Insider dealing and market abuse: The UK's record on enforcement

Paul Barnes,

Professor of Fraud Risk Management

Nottingham Business School,

Burton Street,

Nottingham, UK. NG1 4BU,

United Kingdom.

Paul.A.Barnes@btconnect.com

(44) 1949-850464

www.paulbarnes.org.uk

Abstract

Insider dealing has been unlawful in the UK since 1980 and market abuse, of which insider dealing is just one form, since 2000. It is from this time when the Financial Services Authority (FSA) was established and the creation of these as civil offences that they could be pursued rigorously. It is the purpose of this article to examine the FSA's record of enforcement relative to (i) its estimated level of occurrence and (ii) the US experience.

Paul Barnes, Ph.D. is Professor of Finance and Fraud Risk Management at Nottingham Business School. He has written many academic papers published in journals both in the UK and the USA and a number of books of which *Stock Market Efficiency, Insider Dealing and Market Abuse* is the most recent. Professor Barnes regularly acts as a consultant and expert witness (www.paulbarnes.org.uk). He has acted in a number of high profile financial crime trials in the UK most of which involved stock market abuse and insider dealing.

Insider dealing and market abuse: The UK's record on enforcement

1. Introduction

As a result of the 2007-9 financial crisis, insider dealing (or as it is called in the US, insider trading) has became a matter of public concern and interest. There was the dramatic dawn raid on sixteen addresses in the London area involving 143 officers from the Financial Services Authority (FSA) and others from the Serious Organised Crime Agency (SOCA) in March 2010 (*The Telegraph*, March 23, 2010). There has also been the publication of two best sellers featuring a 'front running' scheme (Moore, 2009) and a 'pump and dump' scheme (Faulks, 2010). It is interesting that, although both novels were supposed to be grounded in fact and representative of today's society and its values, they presented very different impressions of the FSA as regulators.

Despite this, there has been negligible interest in the UK in either insider dealing or market abuse by criminologists (for example Doig, 2006, and Levi, 1999) and counter-fraud specialists have considered them a minor problem (Barnes and Sharpe, 2000). On the other hand, there has been much considerable research by academics in finance, for example Hirshey and Zaima (1989); Lakonishok and Lee (2001); Fidrmuc et al (2006) who are interested in the impact of insider dealing and market abuse on the economic efficiency of the markets.

It is the purpose of this paper, first, to examine what is meant by insider dealing and market abuse and why they are crimes. We then examine how both are regulated in the UK, the law, the actual cases, both criminal and civil. Finally, we attempt to evaluate the performance of the FSA (the principal regulator since 2000) as it has attempted to enforce the law and protect the markets and participants from abuse.

2. What are insider dealing and market abuse and why are they serious crimes?

Whilst the public is well aware of insider dealing and what it is (simply the buying or selling of shares before the public disclosure of information which is likely to affect their price and, as a result the inside dealer gains an advantage over those not privy to the private information), this may not be so with market abuse. Market abuse is a more general term to describe actions by those involved in the markets (investors, brokers, financial advisers, market makers, companies and their employees) that unfairly take advantage of other investors, e.g. providing false information about a company's performance, thereby creating a misleading impression of its economic value and, therefore, a false market in the shares.[1] Another example, is attempting to create a misleading impression of the market in the shares by simply repeatedly buying and selling them in order to raise the reported volume of trade in the shares. There may be many reasons why traders may attempt to do this; for instance, to arouse interest in a company's shares in order to force the price up or down. These

[1] As is shown later, one form of market abuse is insider dealing.

actions, of course, distort and undermine the market, thereby damaging the interests of its ordinary participants.

In order to encourage investment and savings, it is in the public interest that investors are provided with reliable and trusted information. It is only then that they will be prepared to invest and businesses will be provided with the necessary funds and the money channelled into the most worthy areas. [2] For this reason, the law and regulations relating to the informational aspects of the UK stock market are considered to be very important. Not only must the market be fair, it must be seen to be fair and no one should be seen to be at a disadvantage. Although individuals should be rewarded for making good decisions, they should not be able to profit from privileged access to private information in order to take advantage of those without access; nor should they be able to manipulate financial information in order to mislead others.

