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EVOLVING REGULATION

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A. Background

(1) Introduction

1.01 The UK Government, like most others, has long said that the principal aims of its financial services regulation are to preserve the integrity of its financial markets and to protect consumers.[1] The UK Regulator – the Financial Services Authority (FSA) – considers these aims to embrace both 'preserving ... actual stability in the financial system and the reasonable expectation that it will remain stable'.[2] One of the principal ways that this is done is by preventing what is called 'market abuse'. 'Market abuse' can generally be described as improper market behaviour, such as:

- insider trading;
- various techniques of market manipulation, and
- any other behaviour interfering with the fair and efficient operation of financial markets.

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[1] Financial Services and Markets Act 2000 (the 'Act' or 'the FSMA') Pt I, 'The regulatory objectives', ss 3–6. The four stated objectives of the Act are: market confidence, public awareness, the protection of consumers, and the reduction of financial crime. Also see the FSMA Explanatory Notes ('Act Notes'), Pt I.

[2] FSA, *A new regulator for a new millennium* (January 2000), Ch. 1, para. 2.

1.02 Historically, the UK Government had developed two principal tools for addressing improper market behaviour:

- criminal sanctions for insider dealing and misleading statements and practices;[3]
- supervisory and disciplinary powers exercisable over regulated firms and registered individuals employed by a variety of former self-regulatory organizations (SROs)[4] and, later, similar powers conferred on the FSA in respect of authorized firms and approved persons working within them.[5]

The FSA's powers in this regard might be considered powerful weapons against market abuse. They include the 'Principles for Businesses', which are described as 'the fundamental obligations of all firms under the regulatory system' in the FSA Handbook. These impose such general obligations such as the requirement that 'a firm must conduct its business with integrity'.[6] They apply to all firms regulated by the FSA. If the FSA decides that some firm has violated a Principle it may employ a range of sanctions up to and including the option of putting the firm out of business by withdrawing its authorization.

1.03 The above measures were considered, however, in some respects ineffective and in others incomplete. For example, the failure of a number of high-profile criminal trials exposed weaknesses in the insider trading laws and attempts to criminalize improper market behaviour as fraud were not generally successful.[7] As to this 'gap'

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[3] Financial Services Act 1986, s 47 (now FSMA, s 397).

[4] A variety of disciplinary powers were exercisable, for example by the Life Assurance and Unit Trust Regulatory Organisation (LAUTRO); the Financial Intermediaries Managers and Brokers Regulatory Association (FIMBRA); the Personal Investment Authority (PIA) – see in particular Chapters 9 and 10 of the PIA Handbook on the intervention and disciplinary powers of that SRO.

[5] See the disciplinary and intervention powers of the FSA in Part IV of the FSMA in relation to approved persons and firms and the further disciplinary measures in Part XIV of the FSMA (superseding similar provisions in the Financial Services Act 1986.

[6] This is the first Principle for Business listed in PRIN, s 2.1 of the FSA *Handbook*. FSA *Handbook*, *High Level Standards*, *Principles for Businesses*, Reference Code PRIN, 2.1. NOTE: all references in this book to sections of the FSA *Handbook* will be by Reference Code and section number. For example, the section referred to in this footnote will be 'PRIN 2.1'. Where appropriate, the section number will be followed by a 'status icon' letter. These are letters which the FSA uses in its *Handbook* to indicate whether a section is 'R', rules made under the FSMA, s 138; guidance, 'G'; E, which in the FSA *Handbook* Market Code of Conduct (MAR) may be relied on to indicate whether or not conduct is market abuse; 'UK', indicating non-FSA UK legislative material; 'EU' or EU, indicating non-FSA EU legislative material. All references in this book to *Handbook* sections are, unless otherwise noted, references to editions published after 1 July 2005. However, readers should assume that all FSA is subject to continuous revision. For further information see the FSA website and/or contact the FSA.

[7] Notably the failure to sustain convictions against directors and financial advisers for improper conduct in connection with a rights issue in the *Blue Arrow* case (*R v Cohen* [1992] 142 NLJ 1267; see, further, the failure to make criminal allegations stick against Ernest Saunders in relation to suspected wrongdoing in respect of Guinness plc's take-over of Distillers plc (*Saunders v United Kingdom* [1996] 23 EHRR 313.

in protection, Melanie Johnson, economic secretary to the Treasury, commented during parliamentary consideration of the FSMA:

> We protect the financial markets in two ways. First, there are the criminal regimes for market manipulation and insider dealing. These are both serious criminal offences … Secondly, there is the regulatory regime under which various regulatory bodies can take action against regulated persons for market abuse. However, there is a gap in the protections.[8]

1.04 The gap was filled by the market abuse prohibitions now found in ss 118–132 of the FSMA and the explanatory regulations found in the FSA's *Code of Market Conduct*[9] contained within the Business Standards section of the FSA's *Handbook of Rules and Guidance*.[10] This book is principally concerned with this new 'civil offence' of market abuse.

