JONATHAN BARNARD

INSIDER TRADING: AN EASY OFFENCE TO COMMIT

ISSUE FOURTEEN AUTUMN 2011
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Light touch regulation is a thing of the past. Insider trading is being targeted in the criminal courts as never before. In the USA, 53 people have been convicted or pleaded guilty since 2009, spawning a new cast of financial gangsters: enter Samir "shred as much as u can" Barai, Zvi Goffer (aka 'Octopussy' for his many tentacles into inside sources) and the multi-billionaire head of the Galleon hedge fund himself, Raj Rajaratnam.[1] In the UK, after nearly a decade of inactivity in the area, the Financial Services Authority (FSA) is currently prosecuting 13 individuals for insider trading in the criminal courts, having secured 11 convictions in the past couple of years alone.[2]

The results are coming through. For the past four years, suspicious trading ahead of UK mergers and acquisitions has been set at about 30%. This year that figure has been slashed by almost a third to 21%, the lowest level in eight years.[3] The compliance industry is booming.

However, criticism of the aggressive tactics that are achieving these results is beginning to mount. One hedge fund had to wind down after the fall out from a raid. Preet Bharara, the US attorney with jurisdiction over Wall Street, stated that if an institution was that "fragile" then the answer was to be "more careful and scrupulous" than everybody else.[4] It is not, therefore, just those that cross the line who need to watch it: those straying nearby may receive the same brutal treatment.

But is the matrix of statutes and regulations, which are now being so ruthlessly enforced, clear to those being policed? Have the light-touch years blurred the line of legality?[5] "Hedge funds and private equity firms are spending more on training and compliance, and mutual funds – some of the biggest buyers of information – are scrambling to figure out exactly where the boundaries lie on inside information" reports the *FT*.[6] One American law professor has warned, "prosecutors might hope vagueness will deter, but instead it erodes respect for the law".[7] When highly intelligent individuals are under huge pressure to innovate new techniques in the making of money, it is imperative that the moment of crossing the wall to the inside is crystal clear.

MASSEY: CONFUSION

The most recent civil case on insider trading brought by the FSA featured just that unhappy coupling of fear and confusion: **FSA v Massey [2011] UKUT 49 (TCC)**. The FSA brought the case as one of clear insider trading: the Authority's view was that Mr Massey deliberately traded knowing full well that he was committing market abuse. Given such a bullish allegation of high-level culpability, it is curious that the Authority fought shy of using its powers to prosecute the matter criminally.

It turned out to be a wise strategic decision. Contrary to the FSA's case, the Tribunal found that Mr Massey "genuinely believed"[9] that he was not committing insider trading and that he was "*concerned* about whether he was entitled to do as he did" (emphasis added).[10] Mr Massey had even been given the all-clear by his firm's regulatory consultant. Where Mr Massey fell short was in failing to consider the matter "dispassionately

1 Ex-Galleon trader 'Octopussy' convicted, FT, 13 June 2011; Fund manager latest to fall in inside trade push, FT, 27 May 2001; Guilty verdict in expert network case, FT, 20 June 2011
2 FSA regulator Margaret Cole rides through the city with guns blazing, The Times, 27 March 2010
3 Suspicious pre-deal trades fall sharply, FT, 13 June 2011
4 Fraud probes to continue says US attorney, FT, 7 June 2011
5 Hedge funds look to life post-Galleon, FT, 12 May 2011
6 The walls have ears, FT, 15 May 2011
7 The real insider tip from the Galleon verdict, FT, 11 May 2011
8 Or, more accurately, market abuse, under s118 of the Financial Services and Markets Act 2000
9 Paragraph 51
10 Paragraph 54

and objectively".[II] That criticism might amuse compliance officers used to listening to traders' justifications of their actions. When decisions are taken in a fast paced market by intelligent players bearing huge responsibilities for high stakes (including their own livelihoods) the last place to locate the passionless flow of objectivity is the mouth of the trader.

How was it that the FSA's accusation floated so high above reality? The answer lies in the muddy waters of s118C of the Financial Services and Markets Act 2000 (FSMA) – and the knotty definition of what constitutes "insider information". The sections relevant to **Massey** were as follows:

(2) ...inside information is information of a precise nature which—
  (a) is not generally available,
  (c) would, if generally available, be likely to have a significant effect on the price of the qualifying investments or on the price of related investments.
(5) Information is precise if it—
  (a) indicates circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur, and
  (b) is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of qualifying investments or related investments.
(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.

To follow the Tribunal's elegant and complex application of that section, one has to know a little of the facts of the case. In late 2007, David Massey was employed by Zimmerman Adams, a corporate finance advisory company. He had a law degree and was an experienced market professional. He had expertise in the Alternative Investment Market and in Eicom (an AIM-listed company) in particular. Eicom was a relatively illiquid share with small volumes being traded infrequently. This is significant as it means that many market participants would have been unlikely to have public information relating to Eicom at their fingertips.

