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Briefing note

February 2012

FSA market abuse action underlines market participants' responsibilities on inside information

In the well publicised action taken against Greenlight Capital Inc ("Greenlight") and its owner, US based President and sole portfolio manager David Einhorn, the FSA has imposed fines totalling over £7 million following findings that he and the hedge fund engaged in market abuse contrary to section 118 Financial Services and Markets Act 2000 ("FSMA").

The facts

The fines imposed[i] relate to sales by Greenlight in June 2009 of shares held by it in Punch Taverns plc ("**Punch**"). These sales followed a telephone call with a corporate broker acting on behalf of Punch, in which Mr Einhorn participated and in which the broker informed participants that a significant equity fundraising was planned. Mr Einhorn, who had declined to be wall crossed, gave instructions shortly after the call for Greenlight's entire holding in Punch to be sold (although the entire holding was not in fact then sold[ii]).

The FSA has decided that, although the information shared by the broker during the telephone call was not expressly stated to be inside information, Mr Einhorn (and therefore also Greenlight) engaged in market abuse by selling Punch shares as he should have drawn appropriate inferences and interpreted the information as inside information.

Refinement of UK insider trading regime

The FSA's finding that, effectively, Mr Einhorn engaged in market abuse negligently does not create legal precedent. The decisions underline what firms knew already; that it is not necessary for market participants to have been expressly told that information provided to them was inside information in order for enforcement action to be taken against them under the UK civil market abuse regime.

For example, in 2009, the FSA found that Darren Morton[iii] and Christopher Parry[iv] had engaged in market abuse notwithstanding that neither Mr Morton

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nor Mr Parry believed information given to them, which they then used when trading in floating rate notes, to constitute inside information, and were not told by the sell side that the information was inside information. As it has in respect of Mr Einhorn's case, the FSA found that this was not a reasonable belief in the circumstances in which they received the information.

However, the action against Greenlight and Mr Einhorn does differ from that which has gone before in this area, and casts light on the approach being taken by the FSA in this area, in several important respects.

The first of these is the circumstances from which the FSA has found that Mr Einhorn should have deduced that inside information was being passed to him. His "*serious error of judgement*"[iv] was to fail to look beyond his decision that he did not wish to be wall crossed, to fail to aggregate and adequately analyse the contents of communications from the broker and to fail to apply his mind to, and to consult Greenlight's compliance department on, whether it was appropriate, in the light of the information known to him and the circumstances in which he obtained it, to execute trades. The action taken against him and Greenlight clarifies the extent to which the FSA expects market participants to actively apply both their minds and those of their compliance colleagues to whether they have received information which will prevent them from trading. Reliance on assessments or statements made by third parties will not suffice.

The second important difference from previous enforcement cases is the scale of the penalties imposed. Again, Mr Einhorn and Greenlight are not the first individuals and firms to be sanctioned in respect of negligent insider dealing. Messrs Morton and Parry received public censures in 2009. In that case, the Final Notice issued to Darren Morton in 2009, stated that: -

"In the event that the FSA had found Mr Morton to have acted deliberately, recklessly or in breach of compliance department guidelines...This would have called into question his fitness and propriety as an approved person and would have resulted in a more severe penalty, including a financial penalty and a prohibition".[vi]

The FSA has not found it necessary to make any finding that Mr Einhorn acted deliberately, recklessly or in breach of any compliance guidelines. By imposing significant financial penalties on him and Greenlight, and in particular by setting the penalty elements of the fines imposed in both cases high (indeed proportionally higher than recent cases involving deliberate market abuse[vii]), it has demonstrated the seriousness with which it is currently approaching market abuse. A point to note is that, under the UK criminal insider dealing regime[viii], the prosecution is required to prove that the individual concerned knew that the information was inside information.

Contrast with other jurisdictions

This development and clarification of the UK position has understandably caused concern, particularly amongst those with cross border-operations, in view of the geographical disparities which exist between market conduct regimes.

For example, in order to establish insider trading under US federal securities laws, the Securities and Exchange Commission ("**SEC**") must prove that the individual concerned acted both knowingly (or with "scienter"), and that he or she traded on the basis of material non public information in breach of a fiduciary or similar duty of confidentiality owed to another party.

With respect to the latter point, the SEC's action against Mark Cuban in the US illustrates this distinction most clearly. The allegations in the Cuban case involved nearly identical facts to the Einhorn case, with one dispositive distinction: Mr Cuban is alleged to have traded upon inside information obtained pursuant to an ***oral*** non disclosure agreement ("**NDA**"). Whilst the Cuban matter is still pending in the courts, the SEC's claims are predicated on the allegation that Mr Cuban breached this oral NDA.

In Mr Einhorn's case, however, his conduct did not breach any fiduciary or other duty of confidentiality, as he obtained the alleged inside information after expressly refusing to be wall-crossed. Likewise, the FSA has acknowledged that he did not act recklessly or deliberately (i.e., without scienter). As such, several essential elements of a US insider trading claim appear to be absent.

