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ARTICLE

Enforcement of criminal sanctions for market abuse: practicalities, problem solving and pitfalls

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Abstract An outline of the main provisions relating to the regulation of Market Abuse in European financial markets; the limitations of the regulations; the problems facing investigators and prosecutors in UK cases; the principal tools used by enforcers to detect and investigate Market Abuse; the importance of deterring Market Abuse; the outcomes of the current regime.

Keywords Market abuse regulation · Insider dealing · Price sensitive · Specific or precise · Credible deterrence · Prosecutions · Sanctions

1 Introduction

The Market Abuse Regulation (MAR)[1] came into effect on 3 July 2016. Its stated aim is "to increase market integrity and investor protection, enhancing the attractiveness of securities markets for capital raising", across the Euro-zone. Regulators see it as strengthening the existing market abuse framework, in particular by extending its scope to new markets, new platforms and new behaviours. The reach of the Regulation extends, therefore, beyond the more traditional forms of market trading, with the intention of bringing the current range of financial instruments which are subject

[1] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC Text with EEA relevance, OJ L 173 of 12 June 2014, pp. 1–61.

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to the prohibitions spelt out by the MAR up to date.[2] For example, MAR will regulate conduct in relation to benchmarks, spot commodities, emissions allowances and emission allowance market participants, in certain circumstances.

MAR marks a significant step forward, and may cause market participants many headaches, and although listed companies in some EU states, including the UK, have long experience of complying with rules in most of these areas, there are some differences which will need to be reviewed in a company's procedures, systems and controls.

The extent to which criminal sanctions will apply to the new provisions is, however, limited. The process of proving a case to the criminal standard will not be made any simpler by MAR. Indeed, it is unlikely that prosecutors will have their sights set on conduct which breaches the new regulations. For one thing, they are technically complex, to an extent which, when added to the challenges already posed by insider dealing laws, would in all probability make the prospect of mounting a criminal case unattractive.

Therefore, the criminal law approach to market abuse is likely to stay the same as it has been, at least in the UK, since the passing of the current legislative framework as long ago as 1993.[3] This chapter will consider how the current criminal legislation works in practice, looking at the history of the offence, the elements of the offence, the evidence needed to prove the offence, the best practice to adopt in investigating market abuse, the criteria to be adopted when deciding when to prosecute, and issues that arise at trial.

2 The history of the offence of insider dealing in the UK

The first legislation in the UK that made insider dealing a criminal offence was enacted in 1980. The then Conservative government under Mrs Thatcher was determined that share ownership should be available to all, and the government wanted to create a "share-owning democracy". Up till that time the purchase and sale of stocks and shares was effectively limited to market participants and wealthy experts. The stock market was not generally used by members of the public. Trading was done through stock brokers. Further pressure to create the share owning democracy followed when the Conservative government started a process of selling off publicly owned utilities—gas, electricity, railways—to private entities, and as part of the sale made provision for individuals to purchase small numbers of shares in the newly privatised industries. This—and other reasons—led to passing of the Company Securities (Insider Dealing) Act 1985. The market had to be seen to be safe for those who were strongly encouraged to buy the new stock.

The next major development was the 1989 European "Directive coordinating regulations on insider dealing", known as the "Insider Dealing Directive" (IDD).[4] The

[2] Financial instruments, which are currently defined in MiFID 1 will, from 3 January 2018, be defined in Annex 1 of MiFID 2.

[3] The Criminal Justice Act 1993, Part V, sections 52–64.

[4] Council Directive 89/592/EEC of 13 November 1989 coordinating regulations on insider dealing, OJ L 334 of 18 November 1989, pp. 30–32.

IDD was a “minimum harmonisation directive” that led directly to the UK’s first major, and effective, laws which sought to prosecute insider dealing: Part V of the Criminal Justice Act 1993.

The IDD intentionally had a broad remit, focusing on the importance to the EU of the securities markets, the fact that insider dealing undermines investor confidence, leading to an adverse impact on the markets. For the first time, it was recognised that morality was a cornerstone of the markets, and that “investor confidence” had become embedded in Europe’s economic thinking. The threat posed by insider dealing had a major impact on the integrity of European markets, and attitudes had been changed by a number of factors, including the explosion of global capital markets, and a number of Insider Dealing scandals. The IDD led directly to a recognition in London, Europe’s primary financial market, that the preservation of its primacy demanded that effective counter-market abuse laws needed to be enacted.

