CLARE SIBSON

THE PLAYERS MAY CHANGE BUT THE GAME STAYS THE SAME

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CLOTH FAIR CHAMBERS

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RECENT DEVELOPMENTS IN THE PROSECUTION OF INSIDER DEALING
AND THE FUTURE OF THE PROPOSED FINANCIAL CONDUCT AUTHORITY

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INTRODUCTION

For five years or more, the Financial Services Authority has spoken about its crackdown on insider dealing. In the last two years, the public has begun to see results. The first insider dealing case to be prosecuted by the FSA resulted in the conviction of two individuals in March 2009. Since then, a total of ten people have been convicted of similar offences. At least twelve further cases are pending or underway. Such a high rate of prosecution for this offence is unprecedented in the 30 year period during which insider dealing has been a crime in the UK and represents a striking record for a prosecuting authority which is barely ten years old. Despite this, the FSA's future as a public prosecutor is uncertain. The government intends vesting its enforcement powers in another new body, the Financial Conduct Authority (FCA) in 2012.[1]

Whilst the government consults on its proposed changes, there is no sign of the FSA easing off its assault on insider dealing. Reports are that it has plans for "complex event processing" technology, which would automatically alert its staff to market anomalies and dramatically increase the chances of detecting insider dealing amongst the six to eight million transaction reports it receives each day. And in future, new rules for authorised firms will increase the amount of evidence available to investigators once suspected market abuse has been detected: from November 2011, in addition to existing obligations to record landline calls to and from its trading desks, firms will for the first time be obliged to record business calls placed by staff on mobile devices.[2]

For all that, the task of reducing the occurrence of insider dealing will not get any easier for the FSA or its successor. Even more rapid than the rate at which successive incarnations of the regulator appear is the pace of change within the industry. As the different forms of financial instrument become more numerous and more complicated, the number and complexity of potential abuses only increase. Each new financial product has the potential to create an opportunity for misuse which was not contemplated even 20 years ago, when current criminal legislation intended to prevent City insiders from profiting from confidential information was drafted.

A recent development in the USA perfectly demonstrates the difficulty for all regulators. According to the *Financial Times*, the Securities and Exchange Commission is currently investigating the possibility that some individuals on Wall Street have been using exchange-traded funds (ETFs) to mask insider trading activity. This new and – it must be said – ingenious manifestation of market abuse is not only difficult to detect; it is also right at the edge of the forms of abuse which are amenable to criminal prosecution under existing insider trading laws, on this side of the Atlantic at least. Its existence illustrates the importance of the flexibility handed to the FSA by the Supreme Court in the case of **Rollins** last year – a flexibility which must be replicated in any new prosecuting authority if it is to consolidate the progress of the last decade.

INSIDER DEALING – THE CRIMINAL LAW

In the UK, insider dealing is currently penalised by two separate pieces of legislation: one criminal, one regulatory. It is proscribed as a criminal offence by the Criminal Justice Act 1993 (the CJA). New forms of illicit inside activity may fall outside the scope of this statute, despite its relatively recent enactment.

History

Although common law and statutory offences of market abuse have a long history in this jurisdiction, insider dealing did not become the subject of specific statutory provisions until the 1980s. A 1977 White Paper, *The Conduct of Company Directors*, addressed the need for new laws to ban individuals from trading in securities with the benefit of non-public information which affected the value of the stock and gave insiders an unfair advantage over the rest of the market. Since then, successive pieces of legislation have sought to address "the mischief of . . . dealing in securities while in possession of . . . confidential information."[3]

"Inside information" has now become a term of art referring to confidential information about a company or group of companies which would be likely to have a significant effect on the price of any securities if it were made public and which a person has from an inside source. A person has information from an inside source if he has it, and knows that he has it: (a) by reason of his position as a director, employee or shareholder of a company; (b) by reason of some other employment or profession (eg an independent lawyer or accountant advising a company); or (c) from an ultimate source which falls into either of the first two categories, regardless how remote that source is.[4]

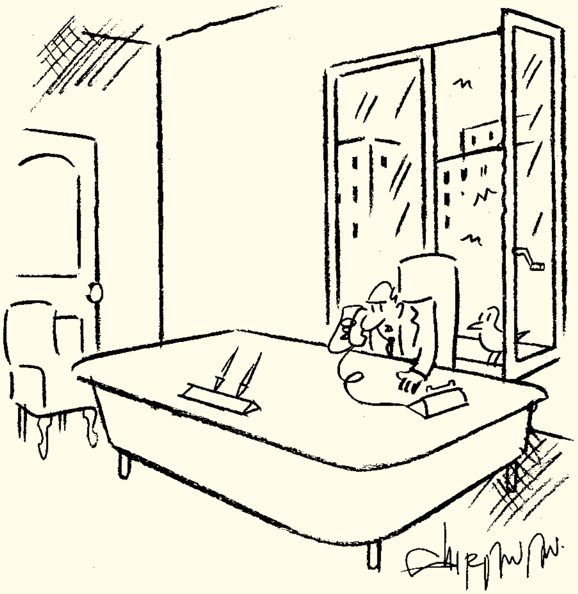
CJA 1993

Today, the criminal offence is defined by Part V of the CJA. The main provision is s52, which proscribes three forms of "insider dealing" (although only one form involves dealing of any kind). An individual who has information from an inside source may not:

(i) deal in the relevant security (either himself or via the agency of a third party);[5]

(ii) tip the relevant security, or in any other way encourage another person to deal in the relevant security (whether or not the other person knows the tip is based on inside information and whether or not the tip/encouragement actually results in a trade);

(iii) disclose the inside information otherwise than in the proper performance of the function of his employment or profession.



