amount to improper disclosure	✔ Disclosure of inside information on behalf of a company will not be in the proper course of the exercise of a person's employment, profession or duties where the consent of the company has not been obtained and confidentiality obligations have not been imposed on the recipient even if the adviser intended to serve the client's best interests
✘ The information was already known by the recipient	✔ Information can be "disclosed" to an individual to whom that information has already been revealed; if the disclosure reinforces the existing knowledge of the recipient, it might constitute inside information
✘ Disclosure was a simple error of judgement, was not deliberate or reckless and was an honest mistake made in good faith in client's best interests	✔ Inadvertent disclosure is no excuse and, whether or not a person is acting in his client's best interests, disclosure will not be in the proper course of the exercise of that person's employment, profession or duties if confidentiality requirements are not imposed on the recipient
✘ Information cannot be inside information if it contains inaccuracies	✔ Where 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
✘ No dealing took place nor was there any intention to encourage a dealing	✔ Whether or not a dealing takes place is irrelevant, if inside information is improperly disclosed this amounts to market abuse
✘ No financial gain was made or loss avoided	✔ Whether or not a profit is made or loss avoided, if inside information is improperly disclosed this amounts to market abuse
✘ The evidence is not sufficient for the criminal standard of proof ("beyond reasonable doubt")	✔ Market abuse cases are only required to be proven on the "balance of probabilities"

What defences work?

The FCA cannot impose a penalty for market abuse if there are reasonable grounds for it to be satisfied that:

- the person believed, on reasonable grounds, that his behaviour did not constitute improper disclosure; or
- the person took all reasonable precautions and exercised all due diligence to avoid improperly disclosing inside information.

Both defences require a level of diligence which should be recorded for evidential purposes including seeking advice from compliance and legal.

A line of enforcement actions has shown that the threshold required to show that "all reasonable precautions" have been taken and "all due diligence" exercised is very high.

Unless advice sought from compliance and legal can be provided to the FCA (i.e. privilege is waived to allow its disclosure in enforcement proceedings), and there is proof that the advice was followed, it is unlikely to provide any real assistance in establishing a defence to an improper disclosure charge.

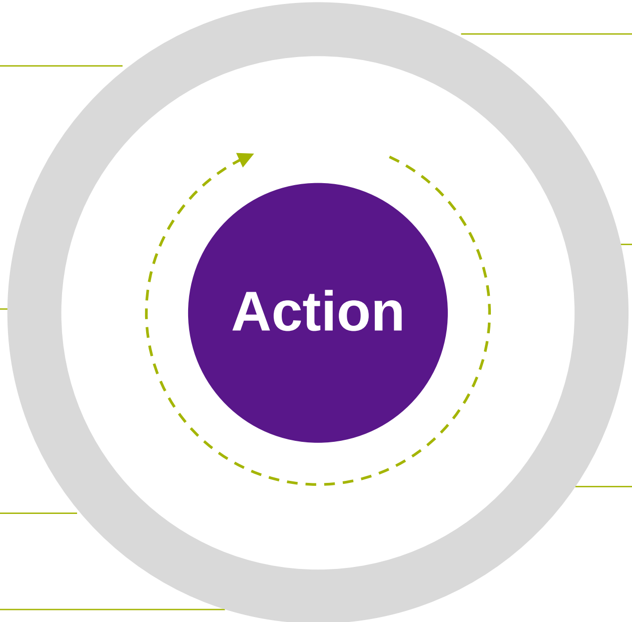
What action should firms take?

If in doubt, tread a cautious path when walking the regulatory tightrope and seek legal advice.

Review wall crossing protocols and procedures to ensure effective systems and controls are in place and provide staff guidance and training to manage wall crossing risks

Consider whether the structure of a transaction and/or nature of the company gives rise to specific issues restricting the number or type of recipient e.g. the "rule of six" on a transaction governed by the UK Takeover Code

Avoid "open" conversations or discussions of a generic nature which might nevertheless result in the inadvertent (but still improper) disclosure of inside information



Consider regulatory issues regarding conduct of pre-soundings and pre-marketing activities in the jurisdiction in which the company's securities are listed and in which the recipient of the information resides (which may be more onerous or restrictive than the UK regime)

If "open" conversation unavoidable, seek legal advice, obtain a script for the proposed call and follow the script without deviation

Before wall crossing
(i) obtain the company's consent; (ii) consider carefully whether there is a reasonable and legitimate basis for disclosing inside information; and (iii) follow wall crossing protocols carefully

Maintain accurate records of conversations

Monitor compliance with wall crossing protocols and procedures and prepare a leak announcement in case the security of the information can no longer be maintained

Monitor transactions and notify compliance team of any suspicious trades arranged or executed by the firm and make a suspicious transaction report (if necessary)

US position: Selective disclosure and wall crossing on capital raisings

A US issuer may violate Regulation FD (Note: Regulation FD does not apply to US "foreign private issuers") if material non-public information is disclosed to a recipient who is not a party to a non-disclosure agreement. Therefore, in circumstances where the recipient of the information refuses to enter into a non-disclosure agreement, no information should be provided.

Where the information relates to a capital raising pursuant to an offering registered with the SEC, any pre-soundings and pre-marketing activities by an issuer and/or its financial advisers would be restricted by the gun-jumping rules under the US Securities Act of 1933.