Part V of the CJA 1993 implemented the terms of the Directive by providing comprehensive definitions for:

- an insider;
- the information insiders may not deal with;
- what they cannot do with that information.

However, both the drafting of the legislation, and the implementation of it, were, and remain, far from simple.

One of the issues raised by the provisions in the CJA 1993 was that it was seen to be vital to balance the interests of deterring unlawful conduct and permitting the financial markets to work. These interests were seen to be significantly conflicting, and during the debates on the Bill, Anthony Nelson, Chief Secretary to the Treasury, expressed the problem as follows:

> “Not only must we crack down on Insider Dealing but we must be seen to be doing so effectively and must send the right deterrent messages to the financial services industry. Furthermore, we must not inhibit unreasonably the legitimate practices and expertise of those in the City of London and the financial services industry in general. The industry is extremely important to our economy and employs very many people.”

3 The elements of the offence

By section 52 CJA a person with inside information may commit the offence either by dealing himself in securities which are “price affected” in relation to the inside information; or by encouraging a third party to deal in the price-affected securities; or by disclosing the information in circumstances where the disclosure is not within the proper performance of the functions of his employment, office or profession. Only an individual can commit the offence. The offence cannot be committed by a corporation or a partnership.

By section 57 CJA: The Insider must either have the information through being a director, employee or shareholder of the issuer of securities (“The Inner Circle”); or have access to the information by virtue of his employment, office or profession

("The Middle Circle"); or obtain the information from a source of the information who is in "The Inner Circle".

The acquisition or disposal must occur on a regulated market, or be conducted through a professional intermediary (important in cases involving Contracts For Differences and spread bets).

Section 56 CJA defines "inside information": the information must:

- Relate to particular securities; and
- Be specific or precise; and
- Not have been made public; and
- If it were made public, the information would be likely to have a significant effect on the price of any securities.

"Significant effect" has been defined by an expert witness as: "a movement in the price of a security which is not accounted for by normal market movements".

The definition of inside information for the purposes of criminal proceedings therefore closely follows the IDD requirements, save that the Directive refers only to "precise". Here one enters into a world of smoke and mirrors, in which the meanings of words are exposed to ever more intensive scrutiny. What does precise precisely mean?

3.1 Specific or precise

Curiously, in order to get round this problem, the UK legislators added the word "specific" when drafting the CJA. However, no definition is provided in the Act of the words "specific" and "precise": the legislators apparently decided that "it is difficult if not impossible to give an exhaustive definition of all the circumstances that would be covered by one word or the other". One reading might be that specific information might be that negotiations are taking place for a takeover. Precise information will include the timing of the transaction and the price at which the bid is to be made, the date of the announcement and other details of the transaction. Neither term, however, should be taken to mean "certain", but at the same time it is much more than gossip and rumour, or general information.

In many criminal insider dealing cases the issue does not become a significant issue because the circumstances are clear enough, although expert evidence of the effect of information on price is often required. The question becomes more acute in civil cases. In section 118 of the Financial Services Act 2000 (which defines market abuse for the purposes of civil proceedings brought by the Regulator), inside information must be: information of a precise nature; which is not generally available; which relates directly or indirectly to one or more issuers of the qualifying investments or to one or more of the qualifying investments; and which would, if generally available, be likely to have a significant effect on the price of the qualifying investments or on the price of related investments.

This closely follows the wording in the Implementing Directive of the Market Abuse Directive.[5] The 2000 Act states that information is only precise if it "indicates

[5] Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation, OJ L 339 of 24 December 2003, pp. 70–72.

circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur, and is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of qualifying investments or related investments."[6]

In *Geltl v Daimler AG*[7] the ECJ considered a referral from the German Federal Court of Justice. The case raised two main issues:

- Precise may be applied to the intermediate steps in a protracted process: negotiations, agreement in principle, terms of agreement, strike price, timing of announcement. Information relating to all these stages may be precise, even though the final outcome is not known until the announcement.
- "May reasonably be expected" may refer to "future circumstances or events from which it appears, on the basis of an overall assessment of the factors existing at the relevant time, that there is a reasonable prospect that they will come into existence or occur".

