

WHEN IS IT SAFE TO CONCLUDE YOU ARE NOT AN INSIDER?

The FSA's enforcement action against David Einhorn, a US-based investment manager, makes clear a key distinction between insider trading and market abuse law in the United States and United Kingdom. Unlike the US enforcement scheme, under English law an investor may be charged with market abuse if it trades while in possession of precise, price-sensitive non-public information even if the investor owes no duty to the issuer or its shareholders and the information carries no confidentiality restrictions. Accordingly, investors in British markets should proceed with caution while in possession of non-public information about, for example, possible future transactions.

Willkie has now brought on board a team in London with expertise in advising clients on the UK regime. When combined with our expertise on the US rules and regulations, Willkie has an unparalleled ability to advise on cross-border compliance programmes. In this bulletin we consider the practical implications for those who are subject to the UK's market abuse regime/insider trading laws and US insider trading laws.

The facts

- Mr Einhorn was the owner, President and sole portfolio manager for Greenlight Capital Inc, based in the US.
- Greenlight funds had shares in Punch Taverns, a UK issuer.
- In advance of a possible transaction, a number of US-based shareholders in Punch were wall crossed by Punch having signed non-disclosure agreements.
- Mr Einhorn was asked to sign an NDA with a view to being wall crossed but refused that request.
- A call was then arranged on a non-wall crossed basis, during which call some information was provided to Mr Einhorn that Punch was at an advanced stage in a process towards the issuance of a large amount of new equity, probably in a timescale of about a week, to repay its convertible bond and create headroom with respect to certain covenants. Six weeks earlier Punch had publicly suggested it was financially on track.
- Immediately following the call, Mr Einhorn directed that Greenlight traders sell the entire shareholding the funds had in Punch. The decision to sell was on the basis, in part, of the information received. Some shares were then sold, about a third of the holding.
- Within a week of the call, Punch announced a transaction and its share price fell by 30%. As a result of its earlier sales, Greenlight avoided a loss of about £5.8m.

The FSA's case was that given Mr Einhorn's experience it should have been apparent that the information he received was confidential and price-sensitive. The FSA accepted that the market abuse was not deliberate or reckless and that Mr Einhorn did not believe the information he received was inside information. Nevertheless, a penalty was imposed.

The issues raised by the case were:

Was the information sufficiently precise?

Was the information generally available?

Was the information likely to have a significant impact on the price?

Was Mr Einhorn entitled to rely on Punch management and their professional advisers on the call not to give him inside information, having refused to be wall crossed?

What should Mr Einhorn have done following the call?

Dealing with each of those questions:

Was the information sufficiently precise?

The FSA's conclusion was that taking into account Punch's circumstances and the information in the market readily available, together with the information disclosed on the call which included the anticipated size, purpose and timing of the equity issuance, it was sufficiently precise. It was not necessary for Mr Einhorn to be told that the issuance was definitely going to proceed.

The fact that Mr Einhorn was told the NDA (which he refused to sign) would last for less than a week and that other shareholders were broadly supportive indicated an issuance may reasonably be expected to occur.

The FSA referred to the fact that wall crossing takes place normally during the latter stages of a transaction and would therefore suggest that a transaction is at an advanced stage of preparation. However, it appears from the decision that this factor in itself will not be sufficient to draw the conclusion a transaction may reasonably be expected to occur. Mr Einhorn argued that he was not told when the equity issuance was likely to occur, simply that the NDA he refused to sign would last for less than a week. To him, that did not indicate that an issuance was imminent or that the transaction was at an advanced stage. On the contrary, he inferred from the request for an NDA that matters were still at a discussion phase. Nevertheless, despite these points the FSA concluded to the contrary.

Was the information generally available?

It was accepted that there was speculation in the market that Punch may have to raise capital by way of new equity at or around that time. However, public statements by Punch were to the contrary.

The FSA concluded that there was no generally available information regarding the timing, size and shareholder support for the transaction. The FSA concluded therefore that it was not generally available that Punch was at an advanced stage of the process towards a significant issuance of equity for the purpose of repaying debt and creating headroom in its bank facilities.

Was the information likely to have a significant impact on the price?

The FSA concluded that the information about the size and purpose of the issuance was sufficient to allow a conclusion to be drawn as to its possible effect on the price of Punch shares, and that, the price would drop. In particular, the FSA referred to the following factors:

- the size of the issuance by comparison to Punch's market capitalisation;
- the issuance was being made when the market was not expecting it since an announcement by Punch six weeks earlier suggested that the Firm was financially on track; and
- the reasons for the issuance, namely to reduce debt and avoid a covenant breach, albeit Punch would still have significant debt afterwards.

Was Mr Einhorn entitled to rely on Punch management and their professional advisers on the call not to give him inside information, having refused to be wall crossed?

