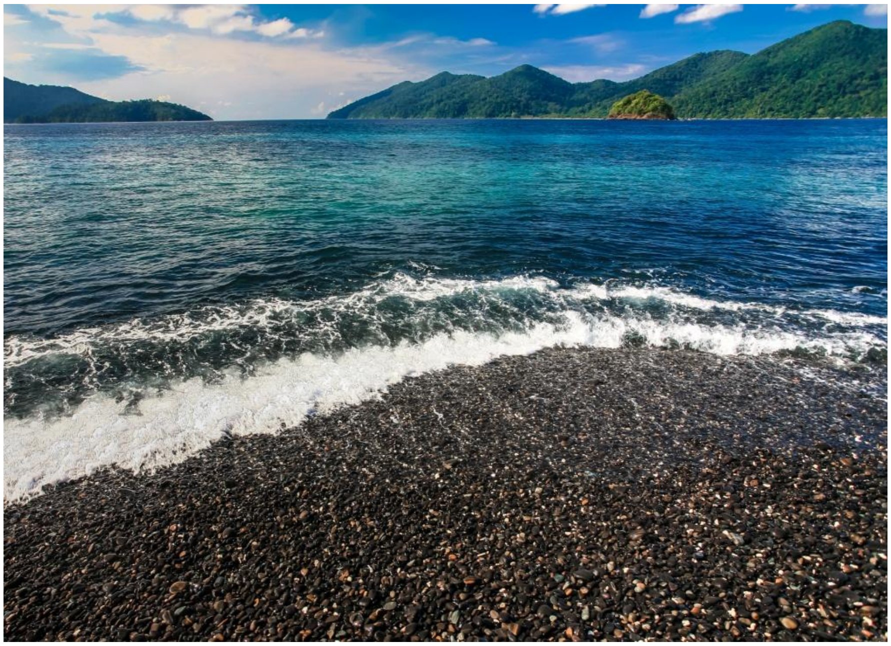
The US and EU – An ocean apart on insider dealing regulation?

On both sides of the Atlantic, enforcement against insider dealing and the abuse of inside information remain key objectives of regulators. But the legal basis and scope of the offences of insider dealing differ significantly between the US and the EU. This has significant, major implications for funds and other market participants, particularly because both the EU and the US regimes have potential extra territorial impact, meaning that compliance policies of funds in particular will often need to take both regimes into account. This article considers some of the key differences between the scope of insider dealing enforcement on either side of the Atlantic, the latest developments which, in some respects, are accentuating those differences and some of the likely implications for funds grappling with the impact of both regimes on their business.

There are two significant contrasts between US and EU law on insider dealing that help to explain why the regimes operate differently and which are also at the root of some of the recent divergences in case law between the US and UK in this area.

First, the US regime has largely evolved through judicial interpretation of the anti fraud provision of the Securities Exchange Act of 1934 - Section 10b – and the SEC Rules established under section 10b, most notably Rule 10b5. These provisions have been used to counteract all kinds of behavior relating to securities, from misleading statements in company filings and documents used to sell the securities, to insider dealing and market manipulation. Consequently,



this has led to a gradually developing body of common law and precedent around this topic and some elements of the concept of insider dealing being open to interpretation as a result. By contrast, the EU regime is largely statute-based, with a series of specific offences being created and developed through primary and secondary legislation. This statute-based regime continues to be developed. The law in the EU is currently largely based on the 2003 Market Abuse Directive, which has then been implemented into the laws of EU Member States (in the UK through Part VIII of the Financial Services and Markets Act 2000). This regime supplemented the earlier EU insider dealing regime which was created in the EU through the 1989 Insider Dealing Directive (implemented in the UK through the Criminal Justice Act 1993) and the law in the area continues to be further developed through the second Market Abuse Directive and the Market Abuse Regulation which are due to be implemented in 2016.

Second, Section 10 (b) and the rules promulgated under section 10 (b) have generally been interpreted to prohibit the purchase or sale of a security on the basis of material non-public information only where this would constitute the breach of a duty of trust or confidence. In the 1996 case of United States v. O'Hagan, the Supreme Court held that there are two distinct types of fiduciary duty that can serve as the basis for an insider trading violation of Rule 10b-5. The first is the relationship between corporate 'insiders' and the corporation's shareholders. This is referred to as the classical theory of insider trading. The second is where 'outsiders' to the corporation obtain non-public information subject to some form of duty, such as a duty of confidentiality, and by using that information to trade or tip off others that duty is breached. This is referred to as the misappropriation theory. The classical and misappropriation theories provide the basis for most US insider trading cases.