(2) The broad scope of the new 'civil offence'

1.05 Since the introduction of express market abuse prohibitions in 2001, and during more recent discussions of the adoption and implementation of the EU Market Abuse Directive,[11] a great deal of concern has been expressed by different sections of the financial services industry concerning the exact descriptions of possible market abuse behaviour and problems of ambiguity relating to such descriptions in the MAR or implementing instruments of the Directive. In fact, it is not particularly useful to spend too much time worrying about such things. True, the MAR does provide some detail about what the FSA is likely to regard as market abuse. However, the sanctions specifically defined as being applicable to market abuse are in many respects no less precise than the disciplinary sanctions the FSA has at its disposal to control and punish market misbehaviour mentioned above. It is clear that complaints about the broad nature of these powers will be given short shrift by the UK Courts. In *Fleurose v The Disciplinary Appeal Tribunal of the Securities and Futures Authority Limited*[12] a complaint that charges made against a Senior Cash Arbitrage Trader employed at the time by J P Morgan Securities Ltd in the following terms were unfairly vague so as to prejudice a fair trial were rejected. The charges read:

> The Securities and Futures Authority Limited pursuant to Rules 7-60 and 7-61 of SFA's Rules, hereby institutes disciplinary proceedings against Mr. Bertrand Fleurose

[8] Standing Committee A, 2 November 1999, HMSO.

[9] Referred to below as the MAR, and/or the 'Code'.

[10] Referred to below as the 'FSA *Handbook*'.

[11] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on Insider Dealing and Market Manipulation (market abuse) (OJ L96, 12.4.2003) (referred to below as the 'Market Abuse Directive', or simply the 'Directive'.

[12] [2001] EWCA Civ 2015.

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> on the grounds that: A. He has committed that following acts of misconduct: (1) In breach of Principle 1 of the FSA's Statements of Principle, Mr. Fleurose failed to observe high standards of integrity and fair dealing in his involvement in the trading activities of the Equity Derivatives Group of J P Morgan Securities Limited on 28th November 1997. (2) In breach of Principle 3 of the FSA's Statement of Principle, Mr. Fleurose failed to observe high standards of market conduct in trading for J P Morgan Securities Limited on the London Stock Exchange on 28th November 1997.

There followed 11 pages of a document headed 'Summary of Facts' giving extensive details of the case and evidence relied upon. In relation to a complaint that such broad allegations conflicted with Mr Fleurose's Article 6 Right to a Fair Trial under the European Convention on Human Rights, the Court held:

> So far as vagueness is concerned, [Counsel for Mr Fleurose] did not and could not seek to suggest that M Fleurose did not know of what he was accused. Having received the document referred to in paragraph 8 of the judgment as the Summary of Facts, he both knew what were the specific acts alleged and what was the state of mind alleged. M Fleurose throughout the disciplinary hearing accepted that those acts coupled with that state of mind amounted to the disciplinary offence alleged. His defence was that he did not have the relevant state of mind. Like the Judge we consider that the admitted lack of specificity in the general principles, quoted in paragraph 18 of the judgment below, did not, in those circumstances, help M Fleurose to make out a case that the hearing had been unfair.[13]

1.06 Therefore, rather than being too concerned about the exact boundaries of specific descriptions of market abuse, it is far healthier for a financial market participant, and its advisers, to be constantly aware of the UK's general regulatory position that market activity must not jeopardize the fair and efficient operation of the UK financial markets. As the FSA continually emphasizes in its press releases:

> The FSA aims to promote efficient, orderly and fair markets, help retail consumers achieve a fair deal, and improve its business capability and effectiveness.[14]

1.07 How the 'civil offence' of market abuse came to be a distinct tool in the UK's regulatory armoury is discussed in the following sections.

B. The Evolution of Market Abuse Regulation

1.08 The regulation of market abuse is an increasingly complex and controversial issue in the world of financial trading. It is increasingly complex because of the proliferation of regulations in different jurisdictions that overlap in the international market. It is increasingly controversial because traders are afraid that overlapping market abuse regulations will harm market liquidity and trading profitability.

[13] *Ibid.*, para[16].
[14] FSA, 'Make sure contracts terms are fair, FSA tells firms', FSA *Press Release*, 19 May 2005.

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1.09 In the US, 'market manipulation' and 'insider dealing' have long been subject to both regulatory and criminal penalties. In some circles, this has been perceived as an effective method of giving US regulators the flexibility they need to deal quickly with developing market changes and/or disruptions.