Mr Massey, however, did. He knew, as anyone who might have bothered to have found out would also have known, that Eicom issued a regulatory news service (RNS) announcement on 3 November 2006 stating that they had made an arrangement with Pacific Continental Securities (PCS) for subscriptions to a maximum value of £2.7 million to be raised in five tranches at a 45% discount to the average bid price. The first three tranches of the take up went ahead without causing any change in the share price. Then calamity struck: PCS went into administration shortly before the announcement of the fourth tranche. PCS's demise was mired in scandal, so Eicom's subsequent predicament was no secret, not least because they were forced to go to 20 companies in the scramble for a replacement for PCS. With Eicom's desperation patently obvious, it was inevitable that the level of discount would increase beyond the 45% agreed with PCS.

One person Eicom approached in a bid to fill the hole in their funding was Mr Massey. On 25 October 2007, Eicom offered to sell to Mr Massey (or through him, it mattered not to Eicom): 3 million shares at 3.5p. That offer was good until 2 November. On 1 November, without yet having taken up that offer to buy the Eicom shares, Mr Massey agreed to sell 2.5 million of them at 8p to Allianz through Shore Capital. Having agreed that naked short sale, Mr Massey went back to Eicom and offered to buy 2.6 million shares at 3.5p. Eicom accepted and the sale went through.

II Paragraph 52

The original offer from Eicom had been to sell 3 million shares, not 2.6 million. That, added to the fact that the deal included an agreement that the entire offer could be withdrawn at any time, created a real, albeit small, risk that Mr Massey would not obtain the shares he needed to make good the deal with Allianz. That risk never materialised and Mr Massey made £100,000.

On 2 November, Eicom made two announcements: first, that a non-executive director had resigned; secondly, that they had managed to sell (to Mr Massey and another, separate, party) just over 4.2 million discounted shares in total for an average of 3.4p within the past ten days. Those figures represented a discount to the share price of nearly 60% on about 13% of the company's stock.

Although Winterfloods, one of Eicom's market makers, thereafter dropped its bid/offer spread from 6-9p to 4-7p, the Tribunal found this was merely "an instinctive reaction": it was not therefore causatively linked to the specific trades carried out by Mr Massey.

Mr Massey explained his trades to Ms Bhattacherjee of Bovills, ZAI's financial services regulatory consultant, who concluded that Mr Massey's trade gave rise to no suspicion of insider trading. Mr Massey's case was simple: he was exploiting the difference between buying and selling price in a way analogous to what market makers do every minute of every day. He did not believe that an announcement of the placing to him would adversely affect the price and it was up to Allianz to review all publicly available information when purchasing the Eicom shares: a classic approach of caveat emptor.

The first question for the Tribunal to resolve was whether the offer made by Eicom to Mr Massey was information which was *"not generally available"* (s 118C(2)(a). The Tribunal found that it was by virtue of its specificity. Mr Massey had argued that the specific details were irrelevant if the general thrust of the information is well known to the market: after PCS's collapse, it was clear that Eicom needed at least £800,000 and was actively trying to sell shares discounted by more than 45%. The specific deal offered to him was of the self-same type as publicly available information and therefore, in reality, no different. The Tribunal distinguished the offer to Mr Massey as "in line with but not the same as" the publicly available

information (paragraph 36). This means that knowing *more* of the *same type* of information which is publicly available could make it "inside".

The Tribunal also found that the precise details of the offers made by Eicom to the various companies to raise funds after PCS's collapse (no doubt in similar terms to those offered to Mr Massey) were "not generally available", although the population of brokers and others who would have been privy to them was by no means tiny. It will therefore not avail a defence to identify a number of other individuals who know the same information as the accused, particularly if issues of confidentiality are bound into that knowledge. But there must come a point, presumably, when so many individuals know information, by whatever means, that it crosses the line into the public sphere.

Was the information "*precise*"? The Tribunal bluntly stated that "we have not found the statutory wording easy to understand". They found the test under s 118C(5)(b), that the information must be "specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of the shares", contradictory and confusing. While a "conclusion" denoted a definite state of mind, the Tribunal found this to be "effectively removed" by that conclusion landing on a "possible effect". The Tribunal noted, with demure exasperation, the lack of guidance on the point.[12]

One pities the trader in the field grappling with these issues when the Tribunal itself was at sea after days of calm contemplation. Such confusion would serve only as the backdrop to the trader having to yank himself from the question that rattles through his head and courses through his veins a million times every day, i.e., what do *I think* is the *likely* impact of this information on the price? Instead he has to consider: what would an *objective observer* think *might possibly* be the impact of this information on the price?

The Tribunal performed those mental gymnastics and found that the information was precise: while "it was *uncertain* whether the issue of at least 2.5million discounted shares at 3.5p when announced would have an effect on the price [as in a particular direction], an effect was *possible*" (emphasis added).[13] It seems that traders must get used to attuning their minds to the consideration of remote, although reasonable, possibilities.

