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Insider Trading

Perils Across the Pond: Understanding the Differences Between U.S. and U.K. Insider Trading Regulation

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The ongoing crackdown on insider trading has been front page news for some time now. Pundits have compared the situation to the 1980s when a wave of similar charges were leveled against Wall Street icon Ivan Boesky and other professional investors, bankers and lawyers of that era. Unlike the 1980s, however, this latest round of insider trading enforcement is not limited to activity in the United States.

This time, foreign regulators have followed suit, bringing their own string of insider trading cases that, on the surface, seem to mirror what has been going on in the United States. The leader of this pack has been the U.K.'s Financial Services Authority (FSA), which has cast aside its historical reputation as a "light touch" regulator by bringing a series of aggressive and unprecedented "insider dealing" cases against their own high-profile targets. The FSA has secured 14 criminal convictions related to insider dealing since 2009 and is currently prosecuting another eight individuals on criminal insider dealing charges.[1] Most recently, on October 1, 2012, the FSA charged four men, including a former managing director of a major investment bank, with participation in an insider dealing conspiracy allegedly involving the front-running of block trades.

This recent flurry of international insider trading enforcement, coupled with the globalization of the world's financial markets, subjects investment professionals to a new and unprecedented set of risks. The crux of the problem is that the rules governing insider trading can differ significantly from jurisdiction to jurisdiction. In many cases, the insider trading laws in the U.S. are actually narrower than they are abroad. Ironically, this is at least in part a byproduct of the long tradition of aggressive insider trading prosecution in the United States. U.S. courts have spent the past three decades refining the boundaries of what constitutes illegal insider trading. No comparable body of precedent exists in other jurisdictions. In the U.K., for example, the FSA won its first criminal insider dealing case just three years ago.

By analyzing the differences between U.S. and U.K. insider trading laws, this article identifies some of the potential pitfalls faced by U.S. investors who are active in investing in the United Kingdom.

Basic Overview of U.S. Insider Trading Law

U.S. Regulatory Overview

In the United States, insider trading is prosecuted through a series of anti-fraud laws, the most prominent of which is Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder. Section 10(b) and Rule 10b-5 do not explicitly prohibit insider trading. Rather, these laws broadly prohibit the use of "manipulative or deceptive devices" in connection with the purchase or sale of securities. The U.S. courts have held that insider trading can be a form of fraud prohibited by Section 10(b) and Rule 10b-5 if the following basic elements exist:

- A person or entity *purchases or sells securities;*

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- While in possession of *material, non-public information*;
- Where the trader or tipper has acted in *breach of a fiduciary or similar duty*; and
- The culpable parties acted with the appropriate level of *scienter* (the Latin word for "guilty knowledge").[2]

There are two basic types of insider trading cases. The first involves situations where the defendant receives material, non-public information in the context of a fiduciary or other confidential relationship and then purchases or sells securities while in possession of that information. The second involves the so-called "tipper/tippee" scenario where an individual (i.e., a "tipper") breaches a duty by providing material, non-public information to someone else who has traded (i.e., a "tippee"). In these situations, the U.S. securities laws impose liability on both the tipper and tippee.

The U.S. Securities and Exchange Commission (SEC) is responsible for bringing civil enforcement actions based on insider trading violations, while the U.S. Department of Justice (DOJ) has the authority to prosecute criminally those who commit insider trading. The only legal difference between a civil and a criminal insider trading violation is the level of intent or "scienter" exhibited by the defendant.

Summary of the Elements Under U.S. Law

Material, Non-Public Information

Information is "material" in the context of a Rule 10b-5 claim if there is a substantial likelihood that a reasonable investor would consider the fact important in deciding how to trade.[3] Put another way, if there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available," the omitted fact is material.[4] According to the SEC, a person trades "on the basis of material non-public information" in violation of Rule 10b5-1 when that person was aware of the information at the time of the trade.[5]

The SEC has stated that the "[p]roper and adequate disclosure of significant corporate developments can only be effected by a public release through the appropriate public media, designed to achieve a broad dissemination to the investing public generally and without favoring any special group."[6] The U.S. Court of Appeals for the Second Circuit, however, has held that information becomes public for insider trading purposes once the information has been "fully impounded into the price of a particular stock," even if only a small number of people are responsible for making those trades.[7]