1.10 Prior to the advent of the 'civil offence' of market abuse in the FSMA, the UK did not have a specific scheme to control 'market abuse'. Aside from the criminal and regulatory sanctions mentioned above, the main protection for investors was to remember the maxim *caveat emptor*, or 'let the buyer beware'. As noted above, there were good reasons to beware. From a criminal perspective, for example, even outright fraud was extremely difficult to prove in the context of investment transactions.

1.11 In fact, it was the *laissez-faire* 'self-regulation' climate of the City of London (where the traditionally guarantee of integrity was 'my word is my bond')[15] that kicked off the original author's long career in financial services law. As a young lawyer, struggling to build his own practice in New York in the late 1970s and early 1980s, the original author had cases involving claims of UK financial market participants against US or UK companies referred to him because redress could not be effectively sought in the UK, and no major US firm would risk taking such untried claims on a speculative basis. Naively, the author did, and established that foreign claimants could bring such litigation in the US.

1.12 Since that time, the financial services business has grown dramatically. The London Stock Exchange's so-called 'Big Bang' of 1986 abolished the traditional regime of 'single capacity dealings', that is, where an investor had to seek advice from a 'stockbroker' who acted as intermediary between the investor and a 'stockjobber' or retailer of shares. This offered some measure of investor protection. Once 'dual capacity dealing' became the norm, firms became simultaneously brokers and dealers. The potential for conflicts of interest became acute and contributed to the implementation of the UK's Financial Services Act 1986 ('FS Act') as a necessary measure to provide protection for investors and deter abuses of the market.

1.13 The UK Government became increasingly persuaded that more formal protection of UK financial markets from 'abuse' would be a key factor in assuring their success. This climate was responsible for the creation of two specific categories of market conduct criminal offences. First, the Companies Act 1980 made insider

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[15] Oddly enough, that phrase originally signalled a trader's willingness to flout English law. In the 18th and 19th centuries, most transactions in which the promissor agreed to deliver certain assets to the buyer in the future were forbidden by statute and unenforceable under English law. Nevertheless, City traders entered into such illegal contracts all the time. Therefore the only hope that the agreement would be kept was that the promissor intended to keep his word. No enforcement remedy was available at law.

dealing a criminal offence for the first time. This made it a criminal offence for the possessor of non-public information which affected the price of *securities* (known as 'inside information') to deal in those securities, to encourage others to do so, or to disclose the information other than in the proper performance of his employment, office or profession. Following revisions to the Companies Act in 1985, the offence was replaced by the Companies Securities (Insider Dealing) Act 1985. In 1993 an EU Directive on Insider Dealing led to the Criminal Justice Act 1993 (CJA) and the insider dealing offences now found in Part V.

1.14 Secondly, s 47 of the FS Act made it a criminal offence for any person to knowingly make a false or misleading statement or to dishonestly conceal material facts in connection with the purchase or sale of an investment.[16]

1.15 Both the above provisions impose severe penalties (fines or imprisonment of up to seven years) but their effectiveness in regulating financial markets is limited in important ways. First, the application of the insider dealing prohibition of the CJA is limited to "price-affected securities", which has been a difficult concept to define. Second, the bringing of a criminal prosecution is a cumbersome process. It takes time, and obtaining a conviction for an offence requires proof of the *mens rea* constituting the offence established *beyond reasonable doubt*, with the defendant entitled to *legal aid* under certain circumstances. It is easy to see that with the high standards required in criminal prosecutions, criminal penalties cannot be used as flexible or efficient regulatory tools.[17]

1.16 The regulatory authorities including the Securities and Investments Board (SIB), the Securities and Futures Authority (SFA), and their successor, the FSA, relied on conduct constituting insider dealing as evidencing a lack of fitness and propriety by the perpetrator to operate in the financial services sector. This could lead to a direction disqualifying an individual from employment in investment business,[18] but such powers did not permit the quick action needed to respond to market disruptions. Also, in responding to an incident of insider dealing the FSA could seek to impose punishment for such behaviour on the basis that the registered person in question was guilty of violating more general FS Act principles such as:

- Principle 1: failure to observe high standards of integrity and fair dealing;
- Principle 2: failure to act with due skill, care and diligence;

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[16] This is now found in FSMA, s 397.
[17] Criminal Justice Act 1993, s 61(2).
[18] Financial Services Act 1986, s 59; see further: Injunction against Mr Sahib Saini, FSA Press Release, 17 March 1999, FSA/PN/027/1999; Disciplinary Action against Richard Philip King, SFA Board Notice 589, 11 June 2001. King pleaded guilty to three charges of insider dealing under Criminal Justice Act 1993, s 52.