How can it be insider trading if a little bird told me?

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Long arm of the law

In one respect, these provisions have a very long reach. If an individual who receives confidential information about a company knows that its ultimate source (however remote) is an insider, that individual becomes subject to each one of the three prohibitions set out above.

Imagine, for example, that a City trader is a member of a tennis club. One morning before a game, she is told by her mixed doubles partner that he has just overheard some interesting talk in the men's locker room: someone in the locker room had dinner with an old friend last night; that old friend is an accountant advising Company A. According to the accountant, Company A will very soon announce results which will beat market expectations by a significant margin.

Although the City trader is, in this instance, removed by some distance from the source of the inside information, although she has no professional involvement, no relationship of trust or confidence with Company A and although she has done nothing wrong by receiving the unsolicited information from her partner, she now has "information as an insider" for the purposes of s52. Not only is she prohibited from dealing in Company A's shares; she is also prohibited from encouraging anyone else to trade in the shares and from passing on the information she has received. Her doubles partner (together with the man in the locker room and the accountant) is already potentially liable for the offence of disclosing inside information. She too will be in jeopardy if she spreads the information any further.[6] The offence is punishable on indictment by seven years' imprisonment and/or an unlimited fine.

The limits of the criminal law

The CJA is therefore very wide in terms of those it deems to be "inside" in relation to confidential information about securities. But it is questionable whether the three forms of activity specifically prohibited by s52 are sufficiently flexible to cover some of the most innovative forms of activity designed to profit from inside information. It is doubtful whether the possible misuse of exchange-traded funds currently under investigation in America would constitute a criminal offence under s52 in the UK.

EXCHANGE-TRADED FUNDS

An ETF is like an ordinary investment fund, only easier for the investor to trade. It resembles a unit trust in the way that it is valued but a listed stock in the way that it is bought and sold. Like most investment funds marketed to consumers, it is an open-ended vehicle: the provider can create and eliminate shares at any time in direct response to a new investor wishing to join or an existing investor wishing to leave the scheme. This allows the price of each unit to mirror the fund's underlying net asset value (NAV) – the total value of all the different assets held by the fund on behalf of its investors – without being affected by demand for stakes in the fund itself. The difference with an ETF is that, like a listed stock but unlike more conventional investment funds, units in an ETF are available on the stock market.[7]

ETFs have two further, defining characteristics: passive management and low expense ratios. Active management is unnecessary because the makeup of the fund is automatically determined by the makeup of a defined group of assets; the manager has no discretion to select which stocks to place in the fund's portfolio. A "FTSE 100 ETF" is comprised of stocks in the 100 largest UK companies and seeks to replicate the performance of the FTSE 100 index. Fees charged for investing in the fund are sometimes as low as 0.1%, rarely over 1% and usually significantly lower than equivalent, index-tracking mutual funds.

ETFs have been a feature of financial investment for over a decade. Available on a large scale from about 2000, their popularity has grown significantly in the last ten years. The number and type of assets which can be held via ETFs[8] have multiplied to include bonds, commodities, currencies and specialist sectors: there is an ETF designed to track the performance of "global timber and forestry". ETF-type products have also became more complex,[9] allowing the purchaser to adopt short and leveraged positions: some American ETFs, for example, seek to "double short" the euro, aiming to generate two points of profit for every one point the euro falls against various other currencies. ETFs have become an easy and flexible way for investors to gain exposure to a wide variety of assets at low cost.

Abuse of ETFs

The critical challenge for someone wanting to profit from insider dealing is to reduce the chance of detection by removing himself physically from his own trade. In most instances of insider dealing which result in enforcement action, the insider attempts to achieve this by splitting the position he wants to take into a series of smaller trades and spreading them out amongst different people who agree to effect the transaction, ostensibly in their own name, in reality on his behalf. This leaves the insider with a dilemma: to be confident that his accomplices will not run off with his share of the profit or report him to the authorities, he must only involve people he trusts; but the people he trusts are likely to be people who are close to him (often members of his own family). The closer the insider is to each of his nominees, the more likely their connection is to be discovered in the event that the stock comes under scrutiny from the regulator.

