Insider trading and the law and why we may see more prosecutions

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Aziz Rahman considers why information is everything when it comes to insider trading and the law…and why we may see more prosecutions.

"Someone reminded me I once said, 'Greed is good'. Now it seems it's legal." So said Michael Douglas' character Gordon Gekko in the film "Wall Street: Money Never Sleeps".

There has long been a perception that the Gordon Gekko-types have been getting away with it for years. But the Financial Conduct Authority (FCA) has replaced the old Financial Services Authority (FSA) and appears to be acting when it comes to prosecuting the sorts of case that Gekko could well have been involved in. In September this year, the FCA obtained substantial confiscation orders following convictions in a major insider dealing case heard at Southwark Crown Court. The FCA, it seems, is keener than its predecessor to use the law that it has at its disposal.

The modern law on insider trading is found in Part V of the *Criminal Justice Act 1993* . Section 52 of the Act provides that it is an offence for *"an insider*" to deal in " *price-affected securities*". An 'insider' is an individual who has 'information' as an insider. The information must relate to particular securities – such as stocks and shares - or an issuer of securities and has to be "specific or precise" and not been made public. The person gains inside 'information as an 'insider' by virtue of his position in the company or through some sort of relationship with the company, such as an independent accountant who is advising it.

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The defences are set out in s53. These include that the defendant "*did not expect the dealings to result in a profi*t", that he had reasonable grounds to believe "*that the information had been disclosed*" or that he would have *"done what he did even if he had not had the information.*" In addition there are four specified 'special defences' set out in Schedule 1 of the Act. Broadly speaking, these are designed to ensure that the offences set out in s52 do not affect practices which have always been regarded as legitimate. This would include having inside information which is also just "market information". Market information basically relates to information pertaining to the acquisition or disposal of particular securities and/or the fact that such transactions are under consideration or negotiation. Account is to be taken of whether the person was acting reasonably "*despite having that information as an insider at the time* ". These special defences are broad and general; allowing traders or buyers to plead that they were doing no more than using information properly and reasonably - and not misusing inside information.

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Prosecutions under the 1993 Act usually require the consent of the Secretary of State or the Director of Public Prosecutions; unless the Serious Fraud Office (SFO) is involved as the case involves serious or complex fraud. The FCA's primary role is to regulate: prosecution is an option but should be the last option. The ***Financial Services & Markets Act 2000*** (FSMA) is the starting point for all FCA matters. The FSMA sets out, at section 188, seven types of behaviour which it regards as 'market abuse'. Unsurprisingly, this includes insider dealing. However, a market abuse matter may be regarded as a civil or a criminal matter (see s123) and representations can be made by suspects to try and push the FCA into the civil/regulatory route, rather than the criminal route, if appropriate.

We have seen recently the FCA fining Barclays and RBS banks for misconduct in connection with LIBOR and EURIBOR submissions while the SFO is prosecuting individuals. Furthermore, the ***Serious Organised Crime and Policing Act 2005 (SOCPA)*** provides powers, in some circumstances, for prosecutors (including the FCA and the SFO) to enter into immunity deals with suspects and be able to offer reduced sentences in return for co-operation. Once into this territory, of course, some delicate handling and very careful consideration is required.

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The FCA has its own systems for monitoring movements within the markets. The FCA's figures showed that in the year end 2008, 53 out of 181 takeover transactions indicated 'abnormal pre-announcement price movements'. This means that just under 30% of the transactions studied were announced to the world shortly after a sudden increase in the price of the company shares (see Compliance Officer Bulletin, Market Abuse, 2010).

But having a chat with a mate down the pub and getting him to buy shares that are about to increase in value is always going to be difficult to detect. That said, the more trusted associates or family members that are involved then the greater the risk of compromise. The reality is that the situation is often much more subtle. For example, a senior broker who is legitimately in receipt of price-sensitive confidential information in relation to an upcoming deal between two listed companies - that will affect share prices - can have his conduct assessed in various ways. How that dealer deals with his junior brokers, how the shares are advertised and how other brokers deal with the same shares will all come into play in assessing whether the broker's behaviour amounts to proper, legitimate trading activity, abusive insider dealing or whether the 'special defences' in Schedule 1 of the Act – that we mentioned earlier - apply.

Prosecutors would point to increased ingenuity on the part of those trading with inside knowledge. For example, the use of so-called Exchange Traded Funds (ETF's). ETF's are basically funds comprised of a bundle of securities, including shares. ETFs will be bought and sold in the same way as simple shares; unlike most conventional investment funds. Thus, someone with inside information about company X can buy into an ETF that includes shares in company X and then short sell the other products – perhaps for a small loss. The effect is to hide the purchase of the shares because it is not purchased directly.

So what does the future hold? The FCA is, in reality, a revitalised FSA and has an increased appetite for prosecutions, as does the SFO. Generally, since the LIBOR scandal and now the FOREX investigations, there is more of a willingness to prosecute the big institutional cases. Where that happens, small cases also tend to be prosecuted rather than dealt with through a civil route. There will undoubtedly be increased co-operation between UK organisations such as City of London Police and the FCA but, more importantly perhaps, this will also occur between the UK and foreign enforcement authorities. We predict that all these factors and the increase generally in the use of plea negotiation, as well as immunity from prosecution under SOCPA, suggest that insider trading will become a much more commonplace prosecution. Suspects on the receiving end will need to take early specialist advice.

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