What is clear from these interpretations of "precise" is that there is no hard and fast rule. Each case has to be decided on its facts, and this decision will rarely be easy.

Another ECJ case, *Lafonta v AMF*[8] (March 2015), shows the difficulties in another light. *Lafonta* concerned a complex transaction, conducted in stages over a period of several months in 2007/2008, involving a company called "Wendel" acquiring more than 20 % of the share capital of Saint-Gobain. The French regulator's case was that in doing so it failed to make public the principal characteristics of the financial operation, which was designed to enable Wendel to acquire a substantial shareholding in Saint-Goblain. Wendel was trading on inside information, namely its knowledge of its own plans to implement the financial operation for the purposes of acquiring a substantial shareholding in Saint-Gobain's capital.

The ECJ found that:

> *"In order for information to be regarded as being of a precise nature for the purposes of the provisions in Article 1(1) of MAD, it need not be possible to infer from that information, with a sufficient degree of probability, that, once it is made public, its potential effect on the prices of the financial instruments concerned will be in a particular direction."*

The UK courts have cast some doubt on the workability of this type of definition. In the 2011 case of *David Massey v FSA*,[9] the Upper Tribunal expressed concern that the words "as to the possible effect on the price" were too wide, and that there should be an element of "probability". Moreover, they said, should "precise" mean that the conclusion is reached that the event may alter the price, and is that sufficiently precise? Should there be proof of whether the effect will be an increase or a decrease in the price of the stock?

[6] Section 118C Financial Services and Markets Act 2000.

[7] Case C-19/11 *Geltl*, ECLI:EU:C:2012:397.

[8] Case C-628/13 *Lafonta*, ECLI:EU:C:2015:162.

[9] *David Massey v The Fincial Services Authority* [2011] UKUT 49 (TCC).

3.2 Trading in securities

Trading in securities includes buying or selling stocks and shares, and other instruments, as defined in Schedule 2:

- Debt Securities (typically: debentures, loan stock, bonds and certificates of deposit).
- Warrants (which grant the holder the right to purchase securities from the issuer at a specific price and within a specified time frame).
- Depository Receipts (a negotiable financial instrument issued by a bank to represent a foreign company's publicly traded securities).
- Options (derivative financial instruments specifying a contract between two parties for a future transaction of an asset at a "strike price").
- Futures.
- Contracts for Differences (not included in the IDD), and by extension spread bets.

By section 60 CJA a Regulated Market is defined as any market which is identified by a Treasury Order as a Regulated Market. The Treasury Order is the "Insider Dealing Order"[10] (IDO), which aims to ensure that "all securities markets which operate in the UK are within the ambit of the legislation". "The power will also be used to catch other EC securities markets, both official lists and junior stocks, and it will include over the counter as well as exchange traded derivative products." While it may be assumed that all securities markets are included, the IDO was last updated in 2002. NASDAQ was the only non-European investment exchange in the Schedule—mainly because at the time it was the only exchange that had physical trading screens in the UK. Nevertheless, it is highly likely that most public companies" shares will be listed on at least one investment exchange (and often more than one) and therefore the security will come within the ambit of the CJA.

3.3 Made public

Another difficult area for investigators and prosecutors is whether they can prove a negative: has the information been made public prior to its use by the insider? If it has been made public, in any sense, the case against the alleged insider will fail. It does not matter whether the insider was aware of the publication. It also does not matter how remote the publication is.

By section 58 CJA, information is made public where:

- It is "officially" published "in accordance with the rules of a regulated market";
- It is available in public records;
- It can readily be acquired by anyone likely to trade; or
- It is derived from such information.

In addition, information is made public where:

- It can only be acquired by using diligence or expertise;
- It is only communicated to a section of the public;

[10] The Insider Dealing (Securities and Regulated Markets) Order 1994, as amended.

- It can only be acquired on payment of a fee; or
- It is published only outside the UK.