Duty

The duty requirement for insider trading liability under U.S. law is rooted in the premise that only fraudulent conduct may be prosecuted under Section 10(b) and Rule 10b-5. Because insider trading is typically fraud by omission, it can only be actionable if the trader or tipper had a duty to either make some sort of disclosure or refrain from trading.[8]

In the U.S., there are two different theories that can be relied upon by regulators to establish a duty. Under the "classical theory" of insider trading, a corporate insider violates a duty to current and future shareholders by trading, without disclosure, on the basis of material non-public information.[9] A corporate insider may be an officer, director or employee, or a so-called "temporary insider" such as a lawyer, consultant or investment banker.[10] Under the "misappropriation theory" of insider trading, persons other than corporate insiders who receive material non-public information in confidence

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and breach their duty to the source of the information by trading are also liable for insider trading.[11] For a duty to be breached in a tipper/tippee case, the tipper typically has to be acting for a "personal benefit," which can be something tangible, such as money, or intangible, such as the desire to make a "gift" of the information to a personal friend, business associate or family member.[12]

Scienter

In the United States, a defendant can only be liable for insider trading if he or she acted with a culpable state of mind, commonly referred to as "scienter." For civil liability, the prevailing view is that the scienter requirement "may be established through a showing of reckless disregard for the truth, that is, conduct which is highly unreasonable and which represents an extreme departure from the standards of ordinary care."[13] To be criminally liable for insider trading, however, the defendant must act *willfully*, which may be established with proof that the defendant knew that "he was doing a wrongful act," provided the "knowingly wrongful act involve[d] a significant risk of effecting the violation that occurred."[14]

Purchase or Sale of a Security

Lastly, under Section 10(b) and Rule 10b-5, there must be a "purchase or sale of [a] security" for anyone to be liable for insider trading.[15] In other words, if the person who obtains the material non-public information decides not to engage in a securities transaction, there can be no liability for insider trading.[16]

Basic Overview of U.K. Insider Dealing Law

The FSA currently oversees enforcement of the U.K.'s two overlapping insider dealing laws.[17] The Criminal Justice Act 1993 (CJA) provides for the criminal prosecution of "insiders" who deal in securities on the basis of "inside information," encourage others to deal in securities on the basis of inside information or disclose inside information otherwise than in the proper performance of their employment, office or profession. The Financial Services and Markets Act 2000 (FSMA) provides for the imposition of civil penalties for various forms of "market abuse," which include the same categories of conduct covered by the CJA. The insider dealing provisions of the FSMA apply to conduct occurring within the U.K. as well as any conduct relating to "qualifying investments" on markets situated, operating or regulated in the U.K.[18] The term "qualifying investment" includes shares in companies, bonds and other forms of negotiable securitized debt, derivatives on commodities, financial futures contracts, forward interest rate agreements, money market instruments, interest-based swaps, currency swaps, equity swaps and options on any of the above instruments.[19] As in the U.S., the primary distinguishing characteristic between criminal and civil insider dealing in the U.K. is the level of intent involved in the violation.

Key Differences in Legal Regimes

Although certain facets of the insider dealing regime in the U.K. are similar to their U.S. counterparts, the U.K. statutes do not incorporate three key elements of U.S. insider trading regulation – scienter, breach of a duty and the existence of a securities transaction. These differences can have very significant practical consequences. Practices that U.S. market participants might consider ordinary, such as channel checking and asking probing questions to management, may be prohibited under certain circumstances in the U.K.

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Liability for Improper Disclosure

In the U.K., an insider may be liable for disclosing inside information "otherwise than in the proper performance of the functions of his employment, office or profession."[20] Inside information is information that is both non-public and "price sensitive" (a term similar in meaning, but not identical, to "material" in the United States). Importantly, and in contrast to U.S. law, the recipient of the disclosed information need not provide a personal benefit to the insider in order for the insider to be liable for improper disclosure. The recipient of the information also need not trade for the party making the disclosure to be liable. Although this can also be said of those who violate Regulation FD in the United States by selectively disclosing corporate information, Regulation FD is a civil regulation that only applies to issuers and their senior officials or their other officers, employees or agents who regularly communicate with securities market professionals or shareholders.[21] Under U.K. insider dealing law: (1) improper disclosure can be a criminal offense covered by the CJA,[22] and (2) persons who are not employees or agents of an issuer can be held liable for improperly disclosing its corporate information, regardless of whether anyone has traded.