Once you start to think about it, there are many ways in which ETFs might be used to solve this problem. One scenario currently under investigation in the USA – dubbed "ETF-stripping" – would involve a person with inside information about Company A buying a position in an ETF which includes that company's stock. Buying the ETF indirectly exposes the trader to Company A's share price. Of course, it also exposes him to every other stock held by the ETF; there is an obvious risk that, as Company A's stock rises, other stocks within the fund will coincidentally fall, diluting the trader's profit or even turning it into a loss. The trader cunningly eliminates this risk in a series of subsequent trades in which he individually short sells each of the stocks, other than Company A, which together comprise the ETF. Any movement in the other stocks will be cancelled out by the trader netting his long (or buy) position in the ETF against the profit or loss he makes on his short selling. The ultimate effect would be to extract from the ETF the performance of Company A's shares without conducting a single transaction in Company A's "hot" stock. Neither the long position in the ETF nor the short positions in all the other companies are illegal per se, but together they allow the trader – quietly and discretely – to make an illicit profit from the confidential information.

Clever. ETF-stripping is an ingenious manifestation of market abuse because, even if the trader causes a tell-tale movement in the stock (a spike in Company A's share price ahead of a significant public announcement, for example) his involvement will be far from obvious. By dealing in the ETF he has achieved maximum possible distance from the stock in which he has an interest: he hasn't traded the price-affected security at all.

Neither will he need to run the risk of drawing attention to himself by disclosing his short positions via an RIS.[10] There is an obligation to disclose net short positions which equal or exceed 0.25% of the issued capital of a company. Guidance contained in the FSA's *Financial Stability and Market Confidence Sourcebook* (FINMAR) states that indirect exposure to a particular stock – which specifically includes exposure via an ETF – should be included when determining whether a party has a disclosable short position.[11] Since the ETF-stripper carefully sizes his short position in each individual stock perfectly to off-set his indirect, long position in the same company held via the ETF, his net position in relation to each of the shorted companies will be neutral: he will not have to make disclosure.

Is ETF-Stripping criminal insider dealing?

Criminal prosecution obviously plays an important part in overall policing of the markets, especially in upholding public confidence in the enforcement of the law. The FSA is clearly of this view. In the last two years, it has shown itself increasingly willing to bring criminal charges in these cases. Following the collapse of the former DTI's prosecution of **Carlisle** in 2009, the FSA has over the last two years pursued a series of insider dealing cases in the Crown Court with much greater success. In that period, convictions against more than ten individuals have been secured. Perhaps most significant was the conviction of Malcolm **Calvert** (a former market maker at Cazenove) in March 2010. To secure its case against him the FSA called a witness named Bertie Hatcher, who had also been involved in the illicit trading. In an arrangement resembling US-style plea bargains, and a little like OFT-type leniency deals, Hatcher was not criminally prosecuted. The FSA used its regulatory powers to fine Hatcher £56,098 instead. It had special regard to the valuable assistance which Hatcher had provided – and his ongoing commitment to attend court to give evidence against Calvert – when agreeing to enter into this settlement.[12]

But there are limits to how far s52 of the CJA can be stretched to fit new manifestations of the crime. In **Calvert**, and in each of the other insider dealing cases pursued by the FSA in the Crown Court, the mechanics of the relevant trading were relatively straightforward. It is questionable whether a criminal case brought under the CJA 1993 would succeed against more innovative forms of insider dealing, no matter how strong the evidence. ETF-stripping is a good illustration.

ETF-stripping is clever not only because it is difficult to detect, but also because it lies at the very edge of the statutory definition of insider dealing. The technical problem for the prosecution would be that the offender had price-sensitive information about Company A, but only dealt in the securities of the ETF and of Companies B, C, D etc. S52 of the CJA does not bite unless a trade takes place in a stock which is itself price-affected by the inside information.

In some circumstances, the price of shares in the ETF might be sensitive to the confidential information which the trader has about Company A. If that is so, the activity would amount to criminal insider dealing. But this would only be the case where shares in Company A constituted a sufficiently large proportion of the ETF. When BP's share price took a tumble last year, the entire FTSE was affected. Further down the weighted list of companies in any index are stocks the price of which may fluctuate quite dramatically without significant effect on the index or the value of ETFs which track it. A prosecutor may not wish to leave to a jury (or to a judge at half time) the issue of the "price-affected" status of the ETF if Company A comprises only a small proportion of the relevant fund.

Other criminal offences under FSMA

The only other criminal provision conventionally thought to be available to the FSA in cases of market abuse was s397 of the Financial Services and Markets Act 2000 (FSMA). This section prohibits the manipulation of stock prices by means of misleading statements or practices. The classic case is where a company director misstates the company's results in order to defend the company's share price. Liability may also arise where connected parties perform a series of trades between themselves in order artificially to increase the value of a stock.

The FSA might consider whether ETF-stripping is a form of market-rigging under s397(3) (misleading practices). It would almost certainly conclude that it is not. The subsection applies to conduct which "creates a false or misleading impression as to the market in or the price or value of any relevant investments". ETF-stripping involves buying a stock (the ETF) in which the trader has no genuine interest and selling other stocks (Companies B, C, D etc) which he has no legitimate motive to short. Viewed in isolation, each of these positions might create a misleading impression about demand for the relevant investment but an allegation to that effect would be difficult to sustain because, viewed together, the trader's long and short positions cancel each other out: overall, the transactions should be neutral as regards all stocks apart from Company A. As for Company A, market perception of the demand for or value of its shares may well change, but since the trader's interest in that stock is real (albeit founded on inside information) that impression is not false.