In order to prove the negative, the Regulator must go to extraordinary lengths, often using the services of a specialist company to search the records. During the proceedings there will be arguments about how far before the date of trading the prosecution must search to find whether any related information has been published.

4 Investigation issues

The FCA is often alerted to possible insider dealing by suspicious transaction reports (STRs) filed by brokers and other market participants, who are required to file such reports with the Regulator. This is an important source of intelligence which is closely monitored.

In addition, the Markets are constantly monitored. Highly sophisticated technology provides real time analysis of trading activity around announcements and transactional business. Suspicious spikes in trading activity are examined by the markets experts at the FCA.

At the same time, the trading activities "persons of interest"—traders who regularly feature in STRs and who trade in high volumes adjacent to announcements and results—are subject to scrutiny.

Initial enquiries will analyse the suspicious trading, the links between individuals, recorded lines, money flows and communications. "Insider Lists" maintained by corporations, banks and brokers will be scrutinised. If sufficient evidence is found, searches and arrests will be conducted, and digital media—laptops, mobile phones, social media - will be analysed.

The investigator will most obviously seek out evidence that shows communication between the insider and the trader at the optimum moment for trading. Recorded lines in regulated firms can often provide primary evidence of the passing on of information. However, serial and serious insiders, who form part of a ring, will communicate by much more subtle means. Mobile phones, particularly "pay-as-you-go" phones which are regularly changed, are used, and therefore mobile phone records are scrutinised. Other forms of modern communication (e-mails, tweeting, WhatsApp, Snapchat) have been accessed for evidential purposes. In serious cases consideration may be given to intrusive investigation techniques.

The investigator will of course want to establish and provide evidence of patterns and timeliness of trading, money movements between traders and an insider and others, and any records of such payments.

5 Expert evidence

Expert Evidence is often a vital part of the prosecution case, helping to prove that information falls within the categories set out within section 56 CJA. There are a number of problems facing an investigator seeking an appropriate expert witness. Firstly, finding the right expert in a specialist market can be a problem, and this can

be the case both for prosecution and defence. Secondly, the work required from an expert in any Insider Dealing case can be complex and substantial. Thirdly, there are presentation issues, because there is a significant risk that expert evidence—for example about whether information was sufficiently specific or precise to have a particular effect—will seem artificial and technical to a jury.

6 Other issues

6.1 Strict liability and statutory defences

Although market abuse is described as cheating and unethical, it is not necessary to prove criminal dishonesty. It is also not necessary to prove gain, or any intention to cause loss. Instead, insider dealing is a form of strict liability offence: if you are in possession of insider information, and you deal, you are guilty of the offence.

Section 53 CJA provides a number of defences:

- "That he did not at the time expect the dealing to result in a profit attributable to the fact that the information in question was price sensitive information in relation to the securities."
- "That at the time he believed on reasonable grounds that the information had been disclosed widely enough to ensure that none of those taking part in the dealing would be prejudiced by not having that information."
- "That he would have done what he did even if he had not had the information."

These defences do not feature regularly in insider dealing trials, mainly because the prosecution would not proceed with a case where an accused person could avail himself of a defence. For example, a company director may have agreed a share purchase or sale programme over a period of months or years, thus demonstrating that his decision to make a purchase or sale was not based on his knowledge of inside information.

6.2 Victimless crime

Insider dealing has been described as a victimless crime, in the sense that it is difficult to identify an individual loser in most cases. Others will argue that the principal victim of insider dealing is the integrity of the market. A loss of confidence in the fair operation of the markets will have a serious impact on financial stability. Unethical conduct by some market participants will tarnish the reputation of stock exchanges and financial institutions generally.

6.3 Credible deterrence

Market cleanliness is therefore considered to be a high priority for the financial regulators, and in 2007 the FSA decided that its Markets and Enforcement Divisions should focus on taking criminal proceedings under the CJA, rather than pursuing insider dealers under the provisions of the Financial Services Act 2000.[11]

[11] Section 118 FSA 2000.

The history of prosecutions under the various Acts since 1980 was considered to have been patchy. Between 1987 and 1993, under the Companies Act 1980 and the Company Securities (Insider Dealing) Act 1985, 33 individuals were prosecuted under the 1985 Act, of whom 16 were convicted. These cases were investigated and prosecuted by the Department of Trade and Industry (DTI), using special powers of investigation.