- Principle 3: failure to observe high standards of market conduct, and
- Principle 6: conflict of interest.[19]

1.17 However, as Sir Howard Davies, then Chairman of the FSA, the UK's main financial services regulator, reflected in 1998:[20]

> I think we have to recognise, sadly, that the City's image is not all it might be. There have been too many 'accidents' for that to be so… Putting all these together might suggest that the City was constantly riven with scandal. And of course those who watch these affairs closely will be aware that in this lengthy list of scandals, relatively few of the participants have been brought to book. There have been some prosecutions, certainly … But the record in heavily contested serious fraud trials has, frankly, not been good. And remarkably few prosecutions have been brought for insider trading. There is a common perception, which is hard to dismiss, that City crime is simply not punished on the same basis as other forms of theft.

1.18 By that time it was recognized that the financial markets were changing and expanding too rapidly for financial services regulation under the FS Act to be able to keep up. As Howard Davies said in another speech that year:

> One of the problems we have experienced with the Financial Services Act of 1986 is that it is not as adaptable to the new markets and products as we, or financial institutions themselves, would like it to be.

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1.19 Consequently, in May 1997, the Government announced proposals to reform the financial services regulatory system in the UK. In July 1998, the Treasury published a paper explaining the policy of the proposed financial services reforms in detail and including a draft of a new Financial Services and Markets Bill[21] ('the Bill'). The Bill proposed to change UK financial services regulation by designating the FSA as the single regulator for authorization, supervision and enforcement in financial services business[22] and giving the FSA a range of new powers to combat market misconduct including:

- investigation powers,
- the power to bring criminal proceedings in cases of insider dealing or with respect to misleading statements and practices;
- the power to impose civil fines in cases of market abuse, and
- the power to seek restitution orders in cases of market misconduct.[23]

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[19] SFA disciplines William Dootson and Paul Sharples for dealing on the basis of inside information: 22 April 1999, SFA Board Notice 514.

[20] Securities Institute Ethics Committee: 3rd Annual Lecture, 2 November 1998, 'Are Words Still Bonds: How Straight is the City?'

[21] HM Treasury, Financial Services and Markets Bill: *A Consultation Document*, July 1998.

[22] FSA, Financial Services and Markets Act, Explanatory Notes.

[23] FSA, *Consultation Paper 17, Financial services regulation*: *Enforcing the new regime*, December 1998, s 115.

1.20 With respect to that Bill, Sir Howard Davies said:

> It is clearly intended to create a one-stop arrangement for regulation and to provide both flexibility and accountability.[24]

1.21 In the Bill, the Government made it clear that its principal regulatory objective was to maintain market confidence in the financial system of the UK, which included the financial markets and exchanges, regulated activities, and any other activities connected with financial markets and exchanges.[25] The other objectives were promoting public understanding of the financial system, protection of consumers and the reduction of financial crime. As the Treasury has stated in a memorandum to the Joint Committee on Financial Services and Markets:

> The UK financial services industry is highly successful and vitally important to the UK economy. It accounts for 7% of the GDP and employs over one million people.[26]

1.22 Early on in consideration of the Bill, Davies made it clear that having the flexibility to deal with changing markets was an important element in the new Bill:

> Stephen Byers has explained the Government's aim in reforming the regulatory system. He has explained that the new legislation is designed to be flexible enough to cope with changing financial markets in the future. Indeed, when he first announced the reform, the Chancellor of the Exchequer said that he planned to devise a regulatory system for the 21st century … But flexibility means a greater degree of freedom for the Regulator to make rules, from time to time, and change them. And that puts a heavy burden of responsibility on those responsible for the details of regulation. So we decided that it was important for the FSA to publish, alongside the new draft Bill, a paper which explained how, in current circumstances, we would use the freedom we would be given, were the Bill to pass its present form. Of course, this cannot prejudge the ways in which we might change the regulation in the future.[27]

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1.23 As Davies said in the same speech:

> … [T]hat points to the need to regulate financial markets in a way which attempts to raise standards within firms themselves, rather than simply imposing them through inflexible rules from the outside.[28]

[24] Howard Davies, Chairman, Financial Services Authority, Financial Services and Markets Bill Conference, Grosvenor House Hotel, 24 September 1998.
[25] Financial Services and Markets Bill 1999 [HC Bill 1, Session 1999–2000], Part I, s 3.
[26] Joint Committee, Second Report, Minutes of Evidence taking before the Joint Committee on Financial Services and Markets, Wednesday 19 May 1999, p. 2, para. 4.
[27] Howard Davies, speech, *Financial Services and Markets Bill Conference*, Grosvenor House Hotel, 24 September 1998, p. 1.
[28] *Ibid.*, p. 8.