In addition, s397(3) carries an absolute pig of a mental element for the prosecutor to prove. The provision only applies where the market abuser acts for the purpose of creating the false impression and of thereby inducing another person to do (or refrain from doing) something in relation to the relevant stock. "Purpose" is a very high form of mens rea, higher than intention and arguably synonymous with motive. According to the criminal law, an actor can "intend" to bring about a particular consequence without actually giving two hoots whether it occurs or not, provided he realises that his proposed course of action is virtually certain to have that effect. Purpose is something more: it is not merely an inevitable consequence of one's actions but a reason for which one acts.

The unusual mens rea proscribed by s397(3) may be unproblematic in a case against a company director alleged to have deliberately given the market a false impression about the performance of his own company: it is not difficult to infer that he acted with the purpose of inducing people to buy, or existing investors not to sell, shares in the company. But in cases of market-rigging by traders it is often possible to argue that, although the trader must have realised that the probable effect of his actions would be to induce some people to trade who would not otherwise have done so (or vice versa), in truth he was ambivalent about that consequence; he did not care whether any other party was induced to change from a buy to a hold position, or from a sell to a buy, provided the particular trades he conducted brought the price of the shares where he wanted it. He did not act for the highly specific purpose contained within the subsection. This technicality has acted as a barrier to criminal charges against traders in market-rigging investigations in the past, will do in future and would certainly complicate an FSA case against an ETF-stripper under this section.

Without a doubt, ETF-stripping (like all forms of market abuse by traders) would still be punishable by the FSA www.cartoonstock.com

Clever defense, but I can't buy calling insider trading an 'alternative lifestyle'.

using its regulatory powers. There is something unsatisfactory, however, about the FSA's being able to bring criminal charges against the City trader who illegitimately acts upon something a little bird said at the tennis club, but not against the trader – potentially in a much greater position of confidence in relation to Company A – who strips an ETF illicitly to profit from the same information.

Where the public interest is in favour of criminal prosecution, a recent development allows the FSA to consider bringing other criminal charges, outside the small number of offences which were previously thought to comprise the limit of its domain as a prosecuting authority.

ROLLINS

In January 2011, Neil Rollins, a former manager of a company within the waste industry, was sentenced to 27 months' imprisonment following his conviction by a jury of insider dealing and money laundering. The case was a landmark for the FSA – not because it represented another successful prosecution of an offence against the markets – but because the FSA had for the first time brought additional charges under Part 7 of the Proceeds of Crime Act 2002 (POCA).

Ss 401 and 402 FSMA

Previously, ss 401 and 402 of FSMA were thought to form a barrier to the FSA's bringing any criminal charges outside those specifically assigned to it by that Act.

S401 has the effect of limiting private prosecutions under FSMA. It restricts the persons entitled to bring proceedings for any offence under the Act (including market-rigging under s397) to the FSA, the Secretary of State and the Director of Public Prosecutions or anybody acting with his consent. S402, which is headed *Power of the Authority to institute proceedings for certain other offences*, provides that the FSA "may institute proceedings" for a small number of other offences: insider dealing under Part V of the CJA 1993; breach of certain money laundering regulations; offences under schedule 7 of the Counter-Terrorism Act 2008 (terrorist financing and related money laundering).

In **Rollins** the FSA brought charges of concealing the proceeds of crime and facilitating the acquisition or retention of criminal property by another, contrary to Part 7 of POCA (ss327 and 328). Money laundering offences under Part 7 of POCA do not appear on the list of other offences which the FSA may prosecute under s402 of FSMA.

At a preparatory hearing before the Crown Court, Rollins challenged the FSA's power to bring its money laundering case against him. The issue was the subject of interlocutory appeals to the Court of Appeal and the Supreme Court.

Enhanced mandate to prosecute crime

In **R v Rollins** [2010] 1 WLR 1922, the Supreme Court upheld the FSA's entitlement to bring proceedings for any criminal offence consistent with its statutory objective to reduce financial crime. It ruled that the purpose of s402 of FSMA was not to restrict the offences in respect of which the FSA could bring a case but rather to allow the Treasury (under subsection (2)) to impose conditions on the prosecution of the offences listed in that section.

The ramifications of this decision are important. The way is now clear for the FSA (and, no doubt, its successor) to prosecute market abusers not only for their principal offences, but also for the additional criminality involved in hiding the proceeds of their crimes from the authorities. This substantially increases the threat posed to a suspect by an FSA prosecution: at 14 years, the maximum term of imprisonment for money laundering is double that for insider dealing. And the potential applications of **Rollins** are much more useful to the FSA than just that.

ETF-stripping is criminal fraud

As new forms of market abuse emerge, if s52 of the CJA and s397 of FSMA provide poor fit, the FSA can now look to other pieces of legislation for their charges.