Nevertheless, it is sometimes said that market abuse and insider dealing are not immoral and are victimless crimes (Hannigan, 1988). Whilst the main reason for them to be treated as crimes is to protect the efficient workings of the financial markets and encourage investment and saving, they are also regarded as crimes both against society and individuals and, therefore, morally wrong (Werhane, 1989). A person who buys a stock because he has inside information in the knowledge that when it is released the share price will rise is defrauding and stealing from the person who agrees to sell the shares but would not have agreed to do so at that price had he also been privy to that information.[3]

2. Insider dealing

2.1 The basic forms

Insider dealing is defined by the Criminal Justice Act 1993, ('CJA'). Section 52 states that an individual who has information as an insider is guilty of insider dealing if he/she deals in stocks or shares whose price will be affected by that information when it is publicly disclosed. In its simplest form, insider dealing may simply be the buying of shares in a publicly listed company that the insider (e.g. a director or executive of one of the companies involved or an employee of an advising merchant bank) knows is about to be the target of a takeover and as a result, its share price will rise significantly. Another common example is where an insider knows a publicly listed company is about to issue a profit warning (a public statement that it will not be able to earn the profits that it has been forecasting and the market expecting) and that, as a

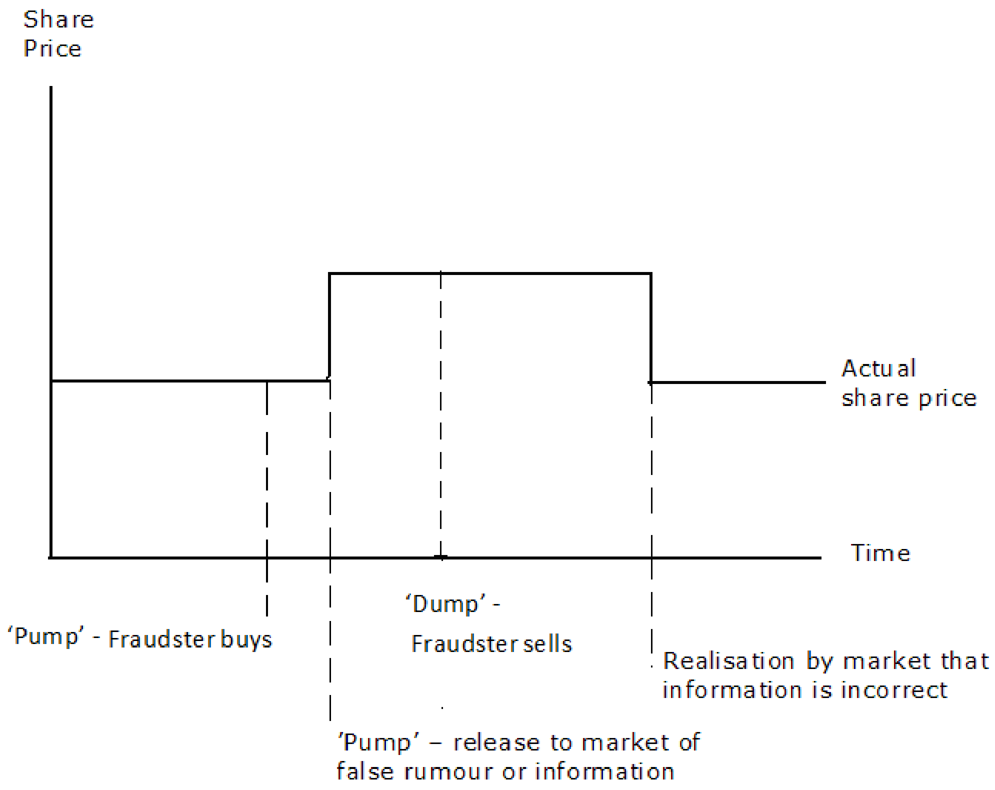
---

[2] This is referred to by financial economists as 'informational efficiency' which is a condition (but not a sufficient condition) of 'allocative efficiency', a term referring to the allocation of scarce resources in an economy where they are most needed (Barnes, 2009).