This knocks onto the issue of whether the information was *price sensitive* (s 118C(2)(c) and (6)). The application of this test demands a jump from the world of possibilities to the more familiar one of probabilities. But one also has to conjure up the spirit of that increasingly visible member of the legal village, the reasonable man, this time incarnated as the reasonable investor. Mr Massey was criticised for relying on his own feeling that the information was not likely to have a significant effect on the price of the shares, a view with which even the Tribunal had "considerable sympathy".[14] That sympathy was no doubt generated by the evidence from the market makers setting the price of the Eicom shares, which was equivocal at best as to whether the announcement did or might have had a significant effect on the price, leaving the Tribunal unable to conclude that there was in fact a causative connection between the announcement of the discounted shares and the share price. Moreover, the previous three announcements of discounted shares made by Eicom had made no impact on the share price at all.

The Tribunal put such matters to one side and based their decision on the effect of the information not on a composite

12 Paragraph 38
13 Paragraph 39
14 Paragraph 41

"reasonable investor" but on one investor in particular: Allianz, the actual purchaser of the shares. Had Allianz known that the shares for which they were paying 8p were on offer direct from Eicom at 3.5p, it would probably have made an impact on the decision to trade with Mr Massey. But was it fair to posit Allianz as the hypothetical reasonable investor? The only evidence from Allianz at the hearing was an unchallenged witness statement. No doubt Allianz asserted strongly that they would not have dealt with Mr Massey if they could have bought the same shares direct from Eicom for less than half the price – what representative of a Plc would, against the pressing weight of professional reputation and fiduciary duties to investors?

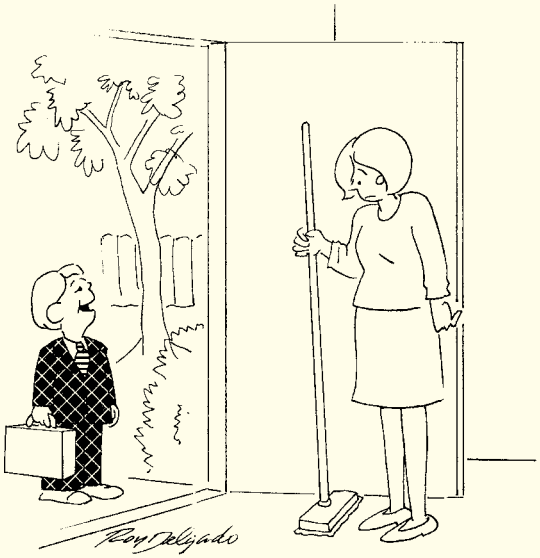
But was it right to hold Allianz as occupying the space of a reasonable investor in the first place? Did they know all that was publicly available about Eicom? Would most reasonable investors not have taken up the 8p offer after proper analysis of that publicly available information? Might there have been undisclosed reasons known only to Allianz which made the Eicom shares attractive even at 8p? Perhaps seeing these problems that muddle the subjective with the objective, other legal tests requiring the assistance of the reasonable man have put conspicuous distance between him and the place of the victim: for example, public order offences put the "person of reasonable firmness present at the scene" in shoes other than the alleged victim's when considering if he would have feared for his personal safety (**R. v. Sanchez [1996] Crim.L.R 572, CA**); and the test for judicial bias is not whether it can be seen by its alleged victim but by the reasonable bystander (**R. v. Helow [2008] UKHL 62**).

Finally, Mr Massey was criticised by the Tribunal for providing "over-simplified and misleading" information to his firm's regulatory advisor. The Tribunal determined that Mr Massey gave the "impression that the issue of shares to him was part of a series of placings which were in the public domain before they occurred" and he was "adamant that he didn't know any insider information".[15] The Tribunal accepted that the latter was Mr Massey's genuine and honest belief. It was based on the former, which was, axiomatically, also a genuine and honest belief: Mr Massey saw a line connecting, not a gulf separating, the placing offered to him to those offered to others, which were in the public domain. That connecting, unbroken line put all but the fine details of his own placing into the public domain, and those fine details were so small that they were unlikely to be price sensitive.

What else could Mr Massey do? He had considered his position and concluded, firmly, that he had done nothing wrong. He had gone further and considered his position together with his regulatory advisor, who had come to much the same conclusion. Inevitably, his regulatory advisor would have reached the same conclusion even if the advice had been sought before the trade was made. After the event, it was open to that regulatory advisor to check the facts which Mr Massey supposedly distorted and Mr Massey knew it. It does not appear that she sought any corroboration or verification. Further, Mr Massey's boss knew all about it.

The Tribunal censured Mr Massey for being "liable to persuade himself of a distorted version of the facts when he feels that his interests are at stake".[16] That is a trait Mr Massey shares with the vast majority of human kind. Yet he was fined £150,000. That might be a relatively modest sum in the recent roll call of FSA fines but it is a colossal amount for someone who genuinely believed he had done nothing wrong.

15 Supra, Paragraphs 46-47
16 Supra, Paragraph 50



Can I come in and play insider trading with Kenny?