The FSMA and CJA also provide that those who encourage another person to improperly disclose inside information may be held civilly or criminally liable. In the FSA Handbook, the following hypothetical is provided as an example of the violation of encouraging another to engage in improper disclosure: "X, an analyst employed by an investment bank, telephones the finance director at B PLC and presses for details of the profit and loss account from the latest unpublished management accounts of B PLC."[23] While the FSA has not yet brought a case involving these facts, it views Handbook examples such as this as putting market participants on notice of the types of conduct that would constitute clear cases of market abuse. Significantly, the hypothetical contains no suggestion that the analyst offered any benefit to the finance director to encourage him to answer his questions. If the hypothetical is taken at face value, then overly probing questions by an analyst could arguably be characterized as "encouraging" improper disclosure under U.K. law.

No Scienter Requirement for Civil Liability

Unlike those accused of insider trading in the U.S., insiders in the U.K. need not know that the information in their possession is "price sensitive" (the U.K. equivalent of "material") in order to be civilly liable for dealing on the basis of the information.[24] Instead, the FSA applies a purely objective test that asks whether a reasonable person would have viewed the information as "price sensitive."[25] In other words, to be civilly liable in the U.K., one must only act negligently (whether by trading or disclosing) with respect to the materiality of the information. In contrast, to obtain civil sanctions in the U.S., the SEC would need to show that the defendant acted at least recklessly. There is an affirmative defense in the FSMA for those who can show they either "believed, on reasonable grounds that they did not commit insider dealing" or "took all reasonable precautions and exercised all due diligence to avoid committing insider dealing."[26] In the authors' experience, however, the FSA does not view this defense as being applicable in cases where the relevant parties failed to engage in detailed consultation with legal counsel or compliance officers before disclosing or dealing.

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No Duty Requirement

The insider trading regime in the U.K. is not based on "fraud," in contrast to the insider trading prohibitions derived from section 10(b) of the Exchange Act and Rule 10b-5. As a result, the U.K. regime does away with the fraud-based requirement of a violation of a duty and prohibits all trading and tipping by an "insider." The FSMA defines an "insider" as a person who holds "inside information" as a result of the person's (1) access to such information through the exercise of his employment, profession or duties; (2) ownership of the capital in an issuer; (3) membership on an administrative, management or supervisory body of an issuer; or (4) criminal activities.[27] Additionally, a person is an insider if he has inside information "which he has obtained by other means and which he knows, or reasonably could be expected to know, is inside information."[28] A person may therefore be prohibited from trading on or disclosing a piece of inside information just by acquiring the information, regardless of its source.

Impact on Conduct of Research

This difference between the insider trading regimes in the U.S. and the U.K. can have a substantial impact on the way that investors can go about conducting research. For example, those accustomed to operating within the constraints of U.S. law should take caution when contemplating engaging in the following activities in the U.K.:

Channel Checking

A "channel check" is a commonly employed research tool, which involves talking to people in a company's supply chain to get a sense of how the company's dealings with their suppliers might affect its overall business. In the United States, many firms have adopted procedures designed to either avoid paid channel checks or to strictly vet circumstances where suppliers are being paid for information to ensure that they are not violating any confidences. These procedures rely heavily on the duty element of U.S. insider trading law, which typically requires the provision of a personal benefit and/or the passing of confidential information for a breach of duty to have occurred. Such procedures will not be as effective under U.K. law, which prohibits *any person* who acquires inside information by *any means* – regardless of whether a duty was breached – from trading on the basis of the information.

