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FINANCIAL INDUSTRY ALERT

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The Greenlight lesson: potential pitfalls when wall-crossing investors - a UK and US perspective

The U.K. Financial Services Authority (FSA) has recently issued a number of widely publicised notices that provide helpful signals as to how the FSA approaches the enforcement of insider dealing and market abuse violations.

On 25 January 2012, Greenlight Capital and David Einhorn were fined £7.2 million for engaging in the market abuse offence of insider dealing under section 118 of The Financial Services and Markets Act 2000 (FSMA) in relation to an equity issuance by Punch Taverns. The FSA concluded that David Einhorn's failure to identify information which he had received during a telephone call with the Punch Taverns' management and financial advisers as inside information, was a serious breach of the standard of market conduct expected from someone with his professional experience. On 15 February, the FSA fined Andrew Osborne, a former Managing Director of what was then Merrill Lynch, who was advising Punch Taverns and participated in the call, £350,000 for improper disclosure in breach of section 118(3) of FSMA by failing in his duties not to disclose inside information and to consider the risk of market abuse. The FSA also fined the trader and former compliance officer at Greenlight £130,000 for failing to question and make reasonable enquiries before effecting the Greenlight sale orders, and fined a trading desk director at JP Morgan Cazenove £65,000 for failing to identify and act on the suspicious Greenlight order.

The FSA's enforcement actions in the *Greenlight* case and the proportionately high sanctions illustrate the seriousness with which it approaches market abuse. This note sets out some of the potential pitfalls highlighted by the *Greenlight* case that market participants and their advisers will need to consider in seeking to avoid falling foul of the market abuse provisions when taking pre-soundings and in wall-crossing situations. Similarly, the considerations below highlight the inherent difficulties and risk with having so called "open" dialogues with investors of any meaningful value when a transaction is at an advanced stage.

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Pitfalls for issuers and advisers

Issuers and their advisers need carefully to consider any initial information that is to be disclosed when making an approach to bring an investor across the wall. Investors may request certain information in order to make an informed decision whether to be brought over the wall or not. However, that information may well come to be viewed by the FSA, with the benefit of hindsight, as constituting inside information.

- **Restating known information.** Repetition of information that has already been disclosed by another party to an individual is still capable of being seen as a disclosure of inside information if it is not "generally available". Market participants, and perhaps brokers in particular who may be seen as lending credence to known information, should therefore be wary of taking comfort from the fact that information may already have been divulged by another party.
- **"Precise" information.** It is not necessary for the information disclosed to include details of the structure, terms and pricing of the proposed transaction in order for it to be "precise" within the meaning "inside information"; information disclosed may be sufficiently specific if it includes the anticipated size, form, purpose, and timing of the transaction.
- **Reasonable expectation.** Certainty as to whether a transaction will go ahead is not necessary in order for the information to constitute inside information. The question is whether the information imparted, taken together in the circumstances, is sufficiently precise to indicate that an event may reasonably be expected to occur. The FSA has indicated that, given the market practice of wall-crossing investors at an advanced stage of a transaction, a wall-crossing request may itself be a strong indication that a transaction is close to launch. Moreover, the fact that a transaction is at an advanced stage of preparation coupled with a request for wall-crossing, may lead to even high-level information raising an expectation that the transaction will go ahead.
- **Seeking advice.** Prior to any approach to an investor, a corporate adviser should seek legal advice and/or guidance from the issuer's brokers as to the information which can be provided to the investor to enable the investor to decide whether to be wall-crossed. In certain circumstances a corporate adviser may not be able to reveal the identity of the issuer.
- **Pre-sounding calls to potential investors or existing holders.** Specific pre-sounding procedures should be established by corporate advisers prior to contacting potential investors or existing holders with respect to pre-sounding a transaction. Key elements of the procedures could include the following:
    - Calls should be carried out on a recorded telephone line using an approved telephone script.
    - It may be appropriate not to disclose the name of the issuer to potential investors during this initial call; interest should be sought solely on the basis of the securities being in a particular market sector.
    - Potential or existing investors should be warned that should they agree to be wall-crossed, any subsequent material non-public information (MNPI) disclosed to them must remain strictly confidential and they must not deal in the relevant securities.
    - On agreeing to be wall-crossed, and prior to the MNPI being disclosed, the potential or existing investor should confirm their understanding of the implications of the MNPI being disclosed to them.
    - Good practice may include keeping a pre-sounding investor log to be maintained for all contacts, whether or not MNPI was shared.