MORTON AND PARRY: SACRIFICIAL GOATS

The earlier case of **Morton and Parry**[17] is perhaps more extreme an example of proceedings against traders who have, at worst, equivocal culpability. Both were portfolio managers of Dresdner's K2 structured investment vehicle (SIV) and therefore approved persons. On 15 March 2007, Barclays Capital (Barcap) contacted key investors to gauge their appetite for a proposed new issue of floating rate notes. One of those key investors was K2. Barcap sketched out the rough parameters of the new issue and told Morton that it would probably be announced the following Tuesday and that he was being given "a very early heads up" and to keep the information to himself and within his firm. Morton relayed that information to Parry, who sold $65 million Barclays FRNs, that is before the flood of new FRNs were issued.

The FSA accepted that Morton and Parry did not believe that they were committing insider trading. It also accepted that their actions were consistent with prevalent market practice. Further, it noted that there was no guidance from the International Capital Markets Association which could have assisted either man at the time. They were "working in an environment where until a deal had closed *the accepted view* was that in the absence of information generally regarded as inside information, that information was not regarded as specific or price sensitive and therefore *any activity related to such information could not be abusive*".[18] Yet the FSA determined that the two "had a responsibility to consider whether the information was capable of being insider

17 Final Notices, dated 6 October 2009
18 Final Notice, paragraph 6.12

information regardless of market practice" and that "market practice did not establish reasonable grounds for believing no insider trading had taken place".[19]

The punishment in light of those findings was simply one of public censure. But in the realm of professional discipline, it is remarkable that there was any action taken against Morton and Parry at all: they genuinely believed that they had done nothing wrong, there was no guidance to tell them otherwise and a significant body of their fellow professionals would have deemed their actions acceptable. If the FSA wanted a sea change in the way things were done, why not start with issuing guidance rather than spiking heads onto poles? The case is significant in that it eviscerates the common sense comfort gained from watching honest and experienced players openly doing for years and years the very thing with which you are accused, and concluding that they cannot all be wrong. Now, they can.

SPECTOR AND "USE" VS "POSSESSION"

As if it were not easy enough already, prosecuting insider trading cases under s 118 just became easier. S 118(2) of FSMA reads: "where an insider deals or attempts to deal in a qualifying investment or related investment *on the basis of* inside information relating to the investment in question..." (emphasis added). The now defunct paragraph 1.3.4 of the Code of Market Conduct (MAR) interpreted "on the basis of" as meaning that the inside information was the reason for or had a material influence on the decision to deal, thereby requiring the FSA to prove intention to secure a civil finding of insider trading.

Then came the European case of **Spector Photo group NV [2010] 2 CMLR 30**, in which the European Court of Justice gave a preliminary ruling on the meaning of "use of inside information" for the purposes of Directive 2003/6 art.2(1), the directive that underpins much of FSMA and the FSA's interpretation of it.

The ECJ was asked to determine whether it was sufficient for a transaction to be classed as prohibited insider dealing when a primary insider merely *in possession* of inside information traded on the market in financial instruments to which that information related, or whether it was necessary, in addition, to establish that that person had "*used*" that information "with full knowledge".

The court ruled that there was a presumption that where a transaction was entered into while the author of the transaction was in possession of inside information, that information must be deemed to have played a role in his decision-making. It followed that the holding of information by a primary insider who traded on the market in financial instruments to which that information related implied that he "used that information", although that presumption could be rebutted.

Interestingly, the UK as intervenor in **Spector** had argued against the winning interpretation, which put any primary insider in possession of inside information who entered into a market transaction automatically within the prohibition on insider dealing. The UK's opposition was put forward on the basis that it would entail extending the scope of the prohibition beyond what was appropriate and necessary to attain the goals pursued by the Directive.

Having lost that argument, the FSA really had no option but to delete MAR 1.3.4. That is what they did on 6 March 2011. Overnight, therefore, a trader in possession of insider information which he did not use found himself on the wrong side of the line of the civil enforcement regime.

Although Spector makes clear that the presumption that the

19 Final Notice, paragraph 6.13

possessor of insider information has used it should be rebuttable, the response by the FSA has been to delete MAR 1.3.4 rather than replace it with the availability of a positive defence. The change is too recent to have been tested, so one must wait to see how it will play out.

THE INTERPLAY OF THE CRIMINAL AND CIVIL OFFENCE

This downgrading of the civil offence has, curiously, brought it in line with the criminal offence on this point (assuming that somewhere there is space for a "no use" defence to flourish). Section 52 of the Criminal Justice Act 1993 (CJA 93), carries the presumption that insider trading has been committed by mere possession of the inside information, underpinned with the safety net of the defences in section 53 which can rebut that presumption.

The CJA 93 was not drafted to anticipate FSMA, nor all refinements to it cascading down from Europe. The job of sections 52 and 53 of the CJA 93 was to replace the Company Securities (Insider Dealing) Act 1985, which in turn replaced similar provisions contained in ss.68–73 of the Companies Act 1980: before 1980, insider trading was not even illegal.