[3] For instance in the AIT case described later, it was argued and a number of fund managers were presented as witnesses to show, how they had made investment decisions based on the misleading information and as a result their funds (which included public pension funds) had incurred large losses.

consequence, its share price will fall when the announcement is made. Here, the insider may decide to profit from the situation by selling shares that he/she already owns before the price fall or even 'short sell' or make a spread bet on the expected price fall [4]. There are many other types of announcement that may affect a share price from which an insider may profit if he/she knows of before they are made.

Figure 1
'Pump and dump' or share 'ramping'.



[4] Short selling involves borrowing shares, selling them to a third party, then buying them back when the price falls. Financial institutions holding stocks or shares are often prepared to lend shares in this way for a commission (FSA, 2009c). Spread betting is a type of gambling that may be done with a specialist firm where the punter bets that a stock will rise or fall by a specified amount (FSA, 2010b).

There are other more complicated forms of insider dealing.

'Pump and dump' and 'trash and cash'.

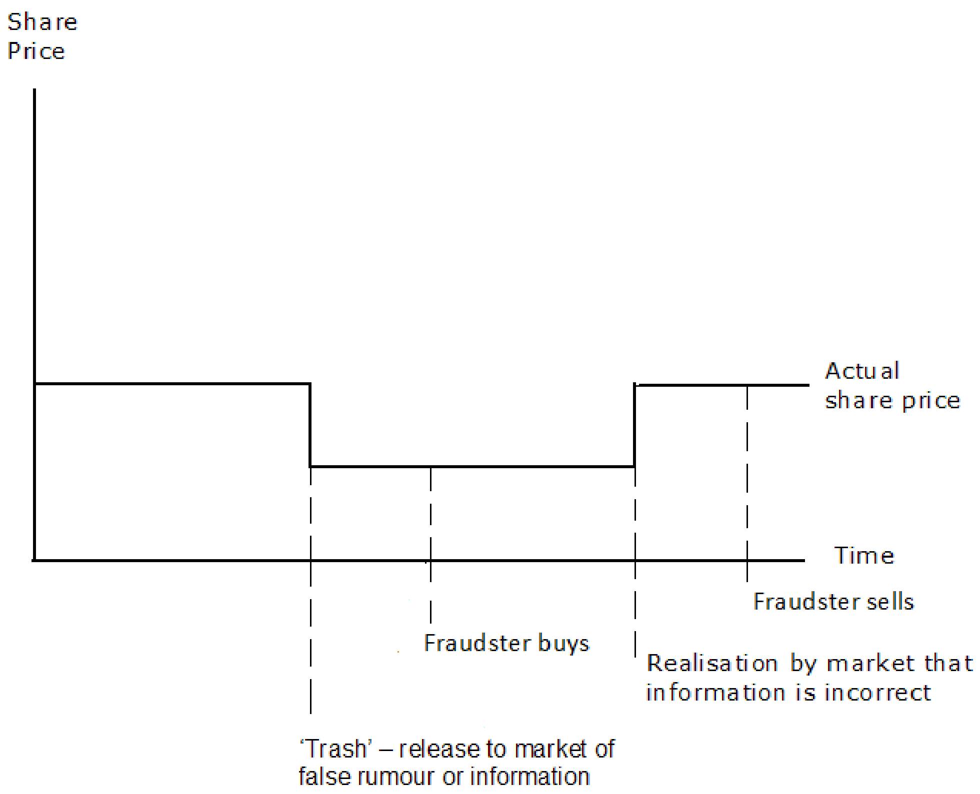
A person may attempt to make a profit by inflating a share price. This is known as 'share ramping' (SFO, 2010) or in the USA as 'pump and dump' or 'short and distort' (SEC, 2010). It may be done in a number of ways. The fraudster may try to influence the share price by broadcasting new information that will affect the share price. This may be done, for example on the Internet through a chat room, notice board or simply emailing investors. This news may or not be true - it doesn't matter. See Figure 1. The important point is not that the information is correct but that the market believes it – and a sufficient number of individuals believe it – to affect the share price. If it is untrue, eventually the market will realize this and the share price will revert to what it was originally, as Figure 1 shows. The fraudster, therefore, has two opportunities to make a profit. In addition to profiting from the pump, he could then short sell, use a CFD or a spread bet, to profit from the fall in the share price when the market realises that it has been misled.[5] The main difficulty for the fraudster, is that the information may not have credibility and not enough people would be prepared to believe the information. Nevertheless, it may be achieved if the perpetrator is a journalist, as in the City Slickers case described later, or in an influential position in the City.

