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CLIENT ALERT

Hedge Funds and Recent Market Abuse Cases in the UK

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"Looking ahead, there are three key issues I want to highlight to you today which require the wholesale market's focus: market abuse, conflicts of interest and hedge funds… Firms must be warned that we know market abuse happens and, if we find it, we will take it very seriously."

- Hector Sants, the Financial Services Authority's Managing Director of Wholesale & Institutional Markets, in a speech to the Securities Houses' Compliance Officers Group on 7 July 2005

"Market Abuse: Some hedge funds may be testing the boundaries of acceptable practice with respect to insider trading and market manipulation and, given their payment of significant commissions and close relations with counterparties, may create incentives for others to commit market abuse."

- FSA Discussion Paper entitled "Hedge Funds: A Discussion of Risk and Regulatory Engagement"

"The current focus of our market monitoring activity is on countering institutional market abuse. …we don't think our markets are rife with insider trading or market abuse. We consider the majority of individuals and institutions…do adhere to high standards. However, a small minority do not and are prepared to engage in unacceptable behaviour."

- Hector Sants again, this time in a speech in Hong Kong in June 2006

This Alert examines whether the Financial Services Authority's (FSA) apparent focus on market abuse and hedge funds was reflected in disciplinary action during 2006, and provides an outlook on the FSA's likely future strategy in this area.

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THE CASES

In the course of 2006, five final decisions were published relating to charges of market abuse.[1] Three of these - the cases involving Timothy Baldwin, James Parker and Paul Davidson/Ashley Tatham - were decisions of the Financial Services and Markets Tribunal (FSMT) following a referral to it.

The remaining two - the cases involving GLG/Philippe Jabre and Sean Pignatelli - were FSA Final Notices. Before drawing any conclusions, let us examine the facts of each case (in chronological order).

TIMOTHY BALDWIN

In January 2006, the FSMT delivered its decision in the case of Timothy Baldwin and WRT Investments Limited. The FSA had alleged that Mr. Baldwin, through his investment vehicle WRT, engaged in market abuse and sought to impose penalties of £25,000 on Mr. Baldwin and £24,000 on WRT.

It was alleged that on 28 or 29 July 2003, Mr. Baldwin telephoned Michael Nolan, the Chief Executive Officer of Minmet PLC, an Irish company specializing in mineral exploration and mining activities.

During that call, Mr. Nolan supposedly gave Mr. Baldwin information about the positive July performance of Minmet's principal asset, a gold mine in Sweden - which was relevant information that was not generally available to the market. In reliance on this information, WRT was alleged to have purchased shares in Minmet.

The positive information was notified to the market on 6 August 2003 and Minmet's share price increased by more than 100%. Not long after, WRT sold its holding in Minmet.

The principal basis on which Mr. Baldwin and WRT contested the allegations was that no such telephone conversation with Mr. Nolan had ever taken place.

The FSMT found on the balance of probabilities that the telephone conversation had not taken place and that WRT's trading in Minmet was therefore innocently conducted.

Notwithstanding that Mr. Baldwin was successful in his defence, the FSMT did not award him his costs. It concluded that although the FSA's decision to bring proceedings was wrong, it was not unreasonable given the facts and circumstances known (or which ought to have been known) to the FSA at the time.

This should be contrasted with the FSMT's subsequent decision on costs in the Davidson case (see below).

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PAUL DAVIDSON AND ASHLEY TATHAM

In May 2006, in a further defeat for the regulator, the FSMT cleared Paul Davidson and his broker Ashley Tatham of market abuse and overturned the decision of the FSA to fine Mr. Davidson £750,000.

The FSA had alleged in the proceedings that Mr. Davidson had engineered spread bets on the shares of Cyprotex, a biotech company, to help the company's flotation on AIM in 2002.

Despite finding against the FSA, the FSMT's judgment did not amount to a glowing endorsement of Mr. Davidson's actions.

It found that the scheme was intended to create a misleading impression of the demand for shares in Cyprotex but that this did not amount to abuse because, at the time, the regulations did not require the disclosure of the spread bets.

The FSMT found that the FSA had failed to prove abuse and said that "it had little hesitation in rejecting the authority's case."

It also censured the FSA for imposing the unprecedented £750,000 fine on Mr. Davidson, ruling that the appropriate penalty under current market abuse rules would have been a published statement.

