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The UK and US Market Abuse Divide: The Winterflood Appeal and Other Developments

The English Court of Appeal has held that a person engaging in market abusive behaviour in the UK need not have intended actually to abuse the market. Dismissing an appeal brought by the defendants in the Winterflood case, the Court of Appeal adopted a wide interpretation of the market abuse offence and provided guidance on the status of the various types of provisions found in the Code of Market Conduct. This memorandum considers the implications of the case, as well as other recent developments in this area.

Background

The offence of "market abuse" in the UK is set out in section 118 of the Financial Services and Markets Act 2000 (the "Act"). This section sets out seven types of behaviour, any of which may constitute market abuse. The FSA is required by section 119 of the Act to prepare and issue a code "containing such provisions as the [FSA] considers will give appropriate guidance to those determining whether or not behaviour amounts to market abuse."

The code issued by the FSA pursuant to section 119, known as the Code of Market Conduct (the "Code"),[1] mainly contains three types of provisions:
(i) descriptions of behaviour that, in the opinion of the FSA, *does not* amount to market abuse, designated using the letter 'C' and that provide 'safe harbours';
(ii) descriptions of behaviour that, in the FSA's opinion, *does* amount to market abuse, designated by the letter 'E', and that are evidential provisions only; and
(iii) factors that, in the opinion of the FSA, are to be taken into account in determining whether or not behaviour amounts to market abuse.

The market abuse regime in section 118 of the Act is a civil one and co-exists with a criminal regime that consists of section 397 of the Act (prohibiting misleading statements and practices) and Part V of the Criminal Justice Act 1993 (which creates the offence of insider dealing). One of the reasons behind the introduction of a civil regime was the difficulty which prosecuting authorities routinely encountered in mounting successful prosecutions under the criminal regime. As a result, the section 118 regime fixed the threshold for market abuse at what purported to be an objective level.

Following the introduction of a civil regime by the Act, a similar, pan-European, civil regime for market abuse was established by the Market Abuse Directive ("MAD"), which came into force in 2005. Section 118 was amended to bring it into line with MAD so that the types of market abuse set out in that section, together with their definitions, corresponded to those in MAD. However, certain types of market abuse in section 118 which went beyond the restrictions imposed by MAD (and accordingly did not correspond to any of the MAD provisions) were allowed to remain in force for a limited period in the UK under "sunset" clauses[2].

[1] Chapter 1 of the "MAR" sourcebook of the FSA Handbook.

[2] These so-called "super-equivalent" provisions will expire on 31 December 2011, unless extended.

Winterflood Case

On 2 April 2009, the FSA issued its largest ever market abuse fine on Winterflood Securities Ltd ("Winterflood"), a market maker on the Alternative Investment Market ("AIM") of the London Stock Exchange. Fines were also applied to Stephen Sotiriou and Jason Robins, traders employed by Winterflood. The fines concerned share dealing in AIM-listed Fundamental-E Investments ("FEI") in 2004. The matter was referred to the Financial Services and Markets Tribunal (the "Tribunal") for a decision on the interpretation of the Code. The Tribunal held that Winterflood and its two traders had committed market abuse. The Court of Appeal[3] has now upheld the Tribunal's decision as well as the FSA fines (£4 million for Winterflood, £200,000 for Stephen Sotiriou and £50,000 for Jason Robins). The court ordered the appellants to pay the FSA's appeal costs.

The limb of market abuse that was considered in the Winterflood case was "misleading behaviour or market distortion" (in what was then section 118(1) and (2) of the Act and now corresponds to section 118(4) and 118(8) of the Act). This limb of market abuse is one of the legacy UK market abuse provisions that is not found in MAD and is therefore not pan-European. It consists of behaviour which either (a) is likely to give a regular market user a false or misleading impression as to the supply of, demand for or price or value of, qualifying investments or (b) would be, or would be likely to be, regarded by such a user as behaviour that would distort, or would be likely to distort, the market in such an investment. A 'regular market user' must be likely to regard such behaviour as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market.

In its role as market maker, Winterflood entered into a number of trades concerning FEI shares during 2003 and 2004. These transactions were part of an illegal share ramping scheme (the "Scheme") operated by a third party to increase the price of FEI's shares, which tripled in value in four months. The FSA considered that the Scheme misled the market as to the supply, price or value of and demand for FEI shares and thus distorted the market in those shares. Although there was no allegation by the FSA that Winterflood or its traders deliberately participated in the Scheme, the Tribunal held that their involvement was critical to its success and thus amounted to market abuse within the meaning of the Act.