1.24 Clearly, the messages which both the FSMA and the FSA are trying to get over to the industry are that:

- confidence in financial markets is critical to the economy of the UK;
- those markets offer significant opportunities to profit and significant risks, both to individuals and to the UK economy;
- participating in those markets is a privilege, not a right;
- to earn that privilege, a participant must be willing to assume, in co-operation with other participants, certain obligations, and
- the principal obligation is for market participants to conduct their affairs so as not to compromise the fair and efficient operation of the market, or to unfairly damage the interest of the investors.[29]

1.25 Effective enforcement of this key obligation requires a regulatory system which the Government, the regulators and market users must recognize requires enough flexibility to deal with unforeseen future events which prevents regulatory standards from being defined, in advance, with complete precision. In late 2001, the UK thus implemented new penalties for market abuse in the FSMA. Their adoption had two important general consequences. First, these penalties for market abuse apply to all regulated markets and to most trading 'related' to regulated markets. Second, they were thought to provide the UK with a new flexibility in regulating its financial markets nearly equivalent to that enjoyed by US regulators.

1.26 The FSA has not had a long history of actively enforcing the UK market abuse regime. However, as shown in Chapter 14 below, it has become increasingly active in imposing fines for certain kinds of market abuse.

C. Implementation of the EU Directive

1.27 Another key block in the structure of UK market abuse regulation is the adoption and implementation in the UK of the new EU Market Abuse and Insider Trading Directive. The Market Abuse Directive was passed by the European Parliament by a substantial majority on 14 March 2002.[30] The European ministers approved a 'compromise text' on 7 May 2002. The Directive was formally made a Directive of the European Parliament and Council on 28 January 2003 and entered into force in April 2003.[31] In theory, the implementation date for the Directive to be written into the national law of Member States was 12 October 2004.[32] In fact,

[29] MAR 1.2.3(5) (revoked 30 June 2005). References to the MAR, cited in this way, are to the pre-1 July 2005 Code.
[30] EUROPARL Daily Notebook: 14.03.2002, p. 5.
[31] Implementing Directive, 2003/124.
[32] Directive, Art. 18.

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the effective date for UK regulations implementing the Market Abuse Directive was 1 July 2005. In truth, this apparent delay should be set against the backdrop of a tough regime the UK was already operating which required minor adaptations to bring it into line with the detailed requirements of the Directive.

1.28 Technical implementation of the Directive was assisted by measures decided by the European Commission, with the aid of the European Securities Commission (made up of Member State Representatives) with consideration of technical advice from CESR[33] (made up of national authorities). The Directive required each Member State to nominate one regulatory body to deal with market abuse and insider dealing.[34] In the UK, that body (or 'Authority' as it is often referred to in legislation or regulations) is the FSA. For purposes of the EC Directive, market abuse may be described as:

> Behaviour causing investors to be unreasonably disadvantaged by others through insider dealing or market manipulation.[35]

1.29 There are a number of similarities and differences between the UK market abuse regime introduced after 30 November 2001[36] and the Directive, which are discussed in more detail in the following chapters. However, the principal differences are threefold. First, in the UK regime, the standard against which market behaviour was originally based on an overarching 'regular user' test. The Directive does not replicate this approach and the 'regular user test' is now the subject of 'sunset provisions' as discussed in Chapter 3.[37] Second, the number of 'safe harbours' is significantly fewer. At present, there are only two definite safe harbours found in the Directive. One relates to share buy-backs and the second relates to price stabilization. These elements of the Directive are discussed more fully below. Third, the pre-Directive definition of market abuse included conduct which a regular user of the market would, or would be likely to, regard as behaviour which would, or would be likely to distort the market in investments of the kind in question.[38] In essence, the pre-Directive regime dealt with three types of behaviour: insider dealing, market manipulation, and market distortion. The post-Directive regime sees market distortion, judged by the regular user of the market, as now subject to the sunset provisions discussed in Chapter 3.[39]

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33 Now the European Securities Authority ('ESA'); formerly the Committee of European Securities Regulators.
34 Directive, Recital 36.
35 Directive Proposal, pp. 2–3.
36 The introduction date, frequently referred to as 'N2'.
37 See paragraph 3.11.
38 See s118(2)(c) as originally enacted and further the discussion in Chapter 3 at paragraphs 3.2 to 3.11.
39 See paragraph 3.11.

1.30 The international control of market abuse became a particularly urgent issue for the EU. It required adoption of common regulatory provisions by all EU Member States and cooperation between those states to prevent market abuse from being initiated in one state and impacting on others.