At a further hearing in October, the FSMT decided unanimously that the FSA should pay Mr. Davidson's and Mr. Tatham's costs of the proceedings because the FSA's decision against which Messrs. Davidson and Tatham had appealed to the FSMT was "unreasonable." This is the first time the FSA has been ordered to pay the costs of a person it had tried to penalize for breaching its rules.

GLG / PHILIPPE JABRE

In August, hedge fund manager GLG Partners LP and Philippe Jabre, a former Managing Director of GLG, were fined £750,000 each for market abuse and breaching FSA principles.

In February 2003, Mr. Jabre was given confidential information by Goldman Sachs relating to the pre-marketing of a new issue of convertible preference shares in Sumitomo Mitsui Financial Group (SMFG).

Mr. Jabre agreed to be restricted from dealing in SMFG securities until the issue was announced, but breached this restriction by short selling around $16 million of SMFG ordinary shares between 12 and 14 February 2003. When the new issue was announced on 17 February 2003, Mr. Jabre made a substantial profit for the GLG Market Neutral Fund.

Mr. Jabre referred the FSA's decision to the FSMT, which was first called upon to rule on two preliminary issues. On one of these issues, the FSMT ruled that it was possible for the FSMT to impose a different or greater sanction than that imposed by the Regulatory Decisions Committee (RDC)

On the second issue, the FSMT concluded that although the trades in question took place on the Tokyo Exchange (not a "prescribed market" for the purposes of s.118 of the Financial Services and Markets Act[2]) in February 2003, the shares were also traded on the OINT segment of the London Stock Exchange (which was a "prescribed market"). Therefore, the trading fell within the market abuse regime.

Following the determination of these two issues in favour of the FSA, Mr. Jabre withdrew his reference of the case to the FSMT.

JAMES PARKER

In October, the FSMT upheld the FSA's finding of market abuse by James Parker, but reduced the penalty imposed by the FSA from £300,000 to £250,000. Mr. Parker was a chartered accountant employed by Pace Micro Technology plc as its credit risk and treasury manager. The FSA alleged that he sold holdings of Pace shares in his and his wife's names and adjusted spread bets he had previously placed.

Additionally, they alleged that Mr. Parker placed new spread bets between the time he learned on 27 February 2002 that a possible takeover of Pace by a much larger competitor had been abandoned and that Pace, for other reasons, was very likely to issue a profit warning within the next few days, and the publication of that warning early on the morning of 5 March 2002.

Furthermore, the FSA also alleged that the information was not generally available, that Mr. Parker had relied on it, and that he did so in order to reduce or eliminate losses he would otherwise have suffered.

The FSMT found that the information referred to above amounted to Relevant Information Not Generally Available (RINGA) and that Mr. Parker's behaviour was based on that RINGA. The FSMT therefore found that Mr. Parker had engaged in market abuse.

The FSA's fine of £300,000 had been calculated by taking into account the amount of Mr. Parker's abusive profit and adding a penal element. However, the FSMT found that the FSA had overestimated the abusive profit element and therefore reduced the overall amount of the fine to £250,000.

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SEAN PIGNATELLI

In November, Sean Pignatelli was fined £20,000 for failing to exercise due skill, care and diligence, and to observe proper standards of market conduct in breach of Principles 2 and 3 of the FSA's Statements of Principle for Approved Persons.

Mr. Pignatelli, an equities salesman in London, received an email relating to Boston Scientific Corporation, which was worded in such a way as to appear that it might have contained inside information about the company's prospects.

The email was described as a "…quick heads up before tomorrow's analysts meeting," and the sender said "… don't want to get in trouble … keep btwn us for now."

Mr. Pignatelli then called a number of clients and passed on the information contained in the email. During the calls, he used language that implied that he thought the email contained inside information. However, the information contained in the email was in fact widely known and was not actually inside information.

Nevertheless, Mr. Pignatelli's employer decided to bring the case to the attention of the FSA who subsequently brought disciplinary proceedings against him.

Although the FSA did not allege that Mr. Pignatelli's behaviour fell within any of the seven categories of behaviour set out in the Code of Market Conduct that amount to market abuse, he was nevertheless found to be in breach of Principle 3 by failing both to exercise due skill, care and diligence, and to observe proper standards of market conduct when carrying out his function as an approved person.

The FSA based its decision upon the fact that despite the warning signals in the email he received, Mr. Pignatelli did not consider whether the email might have contained inside information and, as a result, he did not discuss the email with his senior manager or compliance officer. Further, the way in which he passed on the information gave the impression, albeit unintentionally, that he was passing on inside information.