- **Non-disclosure agreement (NDA).** Where soundings are to be taken of an existing investor, a transaction-specific written NDA may be entered into to prevent the misuse and miscommunication of MNPI. Care will need to be taken in drafting the NDA, however, as certain information (for example, the duration of the NDA which may give a clear indication of the expected timing of the contemplated transaction) may be taken to contribute to the specificity of the information imparted.
- **Hindsight.** When considering issues relating to wall-crossing that arise in practice, issuers and their advisers need to recognise that the FSA will view events with the benefit of hindsight. In the *Greenlight* case the FSA was viewing trades which avoided losses before a 29.9% fall in the share price. The FSA may therefore take a different (and notably stricter) view of possible market abuse in wall-crossing situations than may be anticipated at the time of the event.
- **Defence.** Ignorance of the law (or regulation) is no defence! The FSA adopts a restrictive reading of "reasonableness" for the purpose of the defence to market abuse under section 123 of FSMA. Market participants are expected to address the risks of insider dealing. Therefore, **any failure to obtain advice from compliance and legal functions prior to and also after a call where inside information was imparted may deprive an individual of the section 123 defence of belief on reasonable grounds or having taken all reasonable precautions.**

Pitfalls for institutional shareholders

The UK Stewardship Code states that "Institutional investors may not wish to be made insiders. They will expect investee companies and their advisers to ensure that information that could affect their ability to deal in the shares of the company concerned is not conveyed to them without their agreement". There is a balance to be maintained between enforcing the prohibitions against insider dealing and market abuse and not impeding stewardship responsibilities which require a level of engagement and dialogue between asset managers, institutional investors and the companies in which they invest.

While it is accepted practice for an investor to make explicit at the outset of a conversation if he does not wish to receive inside information, an investor cannot thereby assume that he has received no such information. Moreover, reliance cannot be placed on being expressly alerted to any inside information or on the fact that a discussion is expressed in high level terms if, in fact, inside information was imparted. Probing for further information or indeed spontaneous comments on the significance of the information (such as an utterance by Mr. Einhorn regarding the possible equity issuance, "That would be shockingly horrifying…") are likely to undermine a subsequent contention that an investor did not consider that he had become an insider. If there is a risk that inside information was imparted **the FSA expects market participants to make an independent assessment and take steps, including obtaining compliance and legal advice, to clarify whether information imparted, in fact, constitutes inside information.**

Whether particular information is in fact "inside information" is very often a question for the brokers rather than the lawyers: if it were generally available would it be likely to have a significant effect on the share price? To what extent is the information already reflected in the share price or been taken account of by the market, in pricing the shares?

Would the position in the *Greenlight* case be different under U.S. law

The Greenlight case highlights differences between the U.K. and the U.S. regulatory regimes regarding insider dealing. The U.S. legal requirements for establishing an insider trading case under Section 10(b) and Rule 10b-5 under the U.S. Securities Exchange Act of 1934 are stricter than the general standards applied by the FSA. Broadly, in order to assert a claim for insider trading it must at a minimum be established that (i) a defendant acted with "scienter" (with an intentional or reckless mind), (ii) the trade was made on the basis of material non-public information, and (iii) the defendant breached a fiduciary duty of trust or confidentiality. On the basis of the FSA findings, it appears that a U.S. regulator could have difficulty in prevailing in a claim against Greenlight, Mr. Einhorn or Mr. Osborne based upon Section 10(b) of the Exchange Act and the rules thereunder. Specifically, the FSA found that Mr. Einhorn and Greenlight (to which Mr. Einhorn's behaviour was attributed) "did not believe that the information he had received was inside information . . . he did not intend to commit market abuse" and his behaviour was not "deliberate or reckless". Similarly, the FSA also found that Mr. Osborne's actions were not "deliberate or reckless".

We note, however, that U.S. regulators could take a different view of the evidence – particularly as to the state of mind of Mr. Einhorn or Mr. Osborne – and find that they were reckless and not merely negligent and, similarly, that they knew or should have determined that the information provided was MNPI. U.S. investors should be aware that the FSA does not have the burden of proving that individuals acted with scienter. It is sufficient that individuals did not believe on reasonable grounds that the information provided was inside information.

The lesson for market participants

The FSA has, with its enforcement actions against Greenlight, Mr. Einhorn and Mr. Osborne, indicated that market abuse in general, and wall-crossing more specifically, is likely to be subject to increasing regulatory attention. Asset managers, brokerage houses, hedge funds, corporate finance advisers and other market participants may therefore wish to revisit their internal policies and procedures on dealing with market abuse. Market participants that operate in both the U.K. and the U.S. must be mindful that these jurisdictions may apply different standards for determining when a regulatory breach has occurred and must tailor their compliance policies and procedures to take this into account.

In particular, market participants will want to ensure that their staff have a thorough understanding of the legal framework on market abuse which they operate and the obligation to identify any suspicious transactions to the FSA. Ultimately, no internal procedures and protocols will help if an individual fails to identify inside information or a suspicious transaction and therefore does not take the appropriate action expected of him. The FSA is likely to take a tough stance on any failures to meet such expectations in the pursuit of its agenda of credible deterrence.