Similarly, had Mr Einhorn's conduct occurred within the jurisdiction of the Hong Kong Securities and Futures Commission ("**SFC**"), it would not have amounted to insider dealing. This is again based on a requirement for the individual concerned to ***know*** that the information he or she has received is confidential price sensitive information[ix]. Recklessness or negligence as to whether the information is confidential and price sensitive is not sufficient.

Although the SFC would not have been able to take action under insider trading provisions, there are specific provisions in the Hong Kong Securities and Futures Ordinance[x] which entitle it to take action where it concludes that a person was reckless or negligent as to whether they were trading on the basis of confidential price sensitive information received from a connected person. As the SFC has the power to impose fines of up to three times the profit made or loss avoided by the misconduct[xi], the financial penalties imposed could, in theory, have been significantly higher than those imposed by the FSA.

Regulated entities – action for breaches of Principles

This case also raises issues under the FSA's Principles for Businesses ("**the Principles**") and Statements of Principle and Code of Practice for Approved Persons ("**APER**"). In particular, Principle 5 of the Principles and Principles and Principles 2 (exercise of due care, skill and diligence by approved persons) and 3 (market conduct) of APER have been interpreted as requiring standards of conduct analogous to those expected under the civil market abuse regime[xii].

The language of the Decision Notices issued to Greenlight and Mr Einhorn is clearly intended to reiterate and delineate the standards of market conduct which it expects market participants to observe, and to suggest that action may also be taken under the Principles and/or APER in market abuse cases. For example, passages such as: -

"considers Mr Einhorn's error of judgment to be a serious failure to act in accordance with the standards reasonably expected of market participants"[xiii]

correspond closely with the wording of Principle 5 of the Principles and Principle 3 of APER.

In particular, the question is raised as to which action the FSA may take in a situation where a UK regulated firm engages in conduct which does not constitute market abuse under the applicable law in the territory where the trading occurred and/or the market is located, but which the FSA considers to fall below its standards of proper market conduct. The FSA could conceivably take action in such a situation even where the relevant overseas regulator has not done so if it perceived a sufficiently serious regulatory gap and/or if it considered the conduct concerned to be egregious enough.

Messages for market participants

Neither the Decision Notices issued to Greenlight and Mr Einhorn nor any Handbook provisions set out prescriptively what will constitute inside information, the circumstances in which individuals will acquire it or the steps by firms or individuals which will, in the FSA's view, enable them to identify it.

However, the clear message to market participants from these enforcement decisions is that it is not enough to rely on others. The substantial penalties imposed are a reminder to market participants that they, together with their compliance functions, must make their own determinations, based upon the circumstances of communications, as to whether inside information has been passed to them and decide, based upon those assessments, whether they are able to trade.

Endnotes

[i] The Decision Notices issued to Mr Einhorn and Greenlight are at http://www.fsa.gov.uk/static/pubs/decisions/dn-einhorn-greenlight.pdf and http://www.fsa.gov.uk/static/pubs/decisions/dn-greenlight-capital.pdf respectively.
[ii] Following the orders placed by Mr Einhorn for the sale of Greenlight's holding in Punch, 11.65 million shares in Punch were sold by Greenlight and associated entities, reducing their stake from 13.3 per cent to 8.98 per cent.
[iii] Final Notice at http://www.fsa.gov.uk/static/pubs/final/morton.pdf
[iv] Final Notice at http://www.fsa.gov.uk/static/pubs/final/parry.pdf
[v] Einhorn, Decision Notice at paragraph 2.9(iii)
[vi] Morton, Final Notice at paragraph 7.7
[vii] The penalty element of the fine imposed on Greenlight was 4.7 times greater than the amount of financial benefit disgorged. In the case of the fine imposed on Mr Einhorn, this ratio was 4.61. This compares with ratios of 2.1, 1.152.62 and 4.2 respectively in the relatively recent cases of enforcement action taken against Rameshkumar Goenka, Simon Eagle, Mehmet Sepil and Samuel Kahn in respect of market abuse.
[viii] Part V Criminal Justice Act 1993
[ix] Section 270(1)(e) Securities and Futures Ordinance ("**SFO**")
[x] Section 194, SFO and the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC (General Principle 2) and the SFC's Fit and Proper Guidelines (sections 5 and 6)
[xi] Section 194 SFO – the loss avoided by Mr Einhorn and Greenlight is stated to have been £5.8 million. Therefore, had the conduct occurred within its jurisdiction, the SFC could, in theory, have imposed a fine of up to £17.4 million.
[xii] For example, in 2006, GLG Partners and Philippe Jabre were fined £750,000 each in respect of breaches of Principle 5 of the Principles and Principles 2 and 3 of APER through market abuse by Mr Jabre - http://www.fsa.gov.uk/library/communication/pr/2006/077.shtml
[xiii] Einhorn, Decision Notice at paragraph 2.10

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