Now that the CJA 93 is no longer the only insider trading show in town, should not the criminal offence be revamped in order to sit, clearly and appropriately, on top of its regulatory counterpart? With s.1118 FSMA now more wide-ranging than even the UK government advocated and with the penalties under it arguably more draconian than those in the criminal courts, there is a powerful argument to distinguish what should be a more serious criminal offence with a clearly more serious mens rea.

The need for grave insider trading cases to be dealt with in the criminal courts was addressed recently by the Lord Chief Justice stated in **R v McQuoid [2010] 1 Cr. App. R. (S.) 43 at paragraph 9**: "The message must be clear: when it is done deliberately, insider dealing is a species of fraud; it is cheating". If not the first, that was certainly the clearest articulation of insider trading as fraud. But that ingredient of deliberation, of intentionally trading on the inside information is not clearly set out in the CJA 93, as it would be under the ingredient of dishonesty in a fraud offence.

Might it then be time to assess the efficacy of the Fraud Act 2006 in relation to insider trading? In 1993, the prosecution of fraud was heavily reliant on the common law. The Fraud Act 2006 was designed to do away with the perceived problems of common law fraud. It sought to capture all types of fraud within three descriptions: by false representation, by failing to disclose information and by abuse of position. The original idea driving the Fraud Bill was to jettison common law fraud entirely: it was only retained at the last minute and only then as a catch-all in case the Fraud Act proved more leaky in practice than was hoped for in theory. Even now, the Attorney General requires prosecutors who seek to rely on the common law in an indictment to justify that reliance in writing.

Section 4 of the Fraud Act 2006, fraud by abuse of position, is both under-used and surprisingly flexible. It is compatible with insider dealing allegations, which are based fundamentally on breach of a fiduciary duty (explicitly in the USA, implicitly in the UK), not least because it is not even necessary to establish as much as the existence of a fiduciary duty to proceed under its provisions. Deployment of section 4 of the Fraud Act would herald dishonesty as a clear ingredient requiring proof, rather than a lurking presence never specifically before the jury. It would thereby draw a clear and clean distinction with the civil offence under FSMA, which requires no proof of intention and therefore no dishonesty.

**"You have been tried and convicted of insider trading.
Have you any last tips to offer before I pronouce sentence?"**

A clearer distinction in mens rea between civil and criminal offences through recourse to the Fraud Act might also ameliorate the unsatisfactory situation in which the FSA frequently alleges dishonesty but elects the civil route of enforcement for strategic reasons (see **Massey**, above, for but one example of this). The Lord Chief Justice stressed the importance of matching forum to offence in **McQuoid** (ibid at paragraph 9):

"We therefore emphasise that this kind of conduct does not merely contravene regulatory mechanisms. If there ever was a feeling that insider dealing was a matter to be covered by regulation, that impression should be rapidly dissipated... Prosecution in open and public court will often, and perhaps much more so now than in the past, be appropriate."

As has been said in this Newsletter before, there can be palpable, albeit counter-intuitive, advantages for accused persons in having matters resolved in the criminal courts rather than taking the regulatory route.[20]

There may even be attractions for the FSA. Margaret Cole has recently been calling for an increase in the maximum sentence for the CJA 93 offence, from seven to 10 years. Section 4 of the Fraud Act already has a maximum sentence of 10 years.[21] Further, there could be no objection to the FSA reaching beyond FSMA to fulfil its statutory objectives, after

20 See The Players may change but the game stays the same, Clare Sibson, Issue 12 Spring 2011, pp13-15

21 FSA wants tougher insider trade penalties, FT, 15 May 2011

the Supreme Court decision in **R v. Rollins [2010] 1 WLR 1922**.[22]

"USE" V "POSSESSION" IN THE US

This issue of "use" vs "possession" has been rumbling on in the USA for some time. The Galleon trial, the largest hedge fund insider trading case in history, promised some movement in the debate. The reasons that it did not deliver are perhaps even more interesting.

Raj Rajaratnam faced a tsunami of damning evidence, including 45 conversations taken from wiretaps of his mobile telephone and his own college friends testifying against him. The build up in the press was awash with speculation as to how the trial would develop, the only sure thing being that "neither side will reveal, even to the other, how it plans to present its arguments".[23]

As the defence unfolded, it became clear that Mr Rajaratnam's team had spent a great deal of time, effort and money on establishing a "mosaic" defence:[24] the guiding of investment strategy by the stitching together of many small pieces of information which, on their own, may be inconsequential fragments, but, put together and viewed by an expert, reveal a compelling reason to buy or sell. Those small pieces may constitute public information or indeed non-public information *if* it is immaterial in and of itself (i.e., when viewed in isolation, outside of the mosaic). *Material*, non-public information, on the other hand, can form no part of the mosaic if it is to be lawful.