In the case of ETF-stripping, for example, the FSA might consider whether the trader has committed fraud by abuse of position, contrary to s4 of the Fraud Act 2006. The trader may well be in a position of trust in relation to the company about which he has the inside information. Even if he is not, he is highly likely (in the terms of the Fraud Act) to be "expected to safeguard, or not to act against the financial interests" of the authorised firm which employs him. If he has come by the relevant information via his employment, or if he uses his employment to conduct the illegitimate trades, then he will almost certainly have abused his position of trust at the firm within the meaning of the Fraud Act. The Supreme Court's decision in **Rollins** means that the FSA would be able to consider bringing a charge of fraud in such a case.

Where the underlying crime is hidden

Rollins also hands the FSA a new weapon against organised criminal activity which is so well hidden that no amount of investigation can uncover it with sufficient clarity to found a criminal or, for that matter, regulatory case of market abuse.

It is not difficult to imagine a scenario in which the FSA has reliable intelligence that ETF-stripping or some other illicit inside activity is taking place, but cannot prove its suspicions to the requisite standard. This could occur where its intelligence takes the form of inadmissible evidence (eg telephone tapping), where the intelligence is too sensitive to be made public or where the criminals concerned have hidden their tracks so well that – while it is clear that they are up to something highly nefarious – the details of their scheme are elusive.

In light of **Rollins**, the FSA now enjoys the same advantage that Part 7 of POCA has long afforded all other prosecuting authorities. In the situation just described, the FSA would have the option of turning its attention away from the underlying market abuse and towards the secondary crime of money laundering. As long as the FSA could prove that the trading activity must have involved some kind of criminal offence (be it insider dealing, market-rigging, abuse of trust fraud or tax evasion) then it has the power to prosecute those involved for receiving, possessing, using or helping others to retain any of the profits generated by the scheme. It would also enjoy the benefit of the low mens rea necessary to prove most cases of money laundering: mere suspicion.

Whether the Enforcement Division of the FSA survives under its current name or becomes part of a new FCA as the government proposes, the hope of key players inside it must be that the important advance which **Rollins** represents is preserved in any change. Even where an authority is responsible for prosecuting a very narrow band of wrong doing, it fights with one hand behind its back if it does not have freedom to bring charges across the whole spectrum of criminal legislation.

INSIDER DEALING – REGULATORY OFFENCES

If an ingenious trader managed to design a way of abusing ETFs which did not amount to any form of criminal fraud, the FSA would still be able to penalise the individual for market abuse without recourse to the courts. In addition to the criminal provisions of the CJA 1993 and s397 of FSMA, s 123 of FSMA empowers the Authority to impose fines on persons who engage in market abuse, regardless whether they work within the financial services industry which it regulates. It is highly unlikely that an ETF-stripper, once detected, could escape the reach of s 123, however clever his offence. Under the new proposals for regulation of the financial services industry, the FCA will inherit responsibility for this disciplinary power: the government does not intend to make any substantive changes.

S 118 FSMA

The various different types of regulatory market abuse, including insider dealing, are defined by s 118 of FSMA. As with the equivalent criminal provisions, s 118 proscribes three different forms of insider dealing. They do not, however, exactly mirror the three versions of the offence set out in s52 of the CJA. In combination, the three forms of regulatory insider dealing are broader then their criminal counterparts.

S 118 defines insider dealing market abuse as behaviour where an insider:

- (i) deals, or attempts to deal, in a qualifying investment or related investment on the basis of inside information relating to the investment in question. This roughly corresponds to the first form of criminal insider dealing.
- (ii) discloses inside information to another person otherwise than in the proper course of the exercise of his employment, profession or duties. This roughly corresponds to the third form of criminal insider dealing.

There is then (in s 118(4)) a very general form of regulatory insider dealing defined as conduct other than that falling in (i) or (ii) immediately above which is:

- (a) based upon non-public, price sensitive information and
- (b) likely to be regarded by a regular user of the market as a failure on the part of the person concerned to

observe the standard of behaviour reasonably expected of a person in his position in relation to the market.

ETF-stripping is s 118(4) market abuse

This general provision is obviously capable of covering the remaining form of insider dealing defined by the CJA 1993 (encouraging another person to deal on the basis of inside information). But it is also wider than any definition of the criminal offence. This may be significant if ETF-stripping ever comes under scrutiny in the UK.

As discussed, the prospect of prosecuting ETF-stripping as criminal insider dealing is complicated by the fact that the trader does not deal in the security which is price-affected by the inside information. This would not present the same problem in a regulatory case under s 118(4) of FSMA. The FSA would only need to satisfy itself that the trader's conduct was based on inside information (which it was) and fell short of the standards of the regular market user (which it surely would). Each constituent trade in the series of transactions that together allowed the trader to profit from his unfair advantage would amount to an act of market abuse in relation to which the FSA would have jurisdiction to impose a fine.