In the EU, by contrast, there is no requirement for there to be a fiduciary duty or obligation on the person who deals on the basis of material non-public or inside information, or who tips others off to that information. The offences under the EU regimes prohibit particular behaviors. These include dealing on the basis of inside information and disclosing inside information to others (as well as a series of behaviors relating to misleading and abusing the market). However, there is no requirement for an insider to owe any form of fiduciary duty or obligation to the shareholders of the relevant company or to anyone else to be found liable for insider dealing. In fact, under the 2003 EU Market Abuse Directive, a person can be liable for insider dealing if he deals when in possession of inside information obtained by any means and "which he knows, or could reasonably be expected to know, is inside information".

Recent cases and enforcement action in the US and EU respectively have, if anything, served to emphasize these differences. In particular, the Newman case in the US has enforced the need for some form of fiduciary duty to be breached to constitute an offence of insider dealing. Meanwhile, the lack of a need for any form of duty to be present was highlighted through the UK's FSA enforcement action against David Einhorn and his Greenlight fund.

In the Newman case, the Second Circuit, which has jurisdiction over the majority of US insider trading prosecutions, overturned convictions of the defendants in that case by holding that tippee liability (i.e. liability of the person who is tipped off to a piece of inside information) requires that "…the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit…". This resolved the long outstanding question of whether, in bringing a prosecution involving tippee liability, the US Government must prove that a remote tippee knew that the insider who disclosed confidential to the first tippee received a personal benefit for doing so. The case involved analysts providing to traders information relating to publicly traded companies. The hedge fund managers who were prosecuted, Todd Newman and Anthony Chiasson, were several steps removed from the original tipper within the relevant company. In reaching its decision in the Newman case to overturn the convictions of Newman and Chiasson, the Second Circuit referred back to the Supreme Court decision in the 1983 case of Dirks v SEC. In that case, the Supreme Court held that an insider's disclosure of confidential information alone is not a breach of any duty for the purposes of insider trading, but that it is the "exchange of confidential information for personal benefit" that amounts to the fiduciary breach triggering liability for insider trading.

Consolidating its findings with guidance from previous cases, the Second Circuit laid out the necessary elements for insider trading liability against a tippee:

"(1) the corporate insider was entrusted with a fiduciary duty; (2) the corporate insider breached his fiduciary duty by (a) disclosing confidential information to a tippee (b) in exchange for a personal benefit; (3) the tippee knew of the tipper's breach, that is, he knew the information was confidential and divulged for personal benefit; and (4) the tippee still used that information to trade in a security or tip another individual for personal benefit."

The case also makes clear that the insider tipper must act for "personal benefit" and that a personal benefit to an insider "must be of some consequence . . . that is objective, consequential and represent at least a potential gain of a pecuniary or similar valuable nature".

In presenting the case, the government argued that the analysts realized there was a significant benefit obtained by the tipper inside the company, namely the benefit of friendship. The Second Circuit found that this was insufficient.

This case marks a clear challenge to the Justice Department and SEC's aggressive and relatively inclusive approach in prosecuting the relatively vaguely defined concept of insider trading. The court's judgment sends a clear signal to the authorities that their insistence on broadening the reach of criminal liability for conduct that is not clearly outlawed by statute will come under close judicial scrutiny and potentially be rejected.

At the same time, the Second Circuit judgment in Newman marks a significant disconnect with the approach being taken in Europe, where the concepts of what constitutes inside information are being given a broad interpretation through recent judicial decisions while the lack of any requirement that a duty to exist on the part of the person involved in the alleged offence are being further underlined.

The most notable recent case in this area was the Greenlight case where both Greenlight and Greenlight's well known CEO, David Einhorn, were fined a total of £7.2 million ($11 million) for insider dealing.

This case revolved around a discussion that David Einhorn and others at Greenlight had with the management of a UK public listed company, Punch Taverns, in whose listed equities Greenlight held a significant position. Prior to the call, Einhorn was asked to sign a nondisclosure agreement in relation to the discussion, but refused to do so. The call went ahead despite the lack of an NDA and with all on the call, making clear their understanding that inside information would not be disclosed. During the call, Punch Taverns mentioned that they were in advanced consideration of a further equity raising, and they sought Einhorn's view on this. Einhorn stated that he thought that, as a significant investor/holder of stock this was a bad idea. After the call, Greenlight sold a significant proportion of its holding in Punch Taverns. Several days later, Punch Taverns announced an equity fund raising resulting in Punch's shares dropping in value by 30%. Greenlight's sale led to the fund avoiding losses of £5.8 million ($9 million).

In response to the regulatory enforcement process for insider trading, Einhorn and Greenlight argued that there was no NDA in place and that they had not been wall crossed, so should have been free to infer that they were not going to be given inside information during the call (and, therefore should have been free to trade in Punch Tavern shares). However, the FSA argued that "investment professionals are expected to handle inside information carefully regardless of whether they have been formally wall crossed." Also, even though Greenlight were not told definitively that a further equity raising would be effected or when that would occur, there were sufficient indications from Punch that an equity raising was imminent. That, in the possession of market professionals, the information divulged during the call, constituted inside information.