An expert witness for the defence, University of Rochester professor Gregg A. Jarrell, testified that a reasonable investor could have engaged in the same trading as Rajaratnam based on the "mix" of information available through the press and other public sources.[25] So whatever inside information Mr Rajaratnam may have possessed, it was not that which was driving his trades: instead, his decisions to trade were based on publicly available information put together as a mosaic. So the mosaic acted to smother the inside information. The defence therefore boiled down to Rajaratnam not "using" the inside information which he "possessed".

That strategy would have been coherent if the prosecution had to prove that the decision to trade was made *because of* the inside information rather than simply *while knowing* the inside information. But in the USA it is far from clear that the prosecution need go any further than proof of "possession" in the criminal courts, leaving the issue of whether a defendant "used" the inside information otiose.

Whether it is the "use" or "possession" of the insider information which is determinative depends on one's reading of the Securities Exchange Act of 1934 (the Exchange Act). The debate was cleared up some time ago in relation to civil enforcement of the Exchange Act. On 23 October 2000, Securities Exchange Commission promulgated Rule 10b5-1, designed to address:

"an important unsettled issue in insider trading law: whether the Commission must show in its insider trading cases that the defendant "used" the inside information in trading, or merely that the defendant traded while in "knowing possession" of the information. The Rule would state the general principle that insider trading

22 See The Players may change but the game stays the same, Clare Sibson, Issue 12 Spring 2011, p 11

23 FT, The Galleon Case, 2 March 2011

24 See *The Economist*, The Mosaic Defence, 14 April 2011; Raj Verdict Deals a Blow to Mosaic Defence, Law360, 11 May 2011; Galleon case Test Mosaic Theory, Insider Investor relations, 8 March 2011

25 Raj Verdict Deals a Blow to Mosaic Defence Law360, 11 May 2011

liability arises when a person trades while "aware" of material non-public information...."[26]

But the situation remains unresolved in criminal matters, where the SEC (unlike the FSA) has no jurisdiction. Although the SEC's regulations are treated with understandable deference, they are not binding on District Courts presiding over criminal actions. There has been no significant consideration of Rule 10b5-1 in the criminal courts and the authorities on the previous, unclear, incarnation of the rule are conflicting. Comments in the 1993 case of **United States v Teicher**,[27] although obiter, aligned the criminal law with the civil in approving the "knowing possession" standard.

But the "use" test was endorsed by the Ninth Circuit Court in **United States v Smith**,[28] in preference to the mere "possession" test. Moreover, the court considered and rejected the option of a rebuttable presumption that the accused had used the inside information in his trade (i.e., the European approach after **Spector**), ruling that it was for the prosecution to prove that the trading decision used the inside information. Interestingly, the court grappled with one of the key lines of reasoning explored in Spector, emerging with the opposite conclusion:

"We appreciate that a "use" requirement renders criminal prosecutions marginally more difficult for the government to prove. The difficulties, however, are by no means insuperable. It is certainly not necessary that the government present a smoking gun in every insider trading prosecution. (Not that a smoking gun will always be beyond the government's reach; consider, for instance, that in this case Bravo might herself have gone to the authorities with Smith's statement that "I'm going to short the stock because I know it's going to go down a couple of points here in the next week as soon as Lou releases the information about next year's earnings.") Any number of types of circumstantial evidence might be relevant to the causation issue. Suppose, for instance, that an individual who has never before invested comes into possession of material non-public information and the very next day invests a significant sum of money in substantially out-of-the-money call options. We are confident that the government would have little trouble demonstrating "use" in such a situation, or in other situations in which unique trading patterns or unusually large trading quantities suggest that an investor had used inside information."

Those comments prefigure the Galleon trial, where the evidence from the wiretaps was not so much a smoking gun as a slow-motion, multi-angle replay of the gun going off.

In two opportunities, the US Supreme Court did not resolve the tension between **Teicher** and **Smith**. **United States v O'Hagan, 521 U.S. 642** and **Dirks v SEC 463 U.S. 646**,[29] were both decided before the amendment of Rule 105b-1 in 2000. In theory, therefore, the "use v possession" debate is unresolved in US criminal courts.

From a jurisprudential stand point, it is frustrating that the Rajaratnam defence team did not seek a ruling on the issue before embarking on their mosaic theory defence. From a strategic point of view, it may have been more sensible to dodge a likely ruling that the "possession" interpretation contained within Rule 105b-1 held sway in the criminal courts too (i.e., that the mere possession of inside

26 [http://www.sec.gov/rules/proposed/34-42259.htm]
27 See http://law.justia.com/cases/federal/appellate-courts/F2/987/112/240820, paragraphs 46-60
28 See http://www.hbbllc.com/courses/infosec/ecpa/155_f3d_1051.pdf
29 See http://supreme.justia.com/us/463/646/case.html#648

information taints a mosaic defence). But the defence team's resolve to increase its agility before the jury may have proved fatal to the ability to take the point on appeal. If indeed Mr Rajaratnam fancied his chances more before a jury than before the judges, he may have miscalculated: he was convicted, unanimously, on all of the 14 counts he faced.