The FSA is currently pursuing a policy of prosecuting serious cases of insider dealing in the Crown Courts and one can see why: the public interest is obvious. But regulatory enforcement action is not always the softer alternative. In many situations, regardless of the strength of the evidence against him, the suspected ETF-stripper might prefer the prospect of a criminal prosecution because the sentence he would face upon conviction would be more lenient than the penalty he would be likely to face from the Regulatory Decisions Committee (RDC) of the FSA.

PUNISHMENT FOR INSIDER DEALING

One year ago, the FSA published a new penalties policy which set very high financial tariffs for serious cases of market abuse, including insider dealing. In relation to non-market abuse cases the policy allows for maximum fines: up to 20% of a firm's revenue or 40% of an individual's salary and benefits over the relevant period. In relation to serious market abuse cases there is no maximum penalty. Instead, for individual offenders there is a minimum starting point of a £100,000 fine.

The policy formally applies to all misconduct committed on or after 6 March 2010. It can take years for serious cases to be brought through the various stages of investigation to a final decision; as yet there are no published decisions relating to market abuse committed after the new policy came into force. But the sense amongst practitioners is that the tone of the policy has already had a discernable effect upon levels of financial penalty. It would be unrealistic for someone facing regulatory enforcement action for ETF-stripping to expect anything less than a starting point of a £100,000 fine, regardless when the conduct occurred. Recent penalties have been significantly above that level. In April last year the FSA published its decision to fine Sameer Patel £180,541 for insider dealing activity which occurred in 2004. On 21 February 2011, David Massey was fined £150,000 for insider dealing which took place in 2007. In ongoing proceedings against high net worth individuals for alleged market abuse between 2007 and 2008, the FSA proposes fines many times larger than that. It is not difficult to imagine a City trader accused of using ETFs to mask insider dealing activity who would – were he given the luxury of choice – prefer to appear in the Crown Court than face this sort of fine.

Fines v imprisonment

An ETF-stripper convicted of the criminal offence of insider dealing could expect to receive a prison sentence of several years.[13] He would also face confiscation proceedings to recover the "benefit" of his offending (ie the total turnover of all the money and other property which he personally obtained as a result of his offence).[14] If the value of his benefit was larger than his current net worth, confiscation proceedings would wipe him out financially. In which case, he would almost certainly be better off in a regulatory process: in either process, all his material wealth would be at risk but before the RDC he would at least avoid incarceration.

However, in cases where a suspect's alleged benefit is small (for example where he was the trader who conducted the ETF-stripping on behalf of a client, personally obtaining nothing more than commission from the transaction) or where the benefit figure represents only a small proportion of his net worth, the threat of confiscation will not be a major concern. Focus will be on sentence for the offence itself. In theory, the Crown Court would have power to punish him by way of fine as well as imprisonment but judges are usually reluctant to add a fine to a substantial prison sentence. In these circumstances, a trader accused of ETF-stripping might ask himself which would be worse: to receive, like Malcolm Calvert, 21 months' imprisonment for insider dealing (only one quarter of which is likely to be spent in prison, thanks to current early release provisions); or to face regulatory action which could result in a personal fine of £1 million or more?

Fines exceeding an individual's means

The suspect's preference may be affected by this consideration: in at least one case of market abuse to date, the RDC has decided to impose a financial penalty which greatly exceeds the relevant individual's proven means, even though his personal benefit from the offence was negligible. At the same time (as is almost inevitable in cases of serious market abuse) the individual was prohibited from returning to work in the industry. The prospect of his ever clearing the enormous civil debt[15] with which this decision saddles him is therefore remote. The FSA's stated reason for imposing a penalty of this order was to preserve the deterrent effect of its decision upon others.

The RDC considered itself entitled to take this step because the FSA's *Decision Procedure and Penalties Manual* (DEPP) does not oblige it to reduce its fine to a level proportionate to the individual's means. Section 6.5D of DEPP requires the Committee to consider reducing the financial penalty in cases of "serious financial hardship" (defined as a situation in which the individual's capital will fall below £16,000[16]) but this reduction is not mandatory.

It is worth noting that – outside the confines of confiscation laws designed to recover the proceeds of crime – sentences imposed by the Crown Court never operate to ruin an individual financially. The proceeds of an individual's offending will be ruthlessly disgorged in confiscation proceedings but, where these provisions do not apply, there is no precedent for imposing a fine anywhere near the level at which an individual would lose all his material wealth. Fines which can be met from surplus capital, or out of disposable income within one to two years, are about the upper limit in the criminal courts. It is certainly unprecedented to fine a person more than he can ever hope to pay. Of course, a judge has the ability to impose other forms of punishment, including imprisonment, but this fact does not explain why fines in the Crown Court stop where they do. It is difficult to escape the conclusion that principles of sentencing in the criminal courts operate more mercifully than the FSA's penalties policy. Fines which eat up all of an individual's assets – down to his last £16,000 and beyond – have the ability adversely to affect his life, and the life of his family, for far longer than a prison sentence of several years. The FSA's new policy is at least as draconian as the criminal law of confiscation, but lacks the justification of being targeted solely at the proceeds of the relevant offending.