Winterflood accepted the FSA's allegation that its involvement in the Scheme *prima facie* fell within the statutory definition of market abuse. It argued, based on guidance in the Code, that a person cannot commit market abuse by engaging in price positioning unless the requisite mental element can be shown, i.e., that there must be an "actuating purpose" to mislead or distort the market, defined in the FSA Handbook as "a purpose which motivates or incites a person to act".

The FSA accepted that it could not establish the existence of any actuating purpose in this case and referred the case to the Tribunal. However, the Tribunal held that no actuating purpose to mislead or distort the market was necessary to commit market abuse under the Act. Winterflood appealed to the Court of Appeal.

Winterflood's principal argument before the Court of Appeal was that if the Code specifically described behaviour which *did* amount to market abuse, this indicated that behaviour not falling within that description *did not* amount to market abuse.

Winterflood also argued that guidance in the Code made it clear that if the person concerned was not motivated by an improper purpose, then he would not be committing market abuse. Such a purpose need not be the sole purpose for entering into the transaction but must be an actuating purpose.

Thus, as regards the provisions of the Code to the effect that behaviour would constitute market abuse where a person transacts with the purpose of positioning the price of a security at a distorted level[4], Winterflood argued that this purpose need not be the sole purpose

3 *Winterflood Securities Ltd and others v. Financial Services Authority* [2010] EWCA Civ 423.

4 MAR 1.5.9E and MAR 1.6.9E as at the relevant time.

for entering into the transaction, but must be an actuating purpose.

The Court of Appeal rejected these arguments. Moore-Bick LJ began by emphasising that the test of market abuse was wholly objective and did not require any particular state of mind on the part of the accused. He rejected the appellants' argument that any descriptions of behaviour that are treated as amounting to market abuse by the Code necessarily led to the conclusion that any behaviour not falling within those descriptions is not market abuse. It is only in relation to the safe harbours (designated by the letter "C") that section 122(1) of the Act applies and provides conclusively that any behaviour falling within a safe harbour does not amount to market abuse. By contrast, the evidential provisions are governed by section 122(2) of the Act, pursuant to which such provisions may be relied on so far as they indicate whether or not particular behaviour should be taken to amount to market abuse.

Hence, in setting out (by way of evidential provisions) descriptions of behaviour that constitute market abuse, the FSA was not implying that behaviour falling outside the descriptions was not market abuse. Evidential provisions are intended to provide the market and the regulator with "principles that, although not definitive, can be regarded as having persuasive authority".

EU and UK Convergence

In a European Court of Justice (the "ECJ") judgment[5] earlier this year, an objective approach was adopted on the interpretation of the insider dealing prohibition in Article 2(1) of MAD. The ECJ held that, in relation to insider dealing market abuse,[6] it is not necessary for national authorities to demonstrate that the person accused of insider dealing had 'used' inside information 'with full knowledge'. Instead, the question of whether an insider in possession of inside information uses that information within the meaning of Article 2(1) must be determined in light of the purpose of MAD, which is to protect the integrity of the financial markets and to enhance investor confidence. In other words, there is a presumption that a person who is in possession of inside information and who deals in financial instruments to which the information relates uses that information in contravention of the insider dealing prohibition. The insider would need to rebut this presumption.[7]

Both the ECJ decision and the Court of Appeal decision in Winterflood indicate a trend for an objective determination of instances of market abuse. This trend may reflect a post crisis, post Madoff surge of judicial willingness to take action against objectionable behaviour that might otherwise slip through legislative cracks. The courts are also, however, implementing the original intent of legislators in creating behaviour-based offences that are easier to prosecute, but which would fall outside the criminal regime, under which there were various notorious 'not guilty' verdicts in the 1980s and 1990s. This is also consistent with the FSA's increased reliance on basing its enforcement cases on breach of the FSA Principles (which impose high-level standards of market conduct on regulated firms as opposed to prescriptive rules).