INSIDE THE INSIDERS: THE ADVENT OF WIRETAPS

The crushing evidence from the wiretaps must have been a heavy influence in the defence strategy. The contents of those devastating tapes demonstrated how classic a case this was of insider trading. Starring in several calls was Danielle Chiesi, a former hedge fund manager who bragged to Mr Rajaratnam that she had played a source of inside information, "like a finely tuned piano".[30] "Do you think that I should be showing a pattern of trading AMD?" asked Ms Chiesi. "I think you should buy and sell, and buy and sell, you know", was Mr Rajaratnam's reply.[31] The wiretaps also caught Rajaratnam telling an underling to create an email chain that would show they had discussed investing in a particular stock to hide the fact that his interest had been sparked by a tip.[32] On another wiretap, Mr Rajaratnam was heard discussing the exact date when Advanced Micro Devices' sale of chip unit would be announced. On yet another, he said he had "100 percent certainty" that a takeover of PeopleSupport would go through despite a cautionary press release because he had a source on the company's board.[33]

Once such evidence is before the jury, it is devastating: the inner workings of the conspiracy falling from the defendant's own mouth during conversations when he is most at ease. This is why the prosecutor, Jonathan Streeter, told the judge the difficulty in bringing insider trading cases against hedge fund traders proved the "necessity of wiretaps".[34]

It is this recourse to wiretap evidence that is the real significance of the Galleon trial. Its use in a securities fraud case was unprecedented and its effect revolutionary. That stunning court room debut has already ushered in a deluge of wiretaps to subsequent securities fraud trials: Zvi Goffer's trial, following hot on the heels of his former boss's, featured "dozens" of recorded telephone conversations.[35]

Are UK traders safe from being condemned by their own voices? Many commentators have been quick to point out that the FSA has no power to obtain evidence by wiretap on its own.[36] But the matter does not end there. Such evidence may fall into the FSA's lap through the back door.

That back door is hinged on the international cooperation of enforcement bodies in combating insider trading, which is very much in its nascent stages but already bearing fruit.[37] On 25 November 2010, two former directors and one former senior trader of Blue Index Limited, a specialist contract for difference brokerage, were charged by the FSA with 17 counts

30 Rajaratnam trial was a drama worthy of Hollywood, FT, 11 May 2011
31 The walls have ears, FT, 15 May 2011
32 ibid
33 Lawyers see green light in verdict for wiretaps, FT, 11 May 2011
34 Lawyers see green light in verdict for wiretaps, FT, 11 May 2001
35 Ex-Galleon trader "Octopussy" convicted, FT, 13 June 2011.
36 For example, see The walls have ears, FT, 15 May 2011. Under the Regulation of Investigatory Powers Act 2000 (RIPA), the power to intercept telecommunications is reserved for authorities such as the police and intelligence services, and even they cannot use that intercept material in evidence (see RIPA, section 17). The FSA is authorised to carry out directed surveillance (observation) and to use of covert human intelligence sources (grasses), but it cannot intercept telephone calls, letters or e-mails. But it is important to note that from 14 November 2011 the FSA extended their taping rules to include work-issued mobile phones and any other relevant conversation on private mobile telephones (see Conduct of Business sourcebook (COBS) 11.8).
37 See Cross-border clampdown on insider trading, FT, 28 November 2010; Insider trading: brought to court, FT, 2 March 2011

of insider dealing. Five days later, Arnold McClellan and his wife Annabel, of San Francisco, California were charged by the SEC[38] with repeatedly leaking confidential merger and acquisition information to family members overseas in a multi-million dollar insider trading scheme. Margaret Cole, the FSA's acting head of Enforcement, stated, "the insider dealing charges last week were the result of a coordinated effort and investigation between the FSA and the SEC. The action on both sides of the Atlantic demonstrates the way in which close co-operation between regulators is tightening the net on people who set out to abuse markets, wherever those people or markets are based".[39]

Hand in hand with joint investigations goes the sharing of evidence and intelligence. UK courts have little difficulty admitting evidence obtained lawfully abroad, even if the means by which that evidence was gathered would have been unlawful in this country, with wiretaps being the classic example.[40]

Even where evidence gleaned by intrusive surveillance techniques from abroad has been obtained unlawfully, the

38 While the SEC also has no power to obtain wiretap evidence, it frequently works in conjunction with the Department of Justice, which does

39 http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/169.shtml

40 See R. v. Maguire [2009] EWCA Crim 462 and R. v. P [2002] 1 A.C. 146

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Bob was enventually arrested and charged with outsider trading

courts have been reluctant to exclude it. **Warren v AG of Jersey [2011] UK PC 10** is a recent demonstration of how far courts are willing to bend to make highly damning, intrusive surveillance admissible. In that case, despite "grave prosecutorial misconduct", whereby the police had misled the Jersey authorities and three foreign jurisdictions in their determination to install a tracking and audio recording device in the car of a top level drugs dealer as he moved across the continent, the Privy Council ruled that the conviction should stand.

