

UK SHAREHOLDER ACTIVISM

Briefing

Insider Trading Risks

August 2014

Overview

In the United Kingdom there are two parallel sets of rules which cover insider trading. One is a civil market abuse regime under the Financial Services and Markets Act 2000 ('FSMA'), and the other is a criminal insider dealing regime under the Criminal Justice Act 1993 ('CJA'). The civil market abuse regime under the FSMA is wider in scope than the criminal regime under the CJA, and, as a result, the UK Financial Conduct Authority ('FCA') has a choice of regime when bringing an enforcement action. Both regimes may be applicable, but the FCA will assess under which regime to bring a case depending on, amongst other things, the amount and quality of the evidence and the FCA's assessment of its ability to satisfy the criminal ('beyond reasonable doubt') or the lesser civil ('balance of probabilities') burden of proof. As noted below, criminal convictions have to date been rare.

Activist investors should be vigilant to ensure that they are not in possession of inside information at the time that they are trading in listed securities or other financial instruments. This issue will be particularly critical where an activist investor has appointed a representative to the relevant company's board of directors, as information shared by the representative with that investor could be inside information, thereby requiring that the investor be restricted from dealing in the company's stock until such time as the information is released to the markets generally or otherwise becomes 'stale'.

The Criminal Regime

Investors who are trading in public UK companies or companies admitted to trading on a UK market are subject to strict insider dealing rules and restrictions under the CJA.

The Offences

Under Section 52 of the CJA there are three separate criminal offences:

- *The dealing offence.* An individual deals in securities that are 'price-affected securities' (defined below) in relation to inside information he has 'as an insider' (also defined below, and including a shareholder in some circumstances). Dealing covers the acquisition or disposal of securities (as principal or agent), and in this context, 'acquisition' includes agreeing to acquire a security or entering into a contract to create a security, and 'disposal' covers agreeing to dispose of a

security or bringing to an end a contract which created the security. A person also deals if he or she procures, directly or indirectly, an acquisition or disposal by another person.

- *The encouraging offence.* An individual having inside information as an insider encourages another to deal in securities that are price-affected securities in relation to that inside information. The encouraging offence does not have to result in the other person dealing; however, the defendant must be shown to have encouraged another person to deal in the price-affected securities knowing or having reasonable cause to believe that there would be dealing on a regulated market or by or through a professional intermediary. The person who is being encouraged does not have to know that the encouragement is related to price-affected securities.
- *The disclosing offence.* An individual discloses to another person inside information which he or she has as an insider otherwise than in the proper performance of the functions of his employment, office or profession.

It is important to be aware of the specific definitions of key terms since, although they are similar to terms used under the civil regime (see below), there are some slight differences:

- A person has information as an 'insider' if it is (and he or she knows that it is) inside information and he or she has it (and knows that he or she has it) from an inside source, i.e., where: (i) the person has the information through being a director, employee or shareholder of an issuer of securities; (ii) the person has the information through having access to it by virtue of his or her employment, office or profession; or (iii) the direct or indirect source of the information was a person falling within (i) or (ii).
- 'Inside information' for the purposes of the CJA means information which: (i) relates to particular securities or to a particular issuer(s) and not to securities or issuers of securities generally; (ii) is specific or precise; (iii) has not been made public; and (iv) if it were made public, would be likely to have a significant effect on the price of any securities.
- 'Price-affected securities' include shares, debt securities, warrants, depositary receipts, security options, futures and contracts for differences in each case if and only if the relevant inside information would, if made public, be likely to have a significant effect on their price. The securities must be officially listed on an exchange in the European Economic Area or be admitted to dealing on, or have their price quoted on or under, the rules of a regulated market.

Defences

A person may be able to claim a defence to the dealing and/or encouraging offences if:

- *He or she had no expectation of profit*, i.e., if he or she can show that, at the time, he or she did not expect the dealing to result in a profit (or the avoidance of a loss) attributable to the fact that the information he or she possessed was price-sensitive information in relation to the securities;
- *Adequate disclosure had occurred*, i.e., if he or she can show that he or she believed on reasonable grounds that the information had been sufficiently widely disclosed to ensure that no one taking part in the dealing would be prejudiced by not having the information; or
- *He or she would have acted anyway*, i.e., if he or she can show that he or she would have done what he or she did even if he or she had not had the inside information.

Separately, a person may be able to claim a defence to the disclosing offence if he or she did not at the time expect any person, because of the disclosure, to deal in securities on a regulated market or by or through a professional intermediary, or although he or she had such an expectation at the time, he or she did not expect the dealing to result in a profit (or the avoidance of a loss) attributable to the fact that the information was price-sensitive information in relation to the securities.

There are also a number of 'special defences' to the dealing and encouraging offences which relate to activities carried on by market makers, the dissemination of market information and permitted price stabilisation activities.

Penalty

A person found guilty of insider dealing under the criminal CJA offences may be liable to unlimited fines and/or imprisonment (for up to seven years). The relevant dealing activity, however, remains valid, even if the person is found guilty — so the contract is not voided or otherwise made unenforceable, and the trade stands.

The Civil Regime

Under Section 118 of the FSMA, the term 'market abuse' is defined as seven specific types of behaviour (whether by action or inaction) which occur in relation to qualifying investments admitted (or in respect of which a request has been made for admission) to trading on a prescribed market.

