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A legal update from Dechert's Financial Services and White Collar and Securities Litigation Groups

The FSA Begins to "Think Tough" on Insider Dealing – But Will Thoughts Turn to Deeds?

Recent Press reports indicate that there is growing dissatisfaction within the FSA – and beyond – with Britain's soft approach to suspected insider dealers. For example, the London *Financial Times*[1] recently reported that the FSA had been discussing with the UK government the possibility of introducing "US-style plea bargaining" for suspects.

The FSA's apparent inability to deal robustly with insider dealing has been discussed openly for some time now. For example, in June 2006[2], we reported on the FSA's own statistical analysis of share price movements ahead of market announcements of FTSE 350 companies. In the period under review (which admittedly ended in 2004), "informed" trading appeared to have occurred prior to almost a third of takeover announcements and in one in five cases preceding trading announcements.

Many believe the reason for this is obvious: only a handful of cases of insider dealing in the UK ever make it to criminal trial. Still fewer result in convictions. The implementation of the European Market Abuse Directive in July 2005 was supposed to make it easier for the FSA to take disciplinary action (including fines and banning orders) against participants, partly because of a looser test of insider dealing and a lower standard of proof than required for criminal cases. But in practice, the FSA prefers to rely on "principles-based" regulation to control behaviour. In cases like *Jabre*[3], the behaviour of the trader, along with the formal requirements of market abuse, were emphasised. Indeed in *Pignatelli*[4], the trader was fined, even though his stock tips were, in fact, publicly available (not inside) information. In addition, the sanctions for regulatory breaches (fines, disbarment) are said by some to be insufficient deterrent. What really matters are the odds of being caught and the likelihood of prison. Observers point to the *Jabre* case where the trader was fined £750,000. The FSA presented this as a severe penalty but others pointed out Mr. Jabre was well able to afford this fine.

What benefits would plea bargaining bring? Such bargains are intended to obtain co-operation from smaller fry in order to net bigger fish. But the UK system does not appear to suffer from a shortage of evidence – indeed it is a central tenet of UK financial services regulation that Approved Persons cooperate fully and disclose everything to the regulator. And if there is no realistic chance of being convicted, then what is the incentive on the suspect to enter into a plea bargain in the first place? If the FSA is keen to imitate the US approach, then the UK prosecution authorities need to start convicting and imprisoning wrongdoers. Only then, it is said, will we start to see a difference.

The fact is, in the bigger picture, the FSA has set its face *against* being an 'enforcement led' organisation, and has for example reduced the headcount of its enforcement division from 250 to 200. In the FSA's Business Plan for 2007/8, it states that it intends to continue with its emphasis on "principles-based" regulation as opposed to rules and black letter law (such as the insider dealing legislation needed to secure

1 Monday, April 23rd 2007

2 Dechert Financial Services Update No. 4 : *Insider dealing and market abuse – five years on*

3 FSA Final Notice, 1st August 2006

4 FSA Final Notice, 23rd November 2006

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criminal convictions in the UK). It also wants to promote early settlement with offenders, again pointing *away* from harsher rules-based enforcement with jail at the end. If this turns out to be the prevailing mood, then any reduction in UK insider dealing may turn out to be attributable to the ripple effect of harsher US enforcement reaching its long arms across the Atlantic. As we see below, though, the US model, whilst more aggressive, does in its own way appear to be principles-based, but with a very different outcome.

Here are some perspectives from Dechert lawyers around Europe and the United States:

Germany

While the German Regulator (*BaFin*) is very keen to detect and report insider dealing, the efforts of the public prosecutor's office to prosecute cases have been criticised as too slack. *BaFin* does not have criminal enforcement powers. These are left to public prosecutors. Only recently, the president of the German Regulator stated in an interview that approximately 75% of the cases concerning suspected insider dealing which the German Regulator forwards to the public prosecutor's office are not further pursued. Since 2001, only 40 out of 550 reported cases ended with a verdict. *BaFin* is in particular not satisfied with the public prosecutor's office in Frankfurt where in the past five years only in five reported instances were charges brought.