Insider Dealing investigations under the 1993 Act have been carried out by the Department of Trade and Industry, the Serious Fraud Office, the City of London Police, the Crown Prosecution Service, and the FSA and FCA.

Although the FSA had the power under section 402 of the Financial Services and Markets Act 2000 to bring criminal proceedings for Insider Dealing, it did not start prosecuting such cases until about 2008, since when all cases have been investigated and prosecuted by the FSA and FCA.

In 2006 the Director of Enforcement announced that the FSA was adopting a policy of "credible deterrence" to improve conduct in the financial markets, and in particular market participants could expect to see more detailed analysis of their trading, followed by criminal investigations and prosecutions.

In taking over responsibility for the investigation and prosecution of insider dealing cases from about 2006 from other investigators, the FSA was seeking to comply with a number of its original regulatory objectives, including (a) market confidence, (b) financial stability, (c) the protection of consumers and (d) the reduction of financial crime: section 2(2) Financial Services and Markets Act 2000. In addition, from 2012 it was complying with its strategic objectives of "Ensuring that the relevant markets function well", as set out in section 1B(2) Financial Services Act 2012.

Since 2008 the regulator has brought more than 15 cases to trial. These cases have ranged from one-off opportunist acts to complex insider dealing rings involving numerous individuals. Convictions have been obtained in most cases.

6.4 Market cleanliness index

A "Market Cleanliness Index" measures the extent of market abuse in the financial system. The Index has shown that cleanliness has increased in recent years, and one reason for that might be the increased enforcement action by the regulator. While the FSA and FCA have always treated this statistic with caution, bearing in mind that some improvement in market cleanliness may have been caused by the lack of transactional business following the global financial crisis, it is clear that the number of prosecutions, and the nature of the targets of some of those investigations, has meant that awareness of the risks of insider dealing has greatly increased.

6.5 Prosecution criteria

When reviewing possible investigations, and deciding which cases deserve to be the subject of enforcement proceedings, an initial decision has to be taken: should there be an investigation under the Regulatory procedures, or should there be a criminal prosecution?

In vetting those cases which the Enforcement and Market Oversight Division consider might be suitable for enforcement action, they have to take account of certain

practicalities. First, what type of outcome would be appropriate? In regulatory cases brought under section 118 Financial Services Act 2000, any person found to be in breach of the section may be subject to fines, disgorgement of profits and prohibition from authorisation in the financial services industry. These cases are initially brought before the Regulatory Decisions Committee of the FCA, which will issue a Decision Notice with its findings. There is a right of appeal against an RDC decision to the Upper Tribunal.

The decision to bring a criminal prosecution will involve a number of factors. These are set out in the FCA Enforcement Guide.[12] One overarching consideration will be the impact that a criminal trial will have, and therefore the outcome of the proceedings must be carefully measured. A serious allegation of insider dealing will, on conviction, lead to a prison sentence. The maximum sentence is seven years in prison,[13] and sentences of up to 4.5 years have been passed in UK courts. In addition, a Confiscation Order under Part 2 of the Proceeds of Crime Act 2002 may be made. The Order will calculate the benefit which the convicted person has acquired through insider dealing as the proceeds of sale, not just the profit, arising from the disposal of stock purchased on the basis of inside information. A person convicted of insider dealing will be prohibited from employment in the financial services industry.[14] The seriousness of these consequences will act as a significant deterrent against any person contemplating committing market abuse offences.

Before any decision to start a criminal investigation is made, the Enforcement team will look at two other issues. First, criminal market abuse cases are extremely resource intensive and therefore very expensive. Criminal trials take up a lot of court time, and are therefore also expensive for the Court Service. Where a defendant is on Legal Aid, the cost to the Legal Aid fund can be significant.

Second, the line between a criminal and a regulatory investigation can be narrow. The decision to pursue a criminal case involves certain technicalities. For example, the decision must meet the Code for Crown Prosecutors which applies to all criminal cases: there must be sufficient evidence to ensure that a conviction is likely; and the case must pass the public interest test.