1.31 The Directive required adoption of regulations to control market abuse that impose both negative and positive duties on both Member States and those involved in the financial markets. At the national level, the Directive required Member States to implement the following basic protections against market abuse:

- a requirement that any professional arranging transactions who has any reasonable suspicion that a transaction might constitute market abuse, notify the regulatory authority without delay;[40]
- regulations requiring those producing or distributing research to present it fairly and disclose any conflicts of interest;
- a requirement that issues of financial instruments inform the public of inside information as soon as possible,[41] and
- a requirement that management of issuers (and any persons closely associated with them) disclose their dealing in the issuer's shares or other financial instruments linked to the shares.[42]

1.32 On individual financial market participants, the Directive also required Member States to impose both negative and positive duties. On the negative side, traders must be required to avoid conduct that would constitute insider dealing or market abuse. On the positive side they must be required to take steps to make the financial markets more transparent, such as:

- reporting suspicious transactions;
- maintaining lists of insiders;
- disclosing inside information, and
- disclosing insider trades in an issuer's financial instruments.

1.33 An important element of this Directive is that its provisions apply to both financial and commodity derivatives, generally. The UK Government recognized that the implementation of the Directive in the UK required substantial changes to the UK's market abuse regime. A full review and implementation of those changes was accordingly scheduled for late 2004 and early 2005.[43] To effect the implementation of the Directive in the UK (which was supposed to have been completed by 12 October 2004), the Treasury and the FSA issued a Joint Consultation Paper on

[40] Directive, Art. 6.9.
[41] Directive, Arts. 6.1 and 6.2.
[42] Directive, Art. 6.3.
[43] HM Treasury/FSA, *UK Implementation of the EU Market Abuse Directive (Directive 2003/6/EC), A consultation document*, June 2004 ('Joint Consultation Paper').

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18 June 2004 proposing changes to UK legislation and the FSA Handbook necessary meet the requirements of the Directive. The FSA requested responses to the Consultation by 10 September 2004. They finalized the new provisions at the end of March 2005 and gave the industry three months to adjust. Despite the 12 October deadline, the UK market abuse regime implementing the Directive was not finally implemented until 1 July 2005.[44]

D. International Complications

1.34 All the above creates a complicated situation for those operating in international markets. Market participants cannot simply review UK market abuse regulation and take that as their sole guide to proper behaviour in the world's financial markets. True, the UK is an important market for international trading. But the US is also an important jurisdiction which gives its financial services regulation a very long reach. Regulations in other European jurisdictions introduced in consequence of the Directive will now both overlap, and be somewhat different from, both the previous UK and US regulations.

1.35 The impact of the overlapping nature of these different regulatory schemes needs to be considered by anyone operating in international markets. The markets affected are not discrete national venues for the purchase and sale of financial products. All important financial and commodity markets operate internationally in developing sources of supply, in creating products for sale, and in finding customers. In our electronic age, even if a particular market participant is not physically present in a particular market location his activities can have a significant impact. Market abuse regulation seeks to control not only presence but effect as well. Consequently, the developing market abuse regulations apply to traders who are located far beyond the borders of the government implementing the regulatory schemes.

1.36 Although this book will concentrate on UK regulation, it cannot ignore important international schemes that traders need to keep in mind. Therefore, some attempt will be made to outline the key issues which may make certain market abuse vulnerable to European and US regulatory action or private litigation in key jurisdictions, particularly in the US which, after all, boasts the world's largest economy. The aim of this is to make the consequences of trading in important international markets, and the risks of being charged with 'market abuse' a little less uncertain.

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[44] FSA, *Market Watch*, Issue No. 10, July 2004, p. 3.

E. Other Uncertainties

1.37 In the UK, there are other important levels of uncertainty. The original UK market abuse provisions of the Act were themselves a relatively new concept when first introduced and did not lead to an extensive record of enforcement. Now even that early sketchy record is compounded by the introduction (on 1 July 2005) of newer provisions and statutory amendments implementing the Market Abuse Directive. Therefore, there is not yet available a long-established body of precedents to inform traders about how they are expected to behave and where their behaviour might cross the line into constituting market abuse.

F. The Approach of the Book

1.38 The complexities and uncertainties outlined above create a difficult situation for anyone trying to comment on market abuse at the moment. Nevertheless, this book will try to overcome those difficulties with the following approach.

(1) UK market abuse regime

1.39 First, the UK provisions against market abuse will be the principal focus of this book. This will discuss not only the UK market abuse provisions which have been in operation since N2, but also the changes to that regulatory scheme which were brought about by the implementation of the Directive. Subject to the caveat in paragraph 1.37 above, the fact that the UK has had a formal market abuse regime in operation for several years will assist in describing the reach and impact of UK regulation with some greater certainty than might otherwise be possible.