"Whenever salesmen receive material which appears to contain inside information, they should stop and think before passing it on," said Sally Dewar, Director of Markets at the FSA.

The FSA explained that although in many cases a breach of Principle 3 also implies a non-compliance with the Code, it is not necessarily so. Principle 3 may be breached even though the individual has not failed to comply with the Code.

Mr. Pignatelli agreed to a £20,000 fine in a settlement with the FSA, the latter taking into account the fact that Mr. Pignatelli did not think that the e-mail message contained inside information and that he had cooperated with the Authority.

WHAT DO WE LEARN FROM THE 2006 CASES?

Notwithstanding the FSA's comments in 2005 about the focus on institutional market abuse, it should be noted from the above cases that there have only been five reported decisions during 2006 - all of them relating to individuals and only one involving an institution.

Nevertheless, it is fair to say that there will always be a time-lag between the alleged commission of the offence and the final decision.

Therefore, a better test of the success of the FSA's efforts to counter perceived institutional market abuse may not emerge until the end of 2007 or even later.

It is worth noting that although the FSA believes that "some hedge funds may be testing the boundaries of acceptable practice," only one of the five decisions involved a hedge fund. Additionally, of the five cases that were decided in 2006, the FSA lost two of them - perhaps an indication of the difficulty in obtaining the evidence to mount a successful prosecution.

The Davidson/Tatham case, which resulted in a finding by the FSMT that the Authority had acted unreasonably, led to a substantial costs order against it. This may cause the FSA to be more cautious in the future as to its decision on whether or not to commence proceedings.

The most recent case against Sean Pignatelli makes clear that, even if conduct does not amount to market abuse within the relevant terms of the Code, it may nevertheless still amount to a breach of the FSA's Statements of Principle for Approved Persons.

According to Margaret Cole, the FSA's Director of Enforcement, this was "the first reported case of 'outsider dealing' and had a big market impact, emphasizing the care and attention that Approved Persons must give to the information they disseminate to the market."

THE FUTURE

In its December 2006 Market Watch, the FSA reported that from 1 July 2005 to 31 October 2006, it had received 266 Suspicious Transaction Reports (STRs): 255 were related to insider dealing, eight to distortion

or manipulation, two to false and misleading statements, and one to the scope of the Code.

The FSA has not provided any information as to how many of these STRs are still being investigated and it is not possible to say at this stage how many will result in enforcement action. Nevertheless, tackling market misconduct remains a high priority for the FSA in the coming year, a point emphasized by Margaret Cole, speaking in London on 24 January 2007:

"This year, as last year, tackling market misconduct is a key priority for our Wholesale Business Unit and thus for the Enforcement Division in our role supporting the business units. We will continue to investigate and, where we can gather the requisite evidence, prosecute cases of market misconduct. We will use all the options at our disposal in an Enforcement context, administrative proceedings under section 118 of FSMA, criminal prosecutions under the Criminal Justice Act and the use of our Principles, specifically Principle 5.

"We are looking for heightened co-operation from firms and we encourage a broad view in identifying matters of concern not just through the suspicious transaction reporting process. Where firms identify market abuse through their closeness to a particular market (and not a suspicious transaction) we would still encourage reporting to us. I believe that market participants will benefit in their relationships with the regulator by accepting that they have an important role to play here."

From these statements, it is evident that the FSA recognises the difficulty in effectively identifying, investigating and prosecuting cases of suspected market abuse on its own - hence its call to the market.

In a connected development, it was announced in December 2006 that the FSA had signed a letter of intent for a new software system designed "to analyse trading in a diverse range of financial instruments and provide the FSA with intelligence on unusual and potentially unlawful activity such as market abuse and insider trading."

Although the FSA is at pains to point out that it does not believe market abuse is widespread, it is clear from a number of recent public announcements that it will continue to focus on this area.

It remains to be seen how successful it will be; much may depend upon the cooperation of the market.

[1] The Market Abuse page of the FSA's website also refers to the disciplinary proceedings against Deutsche Bank / David Maslen. As these relate to market misconduct and breaches of the Principles rather than to market abuse itself, we have not included them in the above number.

[2] The wording of s. 118 of the Act has since been amended to reflect the implementation of the Market Abuse Directive, so this point is no longer an issue.

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