One of the most controversial aspects of the case was that the FSA pursued it despite Mr Einhorn's refusal to receive inside information and sign an NDA. He argued that his refusal had an impact on how he interpreted the information provided on the call. He also took comfort from the fact that there were a number of experienced professionals on the call, none of whom raised any concern that inside information had been disclosed, which would itself have constituted market abuse as no NDA had been signed. Perhaps even more re-assuringly from Mr Einhorn's perspective, those on the call did not raise concern when he said on the call that Greenlight might sell its shares in Punch. The FSA's view was that irrespective of the views of those on the call, it did not alter the application of the objective test of whether the information was inside information.

What should Mr Einhorn have done following the call?

In the FSA's view, Mr Einhorn was on notice that the situation was unusual as it involved a conversation with Punch management after he had refused to be wall crossed and that as a consequence he should have sought advice from his compliance or legal team before trading.

Mr Einhorn argued that it was reasonable for him not to consult them as he believed in good faith there was nothing to consult them about. The FSA considered that even though he concluded he had not received inside information, he should have confirmed his opinion with his legal/compliance team or Punch management. In the absence of those steps the FSA concluded he had not taken all reasonable precautions and exercised all due diligence nor that his honestly held belief that he was not committing market abuse was reasonable.

The US perspective

Whilst Mr Einhorn's conduct was found by the FSA to have been in breach of the UK market abuse regime, that same conduct would not likely give rise to insider trading liability under the US's regulatory regime. Absent conduct that can be characterised as "fraud or deceit," Mr Einhorn's trading would not be a violation of US law.

Unlike the UK, the US has no statute expressly prohibiting insider trading. The US Supreme Court has stated that "not every instance of financial unfairness constitutes fraudulent activity under Section 10(b)." Under some circumstances, however, US courts have held that trading based on material, non-public information is deemed "fraud or deceit" in violation of the general anti-fraud prohibition found in Section 10(b) of the Securities Exchange Act of 1934.

Courts have found that insider trading may constitute securities fraud in the US under two theories, referred to as the classical and misappropriation theories. The classical theory covers the use of material, non-public information in trading by corporate insiders who obtain that information by reason of their position within the corporation. Under the classical theory, insiders commit securities fraud by using material, non-public information for personal gain in breach of their fiduciary duties to shareholders. The misappropriation theory applies to corporate outsiders who ordinarily do not owe a fiduciary duty to the shareholders, but who misappropriate confidential information for securities trading purposes in breach of a duty of trust or confidence owed to the source of the information. Under SEC Rule 10b5-2, a duty of trust or confidence exists where there is an agreement to keep the material, non-public information confidential or there is a history, pattern or practice of sharing confidences such that the recipient knows, or reasonably should know, that the source expects that the recipient will keep material, non-public information confidential.

Because Mr Einhorn was not a corporate insider, ie, did not obtain the information by virtue of his position at Punch, he could not be liable under the "classical theory".

Similarly, it is unlikely that he could be held liable under the misappropriation theory, since he owed no duty to Punch, refused to sign a non-disclosure agreement before speaking with Punch's broker and refused to be restricted from trading. Under these circumstances, it is unlikely that a court would find Punch had a reasonable expectation that Mr Einhorn would keep the information confidential. Mr Einhorn therefore engaged in no "fraud or deceit" because he did not trade based on information that he agreed to keep confidential or which was communicated with a reasonable expectation that it would be kept confidential. In the US, the absence of any "fraud or deceit" negates liability.

Lessons learned

In light of the FSA's findings, those subject to the UK market abuse regime need to be more careful than ever. In particular:

- Relying on the issuer's professional advisers may not be sufficient.
- There will be increased emphasis on the need to obtain advice from compliance and/or legal in unusual situations. Firms should therefore, as part of their market abuse systems and controls, consider the types of scenarios in which issuers may disclose inside information.

- As the FSA concluded, no single piece of information amounted to inside information; instead, inferences drawn from the call as a whole led to the conclusion that inside information had been disclosed. Traders will therefore need to be careful to disclose all relevant facts when briefing compliance.
- In some circumstances, UK legal or compliance staff may need to review the recordings of the call so that they can properly evaluate what has been disclosed.

Unlike under US law, investors in UK issuers may face liability if they trade while in possession of non-public information, even if the investors explicitly refuse to keep information confidential.

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If you have any questions regarding this memorandum, please contact Peter Burrell (+44 207 153 1206, pburrell@willkie.com) or the Willkie attorney with whom you regularly work.

Our London office is located at City Point, 1 Ropemaker Street, London EC2Y 9HT, England. Our telephone number is +44 20 7153 1229 and our facsimile number is +44 20 7153 1115. Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

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