Wall crossing has developed in the US in two types of offerings: (1) offerings by issuers with shelf registrations on file with the SEC and (2) PIPE offerings (private investment in public equity). In both cases, potential investors must agree to keep the information confidential before being provided with the identity of the issuer in order to comply with Regulation FD.

In April 2012, President Obama signed the Jumpstart Our Business Startups Act of 2012 (JOBS Act) which permits a new category of companies to engage in limited wall crossing. Emerging growth companies (EGC), which are generally companies with less than $1 billion in revenues, may communicate with certain investors (qualified institutional buyers (QIBs) or institutional accredited investors (IAIs)) to gauge interest in a potential offering before or after filing a registration statement without raising gun-jumping issues. These communications, however, are still subject to the same liability, anti-fraud rules and, in the case of publicly-traded EGCs, selective disclosure rules as any other communication to investors. As a result, issuers and financial advisers contemplating a wall crossing for an EGC should consider following the same procedures discussed above when communicating with QIBs and IAIs.

US position: Insider trading

On the buy-side, the position is very different in the US compared to the UK. In the UK, a person may commit insider dealing under the market abuse regime even if he did not know or could not reasonably have known that information received was inside information. It is not necessary for the FCA to show that the recipient had been warned that the information was confidential or that trading was restricted. In contrast, in the US, not all trades based on material non-public information are illegal.

Indeed, in the US, illegal insider trading only occurs when a person buys or sells a security while in knowing possession of material, non-public information about that security obtained (in the case of an insider) in breach of a fiduciary duty to the shareholders or (in the case of non-insiders) in breach of a fiduciary duty or other relationship of trust and confidence owed to the source of the information. A person who is not a traditional insider can also be held liable for insider trading as a "temporary insider“ or as a "tippee" under the "tipper-tippee" theory.

In a wall crossing context, US liability will often turn on whether the recipient of the information breached a duty of confidentiality owed to the provider of the information at the time of dealing. In the absence of an express non-disclosure agreement, the recipient may be free to use the information to trade because there is no agreement to maintain the confidentiality of the information. Nevertheless, the absence of a non-disclosure agreement is not always determinative in this context; a duty of trust and confidence may exist where the parties to the communication of information have a “history, pattern, or practice of sharing confidences, such that the recipient of the information knows or reasonably should know that the person communicating the material non-public information expects that the recipient will maintain its confidentiality”. It should be noted that where the material non-public information relates to a tender offer which includes US shareholders, no breach of duty need be shown.

Wall crossing – what is in the pipeline?

The Market Abuse Regulation (MAR) will generally take effect in July 2016. MAR will introduce new rules regulating the wall crossing process including, among other things, enhanced record keeping and additional safeguards prior to any market soundings.

Disclosure in the course of a market sounding will be deemed to have been made in the normal course of the exercise of a person's employment, profession or duty, and therefore not constitute market abuse, provided the disclosing party complies with the conditions set out in MAR.

That said, there is no presumption that market participants that fail to comply with MAR when conducting a market sounding will have unlawfully disclosed inside information

Rules will cover soundings to gauge investor interest in offerings of securities and also soundings in takeovers/mergers if necessary to enable target shareholders to form an opinion on transaction and parties reasonably need to know this to decide whether to proceed.

The disclosing party will need to assess whether the market sounding will involve the disclosure of inside information. MAR requires a written record of the assessment and the rationale for the conclusion drawn.

The disclosing party will need to obtain the recipient's consent to receive inside information and provide specific warnings to the recipient before disclosing any inside information. It will need to keep records about the soundings and the disclosures that are made.

The disclosing party will need to disclose to the recipient when information ceases to be inside information after they have been wall crossed. But recipients need to determine for themselves whether it has or ceases to have inside information.

ESMA is consulting on technical standards and guidelines on the implementation of these provisions which will specify further detailed requirements.

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Further information

Clifford Chance briefings

- **Eight things we now really know about market abuse (June 2014)**
- **FSA market abuse action underlines market participants' responsibilities on inside information (Feb 2012)**
- **Differing approaches to pre-sounding across the Atlantic (November 2009)**

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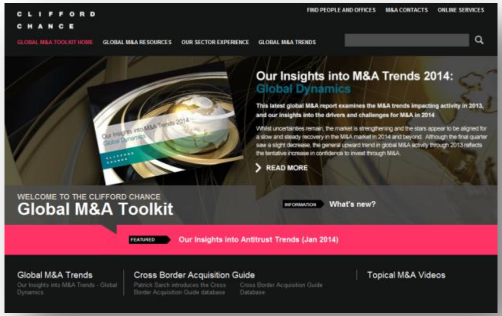

Our Insights into M&A Trends - Global Dynamics

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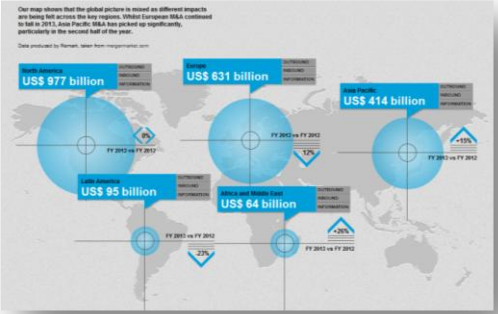

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