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(2) The move to principles-based enforcement

1.40 Second, the reasons for, and the impact of, the FSA's announced move of its enforcement philosophy from rule-based to 'principles-based' enforcement will be examined. Since the introduction of the market abuse regime, its initial impact was probably less than market participants expected, and less than the FSA had hoped. More recently, however, it is clear the FSA is increasingly exercising its powers conferred by the FSMA to address market abuse and send a clear message to the industry that it will not be tolerated. In the years following the enactment of the market abuse provisions in the FSMA the FSA has dealt with a variety of market abuse cases involving allegations such as misuse of information/insider dealing and breaches of High Level Principles; and has recently increased the

number of criminal cases involving insider dealing, misleading statements and inaccurate or misleading disclosures.[45] But it is generally conceded that more needs to be done. On 1 June 2009 Margaret Cole, head of enforcement at the FSA, announced a major recruitment initiative of an additional 80 staff dedicated to investigating 'wholesale' cases. Approximately a third of the enforcement staff are now involved in insider dealing cases.[46] It has also made significant technological advances in its fight against market abuse. There is a new Digital Evidence Unit with a team of 10 specialist investigators responsible for stripping and analysing computers, BlackBerrys and other electronic devices seized from suspected insider dealers.

1.41 For a couple of reasons, the impact of the regime was not what the Government may have initially intended. First, the Government's expressed hope that the market abuse regime would constitute an administrative remedy for market misconduct which could be dealt with by the FSA through the regulatory process was unsettled by decisions of the independent Financial Services and Markets Tribunal ('the Tribunal') to the effect that the standard of proof required for the imposition of market abuse penalties should not be any different from the judicial standard that determines whether legal penalties are to be considered 'civil' or 'criminal'. The more severe the penalties which the FSA seeks to impose, the higher the standard of proof the FSA will have to meet in order to defend those penalties to the Tribunal (and, when appropriate, higher courts). It makes no difference whether the statute characterizes the market abuse regime as a civil remedy. Where the penalties sought to be imposed are sufficiently severe, the standard of proof will be the same as if the remedies were defined as criminal penalties. As shown below, the imposition of this somewhat more difficult standard has caused some important failures for the FSA in attempts to prosecute what it regarded as severe market abuse infractions. In particular, the FSA's failure to persuade the Tribunal that its imposition of penalties was justified in the highly publicized 'Plumber' case was particularly galling to the regulators.[47]

1.42 Perhaps, as a result of this and the general recognition that the standard of proof in market abuse cases is not going to be particularly easy, the FSA might be viewed initially as having decided to make enforcement easier by putting enforcement on a different base. Rather than seeking to enforce penalties based on decisions derived from more 'rule-bound' regulations such as those for market abuse, the

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[45] Sally Dewar, Director of FSA Markets Division, 'Market Abuse Policy and Enforcement in the UK', 22 May 2007.

[46] *Times*, 1 June 2009.

[47] FSMT Decision No. 031: Paul Davidson and Ashley Tatham (16 May 2006); FSMT Decision No. 40: Cost Decision of Davidson and Tatham (11 October 2006). See discussion of case in Chapter 14, Market Abuse Cases, below.

FSA determined to impose penalties for violation of much more ambiguous, broad-ranging, and therefore easier-to-prove violations of High Level Principles. This early set-back, however, has proved less important as cases have been pursued. The forensic reality of the process has demonstrated that in practice it is difficult to draw a meaningful distinction between the so-called criminal standard of proof and simply recognizing that on a sliding scale of proof the FSA and the Tribunal need to approach a serious allegation from the perspective not that the standard of proof is higher but rather that 'the inherent probability or improbability of an event is itself a matter to be taken into account when weighing the probabilities and deciding whether on the balance of probabilities the event occurred'.[48] Indeed, cases have now succeeded in establishing market abuse practices based solely on circumstantial evidence – including an insider dealing case where the FSA accepted it could not demonstrate conclusively that the individual concerned had access to inside information and relied on inferences to that effect drawn from all the background circumstances of the case.[49]

1.43 The FSA has written and spoken a great deal about its move to principles-based enforcement. Consequently, this book will discuss how that relates to market abuse and how it will change the way in which market participants must defend their behaviour under FSA scrutiny. It remains to be seen, however, whether the FSA's expressed commitment to principles-based enforcement survives the impetus of the global crash for a return to rules-based regulation.[50]

(3) US jurisdictional reach

1.44 Third, there is included a description of the reach of US jurisdiction over UK and European financial market activity with respect to 'market abuse' and 'insider dealing' regulations in the US. It is not a full examination of US law on these issues, but non-US traders should be aware of the extent to which their activities may cross the line into US regulatory jurisdiction, because it is nearly impossible to avoid that overlap in contemporary financial trading.