Tracey McDermott, who was at the time the acting director of enforcement and financial crime at the FSA, noted that because David Einhorn is an experienced professional with a high profile in the industry, he is expected to be able to indentify inside information when he receives it and should act appropriately. His actions breached the FSA's expected standards of market conduct.

The FSA's enforcement decision was appealed to the Upper Tribunal, but when that upheld the FSA's case, Einhorn and Greenlight decided to settle the case and not appeal further.

This case provides a very good counterpoint to the position in the US. In the Greenlight case, there was no fiduciary duty to the shareholders of Punch Tavern – Einhorn had refused to sign the NDA and made clear that he did not want to receive, and he was led to believe he would not receive, inside information. An irony with the Greenlight case is that, were David Einhorn to have taken the obvious implication of being asked to sign the NDA that Punch Tavern wished to impart bad news and, consequently, refused to take the call from Punch, he could have sold down Greenlight's position in the shares, and the FSA would have had no grounds to take enforcement action, while Greenlight investors would have still benefited from the sale.

Taking the enforcement action that they did on these facts and then imposing such a large fine in a relatively marginal case such as this, the FSA were signaling several things that are of great relevance to hedge funds.

First, they will enforce extraterritorially. Greenlight is a US hedge fund and David Einhorn is based in the US. Those facts clearly did not deter the FSA from bringing enforcement action. There is no reason to believe that the FSA's successor, the FCA, will be deterred from similarly pursuing non-UK based funds and others for insider dealing relating to activities concerning information, such as equities in UK listed companies, that fall within the UK/EU regime.

Second, they clearly have the appetite to take on what for them are difficult cases.

Third, the FSA was signaling in statements such as the one above from Tracey McDermott, that market professionals will be held to a higher standard. In David Einhorn, they saw someone who "should have known better". So that, even though the facts were relatively marginal – a conversation where everyone involved thought there was no inside information – because David Einhorn is a high profile hedge fund manager, even though based in the US where the standard is different, he was held to the standard where, in effect, he was deemed to have a fiduciary duty to the market as a whole. This "duty" that the FSA deemed in this case was in direct opposition to his only actual fiduciary duty, i.e. to his investors. Once he knew or should have known with his level of expert knowledge that that Punch shares would fall in value, he had a clear duty to his investors to use that knowledge to avoid loss in the value of the portfolio – so long as exercising that duty is not unlawful. He thought that it was not unlawful. However, the FSA are implying that for an investment professional, duty to the market trumps duty to investors and that investment professionals such as David Einhorn will not be given the benefit of the doubt when they have information which is arguable not totally clearly inside information.

What does all of this mean for hedge funds facing this apparent divergence in insider trading law and practice either side of the Atlantic?

First, it can be assumed that the Justice Department and SEC will seek to find ways to neuter the Second Circuit decision in Newman. They will clearly look for ways to continue to apply a broad interpretation of the misappropriation theory of insider trading, and the Second Circuit is only one judicial circuit in the Federal system. Therefore, anyone potentially subject to US jurisdiction relating to insider trading should not assume that

Newman can be relied on as a firm precedent for the foreseeable future to avoid potential liability for insider trading.

Second, the FCA—and other European regulators – are likely to continue to bring cases that test the boundaries of UK/EU insider dealing legislation. They have historically been criticized for failing to prosecute the law on insider trading effectively. The fact that, in the Greenlight and subsequent cases, the FCA has succeeded in arguing that professional investors are subject to higher standards in relation to insider dealing, including that they ought to understand the significance of pieces of information even when they are arguably not specific or precise and that they have in effect a fiduciary duty to the market in relation to inside information, suggests that they will continue to pursue market professionals such as hedge fund managers for insider trading even where the facts are marginal.

In practical terms, therefore, hedge funds should assume that regulators will continue to look to take an expansive interpretation of the concept of inside information and insider trading.

Also, funds that trade in investments listed on both sides of the Atlantic need to have compliance regimes capable of covering the definition of insider trading on both sides of the Atlantic. Although, as noted, the authorities in the US are likely to look to neuter Newman, there will continue to be significant differences between the law on this topic in the US and the EU. Consequently, compliance policies will have to take a "highest common denominator approach" recognizing, for example, that the increasingly expansive concept of inside information in Europe combined with the lack of a need for a duty may lead to a more conservative approach on some aspects than practitioners may have been used to in the US.

Finally, funds need to ensure active and vigilant processes to ensure that where information that is, or arguably could be, inside information, is received, whatever the circumstances, careful consideration is given to whether trading the relevant instruments can continue. It may not be sufficient that there is no NDA or that the information seems to be marginal. One aspect of the insider dealing enforcement regime that is common to the US and the EU is an increased focus on putting in place effective compliance systems and policies in relation to dealing with inside information, and then to make sure the are followed and fully auditable.

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