Declining to Sign a Non-Disclosure Agreement (NDA)

When a company wishes to share material, non-public information with an investor, the typical practice is for the company or its agent to ask the investor to sign an NDA or become "wall-crossed," which amounts to a verbal agreement to keep the information confidential. As a practical matter, this is a critical aspect of how management and its investors communicate because it clearly communicates to the parties the expectations with respect to the ground rules for their discussions. In the U.S., however, the existence of an NDA or a wall-crossing also has important legal significance because it creates a duty on the part of the investor not to trade. Without such a duty, there typically could be no insider trading charge under U.S. law, unless management was corrupt and provided the information to the investor in breach of their own duties for a personal benefit. Investors do not obtain the same degree of protection by refusing to agree to an NDA or to be wall-crossed in the U.K. To the contrary, the FSA has taken the position that a mere NDA request should put an investor on high alert that any further discussion could result in the communication of inside

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information in violation of the FSMA, even if the request has been unequivocally declined. As the case study below illustrates, this places a heavy burden on investors to identify inadvertent disclosures of arguably material, non-public information during even the most routine one-on-one or small group discussions with company management.[29]

Case Study – SEC v. Presstek, Inc.: How Would It Have Played Out In the U.K.?

On May 15, 2012, the SEC settled a Regulation FD case that it had commenced more than two years previously against Edward Marino, the CEO of Presstek, Inc., a Connecticut-based provider of digital imaging equipment.[30] In its complaint, the SEC alleged that Marino selectively disclosed material non-public information regarding Presstek's financial performance during the third quarter of 2006 to an investment adviser, who subsequently caused the sale of all of his firm's Presstek shares.[31] Specifically, on the morning of September 28, 2006, Marino and the investment adviser had an eleven-minute phone call in which Marino stated in response to a question about Presstek's performance in Europe during the summer of 2006 that "'[s]ummer [was] not as vibrant as [they] expected in North America and Europe'" and that while "'Europe [had] gotten better since [the summer]' it was 'overall a mixed picture'" for Presstek's performance that quarter.[32] While on the phone with Marino, the investment adviser told his business associate that the information he was receiving from Marino "sound[ed] like a disaster" and told the associate that the firm should start buying puts on Presstek.[33] After the call, the investment adviser instructed a trader to sell all of the firm's Presstek shares.[34] At 12:01 a.m. the next day, Presstek issued a preliminary announcement reporting that its financial performance was below its prior estimates for the third quarter of 2006.[35] Between the close of trading on September 27, 2006 (the day before the selective disclosure) and the close of trading on September 29, 2006, Presstek's stock price dropped from $7.70 per share to $5.39 per share.[36]

Based on these facts, the SEC found that Marino and Presstek violated Regulation FD, which requires issuers to make public immediately through established channels any material non-public information that persons acting on their behalf selectively disclose to individuals or entities under circumstances in which it is reasonably foreseeable that the recipient of the information will trade in the issuer's securities. The investment adviser, however, could not be charged under Regulation FD, which only covers issuers and their agents. The case also did not involve any allegations of insider trading against either Marino or the investment adviser who received the information. This was most likely because: (1) the investment adviser did not owe Presstek or Marino any duty of trust or confidence pursuant to an NDA or otherwise, and (2) Marino was not violating a fiduciary duty to Presstek by disclosing the information without any expectation of a personal benefit. If Presstek's securities had been listed in the U.K., however, this story might well have played out very differently.

Under U.K. law, the investment adviser's conduct would have arguably satisfied all of the elements of insider dealing. First, like the SEC, the FSA could have concluded that Marino's comments effectively told the investment adviser that Presstek's upcoming financial report would be below market expectations. This would have been "inside information" because it (1) was not generally available; (2) related directly to Presstek; and (3) had a significant effect on the price of Presstek stock when it was made generally available.

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Second, the investment adviser was an "insider" because he knew, or could reasonably have been expected to know, that the information he received from Marino was "inside information."[37]

There is also a possibility that the FSA would have considered bringing criminal charges in the Marino case. As explained above, the main difference between civil liability under the FSMA and criminal exposure under the CJA is the level of knowledge involved in the violation. Under the CJA, criminal liability attaches if a defendant trades with actual knowledge that he possesses "inside information" that came from an "inside source."[38] The investment adviser's characterization of the information as a "disaster" and the fact that he instructed his associates to sell Presstek stock *during* the call with Marino could be viewed as strong circumstantial evidence of his knowledge that he had been given inside information. Furthermore, as Presstek's CEO, Marino would have been an obvious "inside source."[39] As a result, it is at least conceivable that the investment adviser, who escaped all liability for his trading in the U.S., could have faced jail time for the same exact conduct had Presstek been a U.K. issuer.