It is questionable whether this approach can survive. Challenge in the Upper Tribunal, and if necessary from there in the Court of Appeal, might be inevitable.[17]

Co-operating suspects

Stuck between the rock of imprisonment and possible confiscation in the Crown Court and the hard place of the FSA's withering financial penalties, a suspected ETF-stripper may wish to consider the option of cutting a deal with the FSA in return for valuable evidence against others. Even in this situation, he may be better off if the deal involves a plea of guilty in the Crown Court rather than an admission of market abuse and a regulatory settlement with the FSA. Consider the lot of Bertie Hatcher (who gave evidence against Malcolm Calvert in the FSA's insider dealing prosecution) as against the fate of Richard Gledhill, the former General Sales Manager at Mabey and Johnson Ltd, who earlier this year gave evidence for the Serious Fraud Office against two former directors of the same company.[18]

Bertie Hatcher was not criminally prosecuted for insider dealing but, as discussed, was fined £56,098 by the FSA for market abuse. This may seem as lenient an outcome as he could ever have hoped to get: £56,098 represented no more than his post tax profit from the insider dealing; there was no additional penal or deterrent element to the fine. Richard Gledhill, however, was even better off. He pleaded guilty in the Crown Court to his part in the making of illegal kickbacks to the government of Iraq during the UN's oil for food programme.[19] After giving evidence which secured the convictions of his co-accused, he received a suspended sentence of imprisonment. Provided he stays out of trouble for the next two years, Mr Gledhill will never see the inside of a prison cell. So far, so like Hatcher. But unlike Bertie Hatcher, Richard Gledhill paid no financial penalty either: he was not fined and he faced no confiscation proceedings, despite having admitted to receiving £10,000 in commission from his criminal activity. Comparison between the two cases is particularly interesting because insider dealing and the crime to which Richard Gledhill pleaded guilty are equally serious in that both carry a maximum penalty of seven years' imprisonment and/or an unlimited fine.

With these examples in mind, a suspected ETF-stripper wishing to co-operate with the FSA might be tempted to invite the Authority to charge him with a criminal offence and leave him to the mercy of a Crown Court judge rather than opt for regulatory settlement involving some level of fine. In future, it may only be the suspect's desire for certainty of outcome which tips the scales back in favour of settling the case under s123 FSMA. As long as he keeps his side of the bargain, a suspect can have confidence that a regulatory settlement is binding on the FSA. In contrast, there is no means by which the FSA (or any other prosecuting authority in the UK) can agree a deal which will later limit the discretion of the Crown Court on sentence; the judge will form his own view of the individual's culpability, the value of his assistance and the severity of the sentence appropriate to his case.[20]

CONCLUSION

The FSA has succeeded in changing the territory in which insider dealing takes place. No longer is the threat of criminal prosecution theoretical. It has transformed s52 of CJA 1993 from a chronically under-used provision – labelled as a crime too technical to prove by a string of former prosecuting authorities – into an actively charged offence, frequently resulting in conviction by jury. Today as never before, insider dealers face the possibility of prosecution and imprisonment.

It has also succeeded in changing the tone of regulatory enforcement action. Ten years ago, when the FSA had only just been recreated in its current form, much was said about the need for a series of high profile, criminal prosecutions to strike fear into City insiders. Levels of financial penalty have now hit a mark where, in certain situations, criminal prosecution may actually produce a more lenient penalty than regulatory enforcement action under s 123 of FSMA. Any insider dealer who manages to design a form of offence which falls between all possible criminal charges may come to regret that success.

A combination of **Rollins** and the high level of financial penalty routinely imposed in cases of regulatory market abuse make the FSA the most powerful and potentially the most innovative prosecuting authority in the field of financial crime. **Rollins** hands the FSA the same choice of charges enjoyed by the SFO or CPS, but the FSA's regulatory powers give it an advantage over both of those bodies, particularly when it comes to settling cases with suspects willing to provide valuable assistance against others. This advantage is shared to some extent by the Office of Fair Trading and by HMRC, but the FSA's appetite to make cases has given it the highest profile in the last few years.

It perhaps stands to reason, therefore, that the government's proposal for the future of market regulation and the prosecution of financial crime involves the consolidation of all other relevant prosecuting units into a single body (the Economic Crime Agency), whilst retaining this aspect of the FSA's function in the new Financial Conduct Authority. It remains to be seen whether the FCA will in the next decade be able to carry forward the momentum and success built up by the FSA over the last ten years. As the emergence of ETF-stripping and other new forms of financial crime make all too plain, the game will carry on while the players change.

FOOTNOTES

1 See HM Treasury, *A new approach to financial regulation: building a stronger system*, February 2011.

2 See FSA Policy Statement 10/17 *Taping of Mobile Phones* November 2010

3 **Attorney-General's Reference (No 1 of 1988)** [1989] AC 971, HL, per Lord Lowry at 735.

4 See Criminal Justice Act 1993, ss 56 and 57.

5 Off market transactions are exempted from the provisions, provided the insider does not act as or use the agency of a professional intermediary/stock broker in order to place the deal.