1.45 Insider dealing, market manipulation, monopolies and conspiracies in restraint of trade have long been crimes and provided grounds for both regulatory action and private rights of action under US financial services law and regulation. In most jurisdictions outside the US, people are often surprised by the reach of US

[48] Lord Nicholls in *Re H* [1996] 1 All ER 1 at 16–17; accepted as the correct approach by the FSM Tribunal in the *Parker* case (*James Parker v FSA* FSMT, Case 037, 18 August 2006.

[49] *Shevlin* (an RDC decision) – FSA Final Notice to John Shevlin dated 1 July 2008.

[50] A move back to a hard-edged rules-based regime is suggested by the Turner Review – 'A regulatory response to the global banking crisis' (FSA, March 2009).

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jurisdiction over these types of activities. It is worth remembering that a US Federal Court held that:

> [A]ny market that is not exclusively a foreign market is part of US commerce.[51]

1.46 It is also worth remembering that one is not immunized from US law suits or regulatory action simply by the fact that the same area is covered by UK, EU or other non-US financial services regulation. The US Supreme Court has held that where a party is subject to both:

> If compliance with US (in that case, anti-trust) law is not made impossible by British law; there is no excuse for not complying with US law.[52]

1.47 Hopefully, this will give readers an understanding of how far market abuse regulations reach, when conduct begins to cross the line from permitted into abusive market behaviour, how one must conduct trading to comply with the new anti-market abuse standards, and what enforcement actions can follow allegations of market abuse. The issues that will be discussed in the chapters of this book will include the following:

1. What are the underlying elements of the market abuse regime?
2. What is 'market abuse'?
   (a) What sort of 'behaviour' constitutes market abuse?
   (b) Must the behaviour in question actually be market abuse or is it sufficient that it is 'likely' to constitute market abuse?
3. How does 'insider dealing' constitute market abuse?
4. How does 'market manipulation' constitute market abuse?
5. Who judges whether market abuse has occurred?
   (a) Who is the 'actor' whose behaviour is judged?
   (b) Must 'intent' be proved?
   (c) What 'standard' must be met?
6. Which markets are covered?
   (a) Which investments are covered?
   (b) Where will the market abuse provisions apply?
7. What is the relationship to existing 'criminal law'?

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[51] Judge William C. Conner, US District Judge, Southern District of New York in the *Transnor* case. *Transnor v BP North America Petroleum*, 738 F. Supp. 1472 (SDNY 1990). 'The *Transnor* case was a watershed event for energy derivatives and the CFTC's [US Commodity Futures Trading Commission — the principal US regulator for derivatives] approach to OTC ['over-the-counter' or off-exchange] derivative products, upholding on a motion for summary judgment a complaint contending that Brent oil contracts were futures contracts subject to the anti-manipulation provisions of the CEA [the US Commodity Exchange Act].' Susan C. Ervin, 'CFTC Regulation of Energy Derivatives: An Overview' (American Bar Association, Section on Business Law, Committee on Futures Regulation: 'The Aftermath of Enron: More Regulation or Continued Deregulation', 13 August 2002), p. 2.

[52] US Supreme Court in *Hertford Fire Insurance v California* 509 U.S. 764 (1993).

8. What are the penalties for market abuse?
9. What are 'defences' or 'safe harbours'?
10. What is the 'enforcement procedure'?
11. What 'appeal' processes are available?
12. What can be learned from the market abuse cases that have been brought so far?
13. What is the impact of US market abuse regulation on non-US markets?
14. What conclusions can be drawn about the complex web of market abuse regulation?

1.48 The intention of these sections is to give the reader a better understanding of what market behaviour is expected in the financial markets, what behaviour is unacceptable and how the regulators in the UK, Europe and the US intend to enforce separation of the two.

1.49 However, the regulation of any behaviour is not an exact science with clearly defined boundaries. It can probably only be understood as a mandated direction of travel, the exact route of which will have to be modified, as a result of unforeseen events and changing conditions as the journey progresses.

1.50 It may not be possible to know how market abuse regulation will ultimately develop. The paths and byways of market abuse regulation, as discussed in the following chapters, may be seen as diverse and complex. However, the regulators have given a clear message as to where they want to end up. Their goal is to have financial markets that are fair and efficient.

1.51 It is certainly true that the terms 'fair' and 'efficient' are qualitative, ambiguous and resistant to precise interpretation. What they mean will undoubtedly change as time goes on, and the markets evolve. However, no market participant would claim (at least publicly) that it is beneficial to the UK to have markets that are unfair and inefficient. Therefore, in order to avoid unfairness and inefficiency a certain amount of market advantage is going to have to be forfeited to compromise, cooperation and consensus. In seeking to achieve this, the regulator has to maintain a difficult balance between encouraging opportunities for 'fair' profit and limiting opportunities for inequitable profit. This is no easy task. How the regulators intend to maintain this balance is the central subject of the following chapters.

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