Conclusion

The U.K.'s insider dealing regime clearly adopts an "equal access" approach to the prohibition of trading on inside information with profound implications for those who trade on U.K. markets. Rather than restrict liability to those who owe a fiduciary duty to the issuer or the source of the information, the FSMA and the CJA impose liability on a broad range of market participants who come to acquire inside information through means that would not restrict them from trading in the United States. Additionally, the FSMA removes any requirement that the FSA show intent or recklessness on the part of the defendant in order to establish civil liability. As a result, even those well-versed in the details of the U.K.'s insider dealing laws may find themselves walking a razor's edge between lawful trading and insider dealing or improper disclosure without realizing it. Those accustomed to operating under the U.S. insider trading regime, however, must be even more proactive in assessing the potential risks of receiving, disclosing, soliciting or trading while in possession of potentially "inside" information when operating in the U.K.

Mr. Asaro has extensive litigation and investigatory experience involving matters arising under the federal securities laws, including insider trading, market manipulation, accounting irregularities, Foreign Corrupt Practices Act (FCPA) violations, and broker-dealer and investment adviser regulation. He is a former assistant U.S. attorney for the Eastern District of New York, where he served as deputy chief of the Business and Securities Fraud Section. Earlier in his career, Mr. Asaro served as a branch chief in the SEC's New York office, where he supervised staff attorneys working on a wide variety of regulatory investigations and enforcement actions.

Mr. Rappaport's practice focuses on advising investment funds and other public and private companies on issues involving corporate governance, insider trading, market manipulation, corporate compliance, securities regulation, fiduciary duty and fund formation. He also regularly litigates complex commercial and securities disputes and represents clients in front of the SEC and other regulatory agencies. He has extensive experience in matters regarding fiduciary obligations, securities fraud, breach of contract, limited partnership interests, insider trading, tender offers, proxy contests, professional liability, insurance issues and bond defaults.

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Mr. Mott's practice focuses on litigation, with experience in the areas of bankruptcy litigation and white collar criminal investigations.

[1] Press Release, FSA, Four Charged with Insider Dealing (Oct. 1, 2012), *available at* http://www.fsa.gov.uk/library/communication/pr/2012/090.shtml.

[2] *United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997).

[3] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

[4] *Basic Inc. v. Levinson*, 485 U.S. 224, 231 n. 28 (1988).

[5] 17 C.F.R. 240.10b5-1(b) (1998).

[6] *In re Faherge, Inc.*, 45 S.E.C. 249, 256 (1973).

[7] *SEC v. Mayhew*, 121 F.3d 44, 50 (2d Cir. 1997).

[8] *See Chiarella v. United States*, 445 U.S. 222, 230 (1980) (holding that "[w]hen an allegation of fraud is based upon nondisclosure, there can be no fraud absent a duty to speak," which only arises when one party has information "that the other is entitled to know because of a fiduciary or similar relation of trust or confidence between them.").

[9] *See Chiarella v. United States*, 445 U.S. 222, 226-30 (1980).

[10] *Dirks v. SEC*, 463 U.S. 646, 655 n. 2.

[11] *United States v. O'Hagan*, 521 U.S. 642, 652 (1997).

[12] *Dirks v. SEC*, 463 U.S. 646, 664 (1983). There are at least two important exceptions to the requirement of a breach of fiduciary duty. First, Section 14(e) of the Exchange Act and Rule 14e-3 thereunder allow the SEC to bring insider trading charges where a "substantial step" has been taken to commence a tender offer and the trader possessed material non-public information about the potential transaction, regardless of whether any duty was breached. 17 C.F.R. 240.14e-3. Second, at least in the Second Circuit, one who makes some type of affirmative misrepresentation to steal material non-public information and then trades on the stolen information could be liable under section 10(b) of the Exchange Act even if the thief owed no duty to the owner of the information. *See SEC v. Dorozhko*, 574 F.3d 42 (2d Cir. 2009).

[13] *SEC v. McNulty*, 137 F.3d 732, 741 (2d Cir. 1998).