6 If she merely reports what she has heard to the FSA, or to a colleague whom she believes will not break the law, for example in order to seek advice about what she should do or to express surprise that the accountant should have been so indiscreet, she will be in a position to plead one of the four general defences to insider dealing provided by s53 of the CJA. It is a defence to disclosing insider information to prove that the suspect did not expect any person to deal in the relevant security on the back of the information. The Act also provides several technical defences which apply to market makers and other members of the regulated community who have highly specific, legitimate reasons to deal as insiders.

7 In fact, although this would not be evident to the average retail investor, the publicly traded market in ETFs is secondary. In order to preserve the open-ended qualities of the fund, only authorised participants (large institutional investors) can trade ETF shares directly with the fund manager. These participants typically act as market makers, providing liquidity to the rest of the market and helping to ensure that the NAV of the ETF approximates the market price of shares in the fund. Trades between authorised participants and the fund take place in sizable blocks of shares ("creation units") which are usually exchanged in-kind for underlying securities. For these reasons, ETFs are not as good at replicating NAV as conventional unit trusts.

8 Or their cousin, the ETN (exchange-traded note).

9 ETFs and ETNs are currently on the FSA's list of emerging market risks for consumers: the concern is that public understanding of the structure of different kinds of ETFs, and the risks which they carry, has not kept pace with their evolution into increasingly complex products. See the FSA's *Retail Conduct Risk Outlook 2011*, March 2011.

10 A regulated information service.

11 See FINMAR 2.3.8..

12 See the FSA's *Final Notice: Bertie Charles Hatcher*, 18 May 2008.

13 See **R v McQuoid** [2010] 1 CrApp (S) 43.

14 S340(5) of POCA 2002 defines a person's "benefit" from criminal conduct as all property which he personally obtains as a result of or "in connection with" the criminal conduct. Note that, where a person buys shares on the back of inside information and then re-sells them, the prosecution would be entitled to argue that his benefit comprised the sum of: the entire purchase price he paid for the shares; the entire sale price he later gained for the shares. The shares and the onward sale moneys are separately capable of constituting property obtained for the purpose of Part 7 of POCA. It is very well established that there is no mechanism in law for deducting outgoings from receipts when calculating benefit. It is more frequent that outgoings and receipts have to be added together to produce the correct figure.

15 Under s390(9) of FSMA, if all or any of the amount of a penalty is not paid within the time allowed, the FSA may recover the outstanding amount as a debt due to it.

16 PC 10/4, *Enforcement financial penalties*.

17 The Upper Tribunal has endorsed the imposition of penalties which possibly exceed an individual's means but only in special circumstances, such as where the individual has not made full disclosure of his means of income or where he has taken positive steps to reduce his net worth so as to avoid the effect of a fine. Whether the Tribunal would endorse the same level of fine outside these circumstances remains to be seen.

18 **R v Forsyth and Mabey**.

19 The specific offence charged was making funds available to the government of Iraq without a Treasury licence, contrary to articles 3 and 11 of the Iraq (United Nations Sanctions) Order of 2000, as it was in force in 2002.

20 See issue no 10 of this publication, *The American Way: Pragmatism, Principle and the Pursuit of Settlements*.

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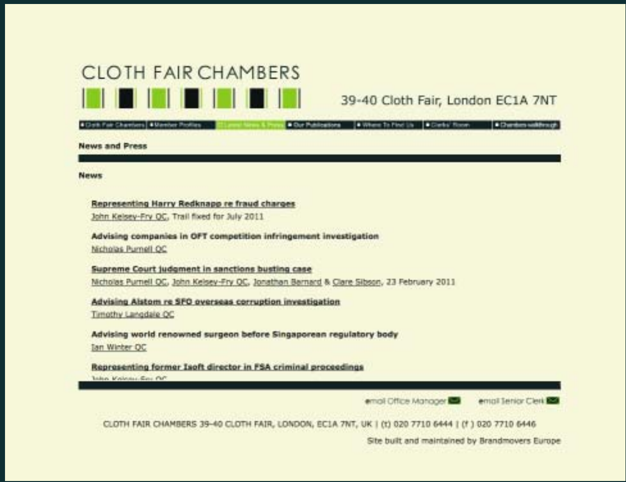

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CELEBRATIONS AND CONGRATULATIONS

MR AND MRS NICHOLAS NEWMAN

Cloth Fair Chambers takes great pleasure in congratulating Mr and Mrs Nicholas Newman on the occasion of their marriage in Cambridgeshire on Saturday 2 April 2011 and we send them both all our best wishes for the future.

SHANA GARLAND

We welcome Shana in her new role as Chambers' Office Manager. Shana looks forward to meeting our professional clients in the coming months and is available to provide any information about Cloth Fair and the services we provide.

CHARLOTTE BIRCHER

At the end of the year, we said farewell to Charlotte Graham nee Bircher as our Commercial Director. Charlotte and Andy married last Summer and Charlotte has been offered the opportunity to give full rein to her creative talents by becoming self-employed in her own interior design business for clients within the UK and internationally. We are sure that she will be a huge success and thank her for the important part she played in the creation of Cloth Fair Chambers.

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