UK and US Divide

Violations of the principal US anti-fraud provisions, found in the Securities Act of 1933 and the Securities Exchange Act of 1934 (together, the "U.S. Securities Acts"), may be prosecuted either civilly by the Securities and Exchange Commission ("SEC") or criminally by the Department of Justice ("DOJ"). Under either regime, the government is required to prove a subjective mental element, although civil cases may generally be proved by a showing of either intent or recklessness amounting to intentional disregard for the fraudulent nature of the conduct engaged in. The anti-fraud provisions govern

5 *Spector Photo Group NV v. Commissie voor het Bank, Financie-en Assurantiewezen,* C-45/08.

6 Insider dealing market abuse occurs where an insider in possession of inside information uses that information by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates: Article 2(1) of MAD.

7 See our client publication, *The Spector Photo Case: ECJ Rules on the Interpretation of the Market Abuse Directive*, 5 February 2010, available at http://www.shearman.com/the-spector-photo-case--ecj-rules-on-the-interpretation-of-the-market-abuse-directive-02-05-2010.

cases associated with the use of any scheme to defraud, whether the scheme involves manipulation, insider trading or false statements in connection with the purchase or sale of securities.

In market manipulation cases in particular, courts in the US have invariably required that a market participant alleged to have engaged in manipulative conduct must have acted with "manipulative intent" in order to be held liable, even in a civil proceeding, for having violated the US securities laws. Indeed, to the extent that there is debate about the mental state required for liability for market manipulation, it revolves around whether a showing of "manipulative intent" with respect to otherwise normal trading activities is sufficient. Some courts have expressed the view that the securities laws, with their focus on deception on the part of the market participant, require an additional showing of fraud, for example, dissemination of false information. In any event, courts have held that, at a minimum, "manipulative intent" must be a "but for" cause of the alleged manipulative trading in question which contrasts with the notion of an "actuating purpose" that was rejected as a necessary element in Winterflood.

This treatment of market manipulation is consistent with the emphasis on a participant's state of mind as a critical element in the securities laws governing market abuse in the US.

Although the US regime is similar to the UK criminal regime, in that both require the prosecution to prove some subjective mental state such as dishonesty or manipulative intent, the civil regime in the UK and Europe concerns itself more exclusively with objective conduct, as reflected in the Winterflood decision. The subjective mental element requirement in both the US criminal and civil regimes and the fact that the vast majority of enforcement action in relation to market abuse in the EU (including the UK) is taken under the civil regime shows a stark divergence between the US approach of treating market abuse as akin to criminal conduct and the EU approach of dealing with it as a regulatory offence.

FSA Credible Deterrence

Simon Eagle, the main instigator of the illegal Scheme in which Winterflood and its traders participated, was handed the FSA's largest fine on an individual - £2.8 million – on 18 May 2010. Mr. Eagle was also banned from working in the regulated financial services sector. This huge fine did not fall under the FSA's new penalties policy which came into force on 6 March 2010 and which applies to any breaches that occur on or after that date. It is envisaged that the new penalties policy, which is linked more closely to income, will significantly increase the size of fines, thus imposing harder hitting financial penalties aimed at achieving real credible deterrence.

Another implication of the Winterflood case is that the FSA expects market participants to monitor transactions for any warning signs of abusive behaviour. The FSA considered that the unusual aspects of the FEI share trades should have alerted Winterflood to the risk of market manipulation.

The Court of Appeal's dismissal of the appeal and the costs order against the appellants indicate the courts' support for the regulator's clampdown on market abuse. Other recent cases illustrate similar support by UK courts in other regulatory areas: for example, the Court of Appeal increased the FSA's proposed fine in the Fox Hayes case.[8]

The FSA has changed its approach to enforcement and aims for credible deterrence, resulting in a more aggressive strategy to prosecuting perpetrators of abusive behaviour. The director of enforcement at the FSA, Margaret Cole, stated that the Winterflood decision should "serve as a clear message to other market participants that [the FSA is] determined to stamp out market abuse". It is expected that the FSA (or its successor authority) will fully utilise the additional powers it has been granted under the Financial Services Act 2010 to advance its credible deterrence agenda and to increase its intensive supervision of firms generally. The additional powers include the suspension of an individual guilty of misconduct from carrying on certain functions for up to

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8 *Fox Hayes v. Financial Services Authority* [2009] EWCA Civ 76.

two years or the imposition of a penalty and cancellation of a firm's authorisation (whereas in the past the FSA has only been only been able to impose one or the other).

It should be noted that the UK Government has now announced that the FSA will cease to exist in its current form and at the time of writing it is believed that its enforcement powers in relation to market abuse are likely to be transferred to a single agency that will tackle economic crime.

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