[14] *United States v. Peltz*, 433 F.2d 48, 55 (2d Cir. 1970).

[15] *See* Exchange Act, §10(b).

[16] Note, however, that in the criminal context, the U.S. Department of Justice could charge a defendant with conspiracy to commit insider trading even if no trade actually occurs. The federal general conspiracy statute, Title 18 U.S.C. Section 371, makes it a crime for two or more persons to act in concert to violate the securities laws through insider trading. To establish a conspiracy to violate the securities laws, the criminal authorities must prove that (1) there was an agreement among two or more persons to violate the securities laws; (2) the defendant joined in the conspiracy knowingly and willfully; and (3) at least one of the alleged co-conspirators committed an overt act in furtherance of the conspiracy. *See United States v. Svoboda*, 347 F.3d 471, 476 (2d Cir. 2003).

[17] In 2013, the FSA will be replaced by two new entities, the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The FCA will be responsible for enforcement of financial regulations while the PRA, which will be a subsidiary of the Bank of England, "will be responsible for promoting the stable and prudent operation of the financial system . . . ." Financial Services Authority, *Regulatory Reform – background*. The FCA will continue to pursue the FSA's "credible deterrence strategy agenda . . . vigorously in relation to conduct which puts integrity at risk, such as insider dealing and market manipulation." Financial Services Authority, *The Financial Conduct Authority: Approach to Regulation*, §5.22 (Jun. 2011).

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[18] FSMA, §118(1)(a).

[19] *See* Financial Services and Markets Act 2000 (Market Abuse) Regulations 2005, Reg. 10(2) (defining "qualifying investments" as "all financial instruments within the meaning given in Article 1(3) of the Directive 2003/6/EC of the European Parliament and the Council of 28 January 2003 on insider dealing and market manipulation").

[20] CJA, §52(2)(b); *see also* FSMA, §118(3).

[21] *See* 17 C.F.R. 243.100; 17 C.F.R. 243.101(c).

[22] CJA, §52(2)(b) ("An individual who has information as an insider is also guilty of insider dealing if . . . he discloses the information, otherwise than in the proper performance of the functions of his employment, office or profession, to another person.").

[23] The Code of Market Conduct (MAR 1), §1.4.7, *available at* http://fsahandbook.info/FSA/html/handbook/MAR/1/4.

[24] Criminal liability under the CJA, on the other hand, requires a finding of intent – i.e., that the person (1) knows that the relevant information is "inside information" and (2) knows that he obtained the relevant information from an "inside source." CJA, §57(1). While this is more in line with the requirements for criminal liability in the United States, it is still arguably a lower standard since there does not appear to be any requirement that the defendant knows that he or she is engaging in a "wrongful act."

[25] FSMA, §118C(6) ("Information would be likely to have a significant effect on price if and only if it is information of a kind which a reasonable investor would be likely to use as part of the basis of his investment decisions.").

[26] FSMA, §123(2).

[27] FSMA, §118B.

[28] FSMA, §118B(e).

[29] The authors do not mean to suggest that it would be wise to trade on clearly material, non-public information under U.S. law merely because there is arguably no duty. However, the question of whether information is truly material can often be difficult to assess before it is disclosed to the public and the market has a chance to react. In the U.S. the duty requirement gives investors who engage in fairly common research practices such as unpaid channel checks and routine discussions with management an important added level of protection against their materiality judgments being second guessed that does not exist under U.K. law.

[30] *In the Matter of Edward J. Marino*, Exchange Act Rel. No. 66990 (May 15, 2012).

[31] Complaint, *SEC v. Presstek, Inc.*, No. 10-cv-10406 (D. Mass. Mar. 9, 2010).

[32] *Id*. at 5.

[33] *Id*.

[34] *Id*.

[35] *Id*. at 6.

[36] *Id*.

[37] The means by which the investment adviser obtained the information would be irrelevant under section 118A(e) of the FSMA, which includes in the definition of "insider" any person who has inside information "which he has obtained by other means and which he knows, or could reasonably be expected to know is inside information."

[38] CJA, §57(1).

[39] CJA, §57(2) (defining "inside source" to include a "director" or "employee" of the company).

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