The term 'qualifying investments' covers: (i) 'transferable securities' (shares in companies and other securities equivalent to shares in companies, bonds and other forms of securitised debt which are negotiable on the capital market, and any other securities normally dealt in giving the right to acquire any such transferable securities by subscription or exchange or giving rise to a cash settlement, excluding instruments of payment); (ii) units in collective investment undertakings; (iii) money market instruments; (iv) financial futures contracts, including equivalent cash-settled instruments; (v) forward interest-rate agreements; (vi) interest rate, currency and equity swaps; and (vii) options to acquire or dispose of any instrument falling into these categories, including equivalent cash-settled instruments.

A 'prescribed market' includes: (i) all markets established under the rules of a UK-recognised investment exchange (so including AIM); (ii) OFEX; and (iii) all UK-regulated markets (including the London Stock Exchange).

Market Abuse

'Insider dealing' is one of the seven types of market-abusive behaviour and occurs when an insider deals, or attempts to deal, in a qualifying investment or a related investment on the basis of inside information relating to the investment in question. For these purposes, an 'insider' is a person who has inside information: (i) as a result of his or her membership of the administrative, management or supervisory bodies of an issuer of qualifying investments; (ii) as a result of his or her holding in the capital of an issuer of qualifying investments; (iii) as a result of having access to the information through the exercise of his or her employment, profession or duties; (iv) as a result of his or her criminal activities; or (v) which he or she has obtained by other means and which he or she knows, or could reasonably be expected to know, is inside information.

'Inside information' in relation to qualifying investments, or related investments, which are not commodity derivatives, is information of a precise nature which: (i) is not generally available; (ii) relates, directly or indirectly, to one or more issuers of the qualifying investments or to one or more of the qualifying investments; and (iii) would, if it was generally available, be likely to have a significant effect

on the price of the qualifying investments or on the price of related investments (which is the case only if it is the kind of information which a reasonable investor would be likely to use as part of the basis on which to make an investment decision).

Other heads of market abuse include disclosure of inside information to another person otherwise than in the proper course of the exercise of the discloser's employment, profession or duties; effecting transactions or orders to trade which give or are likely to give a false or misleading impression as to the supply of or demand for, or as to the price of, qualifying investments; or to secure the price of such investments at an abnormal or artificial level and disseminating information which gives or which is likely to give a false or misleading impression as to a qualifying investment by a person who knew or could reasonably be expected to know that the information was false or misleading.

The civil FSMA regime relates to qualifying investments admitted (or in respect of which a request has been made for admission) to trading on a prescribed market, or to derivative instruments ('related instruments') whose price/value is referable to that of the qualifying investment. A person must be in possession of inside information (whether or not he or she knows it is inside information) and must then deal on the basis of that information to be in violation.

Defences

Unlike the criminal offences under the CJA, there are no set defences to civil insider dealing, and as a result, defences to civil FSMA cases of insider dealing have tended to turn on the specific elements of the relevant branch of market abuse not being proven (on the balance of probabilities) as a part of the FCA's case.

Penalty

The FCA has the power to fine a person if he or she is found guilty of insider dealing under the civil FSMA regime. The FCA can also issue 'notices' to the market warning that the relevant individual has conducted abusive activities, as well as removing a person's approved persons status (if he or she has it) such that the individual may be banned from working in a role of any significance in the UK financial services industry.

Enforcement

The FCA has primary responsibility for enforcing the UK insider dealing and market abuse rules (although because FCA investigators do not have any power of arrest, it tends to be the case that FCA investigations with a view to criminal prosecutions under the CJA are conducted in conjunction with UK police). However, the UK has a poor record on criminal prosecutions for insider dealing under the CJA because of the high burden of proof (beyond reasonable doubt) and the many elements of the criminal CJA offences that have to be proven in court. Instead, the FCA and its predecessor (the FSA) have tended instead to bring cases under the civil market abuse regime, which has a lower burden of proof under which the FCA can more easily prove all the necessary elements of the case to secure a penalty.

For the year 2012–2013 the FSA imposed £423.2 million in financial penalties under the civil market abuse regime and concluded four trials under the criminal CJA regime which resulted in 13 criminal convictions, 12 of which were for insider dealing. The FCA has confirmed its intention to be ever more vigilant and to bring as many insider dealing cases to court as it can, continuing the FSA's previous strategy of 'credible deterrence' whereby wrongdoers should come to the realisation that they face a real and tangible risk of being held to account and can expect to face meaningful sanctions against them, including significant fines and imprisonment.

Application to Activist Investors

Activist investors, like any investor, should be vigilant to ensure that they are not in possession of inside information at the time that they are trading in listed securities or other financial instruments. Insider dealing is a significant risk for activist investors, particularly where they have appointed a representative to the relevant company's board of directors. A director of a company whose shares are admitted to trading on a prescribed market will, by definition, be an insider, so information shared by that director with the activist investor would likely be inside information.

Similarly, information as regards the intentions of other shareholders — for instance when an activist investor shares strategic or campaign information with another investor with a view to assessing support (and where that information has the necessary characteristics described above, including being likely to have a significant effect on the price of the relevant securities or investments) — can constitute inside information. Any time that an activist investor is in possession of inside information, it should have the relevant company's name on its restricted list and there should be no trading or dealing in the company's shares until the company releases the information to the markets or otherwise a sufficiently long period of time has passed such that the information held by the activist investor becomes 'stale'. Every case turns on its own facts and circumstances, so legal advice should be sought if there are any concerns about a specific situation or a specific course of dealing.

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If you have any questions concerning this *Briefing*, please contact your attorney at Schulte Roth & Zabel or one of the following attorneys: [Eleazer Klein](#), [Jim McNally](#) or [Marc Weingarten](#).

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