In considering the public interest test for market abuse cases, the criteria set out in the Enforcement Guide, Chapter 12.8, will be considered: where there has been significant market disruption, repeat behaviour, a concerted conspiracy, large profits and highly secretive conduct, a criminal investigation will be seen to be justified. Where, on the other hand, there has been cooperation from the accused, or the offending is seen to be technical, and there has been no previous misconduct, a regulatory outcome is more likely.

6.6 Trial

Complex fraud trials present a number of serious problems for all parties. Not only, as stated above, are there significant costs, but there are trial management issues which create problems.

[12] *Financial Conduct Authority* [1].

[13] Section 61 Criminal Justice Act 1993.

[14] Section 56 Financial Services and Markets Act 2000.

Under the UK jury trial system, insider dealing cases have to be presented before a randomly selected jury which has no specialist knowledge of the financial markets. The jury therefore has to be educated about market issues, and to understand the various expert subjects—inside information, specific or precise, significant effect, unpublished—which require detailed exposition. The facts will be complex. Almost all the oral evidence from the prosecution will be technical. There will be schedules of communications and trading.

The prosecution will attempt to make all this evidence comprehensible, and will, for example, produce graphics to simplify the issues, but each element of the offence has to be proved, and this takes time.

In an insider dealing ring case there will usually be a large number of potential defendants, each playing their separate part in the conspiracy, and the preference of the prosecution will be for all the defendants to be tried together, so that the totality of the criminality is shown to the jury as a whole. However, if there are too many defendants, the trial will take too long. Judges regularly seek to restrict the number of defendants to five or less.

There will also be a large number of trades in a typical insider dealing ring case, and again the prosecution will want to include as many as possible of these trades in the evidence so as to demonstrate how serious the conduct was. It will also prove that there was a criminal intent, and that it was not just a coincidence that on one or two occasions the defendants struck lucky. Again, however, the judge will limit the number of counts on the indictment, and the number of trades to be proved, in order to ensure that the trial is manageable. Usually, the prosecution may be allowed to adduce evidence of 6 trades in one trial.

One common defence to insider dealing allegations, where the accused is the one who is alleged to be using inside information provided, directly or indirectly, by an insider, is that he regularly trades in high volumes in the market, and that if all his trading is examined, it will be seen that he follows the market closely, noting slight movements in stock prices, and applying his expert knowledge of certain industries or sectors; he also listens to gossip, and therefore it is not surprising that he is one of many people who traded in the run up to an announcement of results or a takeover or merger. An analysis of his trading record will also show that he does not always make a profit, indeed he quite often makes a loss. He will therefore argue that selecting a few profitable trades to prove the case against him gives a false impression of his trading history.

Therefore, the process of selecting trades for inclusion in the indictment is a highly complex issue, which must apply fairness at the same time as having regard to the manageability of the trial.

In a recent insider dealing ring case prosecuted by the FCA,[15] the allegations dated back to 2008, and the investigation had started at about the same time. About 10 individuals were prime suspects, with a number of others coming under the spotlight but not being charged. In 2016 five men stood trial. Three were acquitted and two were convicted. Prior to the trial four individuals had entered guilty pleas. The investigation and trial were said to have cost £14m. The trial lasted 4 months. At the end of

[15] "Operation Tabernula", *R v. Andrew Hind, Iraj Parvizi, Benjamin Anderson and Martyn Dodgson*, T20127434, and *R v. Andrew G Harrison*, T20127434, Southwark Crown Court.

the case Bloomberg commented: "*What made the case fascinating—what had the entire London financial scene watching and waiting for the precedent it might set—was that the defendants' version of events wasn't so different from that of the prosecution. Parvizi and the others acknowledged joining up to trade. They acknowledged disguising their activities with encrypted devices and burner phones. But, they maintained, they'd never knowingly traded on information that was, legally speaking, "insider." The men said their investments, even those that were incredibly well-timed, stayed on the legal side of the line between privileged information and well-informed rumor.*"[16] To a significant extent, the jury accepted this explanation. The length and cost of the investigation, the relative lack of success of the proceedings, and the long delay in bringing the case to trial demonstrate the extreme difficulties in prosecuting insider dealing.

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