France

Changes made in recent years to the powers of the French regulatory authority, the *Autorité des Marchés Financiers* or AMF, did increase its ability to seek administrative sanction for violations of the insider trading and other market rules, but the power of criminal prosecution still lies with the public prosecutor's office. In either case, the manpower available is limited and in the case of the AMF, is but a fraction of that available to the FSA or BaFIN, and is not even on the same scale as that of the SEC. In theory, aggrieved parties acting as civil parties could force the public prosecutor to pursue criminal proceedings, although this could be costly and given the evidentiary issues is a rarity in the area. Recent changes in French criminal procedure now make it possible to obtain plea bargains as well, but the law is relatively untested and the rules of criminal procedure such that one wonders whether defendants would not be better off if they took their chances on a full trial. Still, recent scandals have given rise to a series of high profile investigations; they might give the AMF a taste for prosecution that it has not until recently seemed to relish.

USA

In a period during which the US SEC's enforcement division appears to be searching for a "theme" (aside from the "options backdating" investigations – which have been driven more by academic research than by corporate melt-downs or other public scandals), investigations and prosecutions of insider-trading have become the "face" of securities enforcement.[5] In announcing a recent action,[6] Linda Chatman Thomsen, the Director of the SEC's enforcement division, used some of her most aggressive rhetoric to date: "[A] market participant who engages in illegal insider trading undermines the level playing field that is the hallmark of our capital markets... We are passionate about protecting investors and the integrity of our markets. And if we catch you, we will use all resources at our disposal to hold you accountable."

It is likely that this focus will continue, as the SEC, the US Department of Justice and other regulators have been scrutinising, among other practices, information flows among hedge funds, prime brokers and other sophisticated market participants. Similarly, SEC officials have raised questions concerning so called "10b5-1 plans" which enable corporate insiders to set up plans to sell shares of their companies' stocks at pre-determined periods without running afoul of insider trading

[5] The SEC and the US Department of Justice have pursued several high-profile insider trading matters in the past few months. See, e.g., *SEC v. Melton* (civil insider trading action against spouse of Amgen executive); *SEC v. One or More Unknown Purchasers of Call Options for the Common Stock of TXU Corp.* (SEC obtained Temporary Restraining Order freezing assets of certain purchasers who had purchased options in advance of a public announcement of a merger agreement); *SEC v. Guttenberg et. al*, (action against 14 defendants, including several employees of major securities firms, for alleged insider trading). The government also has achieved some notable recent victories. See, e.g., *US v. Nacchio* (guilty verdict in criminal insider trading prosecution of former CEO of Qwest Communications). The *TXU* matter is especially noteworthy because the SEC obtained, among other things, an order in US court freezing the assets of individuals in the UK who had purchased TXU options. The SEC publicly acknowledged the FSA's contribution to the investigation.

[6] *SEC v. Guttenberg,* cited in previous footnote.

laws. The regulators are investigating whether corporate insiders have manipulated the timing of corporate announcements in order to maximize the returns achieved through their 10b5-1 plans.

This continuing scrutiny – and the historical effectiveness of the SEC's and the Department of Justice's policing of insider-trading – provides an interesting perspective on the discussion of rules-based, "US-style" and principles-based, "UK-style" approaches to securities regulation. The basic statute under which US authorities pursue insider-traders, Section 10(b)(5) of the Securities Exchange Act, says, basically, "thou shalt not commit fraud" but does little to define where lines are to be drawn. In other words, the prosecution of insider-trading is one of the best examples of principles-based regulation in the US, which suggests that a debate concerning whether the FSA should adopt "rules" proscribing insider-trading before embarking on a campaign of vigorous prosecution may be largely irrelevant if the will exists to address such activity.

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