The sheer power of evidence obtained through intrusive surveillance often steamrollers well–founded objections to its admissibility. It is salutary to note that the recordings from Raj Rajaratnam's personal mobile telephone were ruled admissible despite there being no specific provision for authorising wiretaps for insider trading in the relevant act[41] and heavy judicial criticism which found that the government's application contained numerous "inaccuracies and inadequacies" including "the glaring omission" of "highly relevant information",[42] which went directly to the issue of whether the wiretap was necessary, one of the key tests required for the granting of a wiretap.[43]

CONCLUSION

Waking up to a level of insider trading activity which had reached systemic proportions,[44] it is unsurprising that the FSA decided to bring the stick down hard. Yet with all its recent successes, the FSA has yet to snare an insider the size of Rajaratnam. While a big scalp to pin to the FSA's mosaic of deterrence may be just around the corner, is it not time to ensure that all the smaller players know exactly what is expected of them? Just over a year ago, Hector Sants, chief executive of the FSA famously stated, "We do want publicity. We do want people to be afraid, to say, 'Hold on, maybe I don't want to do this. Maybe the FSA will catch me'."[45] For that fear to operate efficiently, market participants must know precisely where the lawful line is drawn and enforcers must use the best tools available to draw it clearly.

41 Title III of the Omnibus Crime Control and Safe Streets Act 1968

42 United States v. Rajaratnam, No. 09-Cr.-1184 (RJH), 2010 WL 3219333

43 Judge Holwell made the following scathing remarks: "The Franks hearing established that the criminal authorities in this case made a glaring omission. They failed to disclose to the Judge that the SEC had for several years been conducting an extensive investigation into the very same activity the wiretap was intended to expose using many of the same techniques the affidavit casually affirmed had been or were unlikely to be successful. The Court is at a loss to understand how the government could have ever believed that Judge Lynch could determine whether a wiretap was necessary to this investigation without knowing about the most important part of that investigation—the millions of documents, witness interviews, and the actual deposition of Rajaratnam himself, all of which it was receiving on a real time basis and all of which was being acquired through the use of conventional investigative techniques."

44 Plea deals plan to beat insider trading, FT, 22 April 2007

45 Insider trading: a bigger bite, FT, 12 May 2010

CLOTH FAIR KALISHER SCHOLARSHIP 2011

By Elaine Freeer

I remember having a vague notion of wanting to work in the legal profession from early on in my time at senior school. In Year 10, I arranged to do my work experience with the Immigration Appellate Authority (now the Immigration Appeals Tribunal). By the end of that week, my decision to pursue a career in the law was finalised.

I read Law at Selwyn College, Cambridge between 2007 and 2010. During my time there I had to decide whether to follow the route of solicitor or barrister. I attended open days at London solicitors' firms but, although impressive, they did not inspire me. I then arranged two mini-pupillages over my first summer vacation; one in Nottingham, the other in London. In Nottingham I shadowed a barrister who was prosecuting a marital rape case, and in London; two counsel who were prosecuting a large scale conspiracy to import illegal immigrants.

I thoroughly enjoyed being in court, and, as I undertook further mini-pupillages, knew that I wanted to do it for the length of a career. I particularly liked the variety of criminal trials. The possibility of appearing before a professional tribunal of Magistrates acting as the tribunal of both fact and law one day; and then the next, appearing in front of 12 lay people aided by a judge as the tribunal of law. The adaptability required within trials also appealed to me; the differences in style needed to make an opening speech, compared to handling a witness, or making submissions to the judge sitting alone. As someone who enjoys memorising large numbers of facts, even the amount of preparation needed to present a case well appeals to me.

However, perhaps my biggest attraction to the law is not just the opportunity for intellectual challenges, or those created by advocacy, but by the human stories behind the cases. It cannot be denied that the criminal justice system changes people's lives every day; so often in ways underestimated or unseen by large parts of the population. For me, that is the most challenging, yet also most rewarding, part of criminal practise; seeing cases in context, and not simply as a mass of law and facts.

In September 2010 I began the BPTC at Kaplan Law School in London. I completed the course in June 2011 with a 'Very Competent' overall, including 'Outstanding' gradings in Conference, Opinion Writing, and Criminal Litigation and Evidence.

I am now beginning an MPhil in Criminology at the Institute of Criminology at Cambridge, in the hope that it will allow me to develop a greater understanding of the context of criminality, and the role of the criminal justice system within society. I then hope to secure pupillage for 2013.

Being awarded the Cloth Fair Scholarship is a great honour, and I hope that I can repay the faith put in me by the Kalisher Trust by achieving highly at the Bar, and always trying to exhibit the qualities that Michael Kalisher QC himself displayed both as an advocate and a member of the profession.

Elaine Freer will be awarded The Cloth Fair Kalisher Scholarship at the Kalisher Lecture on 25th October 2011 by Baroness Ruth Deech DBE, Chair of the Bar Standards Board.

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