The investor may also profit from 'bad news' by 'trash and cash', the opposite to 'pump and dump'. See Figure 2. Here, instead of releasing false good information to push up the share price, the investor releases false bad information ('trashing' the company) to force it down. Again, the fraudster has two opportunities to make a profit. He may short sell, use a CFD or a spread bet, to profit from the fall in the share price. Later, he may buy at the artificially low price with a view to profiting from them when the market recognizes the information is wrong and the share price rights itself. Short selling and the spreading of rumours involving 'trash and cash' schemes at the time of the credit crunch when the stock market became so volatile became the subject of so much criticism that short selling of bank stocks was prohibited. Although there were rumours of 'trash and cash' schemes and an investigation into share dealing in HBOS, no evidence was found and no charges made (*The Sunday Times*, March 20, 2008).

[5] A contract for difference (CFD) is a contract designed to make a profit or avoid a loss by reference to movements in the price of a stock. The stock is not bought or sold itself.

Figure 2

‘Trash and cash’ or ‘short and distort’



Front running
This is the purchase or sale of stocks or shares on the basis of advance knowledge of a large purchase or sale that will affect the price (FSA, 1999). For example, an employee of a financial adviser buying shares knowing that a client will be purchasing a large block of shares in a few days' time. A recent case was where the FSA fined and banned Nilesh Shroff, a trader at Morgan Stanley, who "pre-hedged" clients' trades on seven occasions without their consent (FSA, 2009d).

2.2 The main perpetrators

The general view is that most of the insider dealing is done by those in the city with access to inside information in their professional capacity. For example, *The Financial Mail*, January 2005, refers to 'a small army of Square Mile professionals' and as long ago as 1987, *The Financial Times* (2 July) estimated that between a quarter and a half of all insider dealing is attributable to city firms acting as advisers. This estimate is unlikely to have changed. Barnes (1996) found that almost 75 per cent of the rise in a target's share price at the time of a bid occurs before its announcement. When this was analysed between bidders' advising merchant banks, it was found that this occurred significantly earlier in the case of two major advisory firms than others, suggesting their association with the leakage.

Despite this, most of the cases that have come to the courts and have been successfully prosecuted are small, probably one-off instances. A director or a friend of his/her, say a secretary or assistant, acquires a piece of inside information, either good news or bad news. He/she will invest if it's good news and sell when the information reaches the market and the share price rises. Typically, he/she does not 'dabble in stocks and shares' and does not think to cover the transaction even though they probably know it's illegal. In most cases, they will not be discovered because so minor case making it difficult to trace. For such a transaction to be noticed, it must be a very large purchase or sale to affect the price and the volume of trading data or simply be so large or so perfectly timed as to appear suspicious. However, if the person is caught, it is usually obvious what has been happening as the individuals concerned have made no attempt to disguise or hide their share dealings.

The City view and that of financial commentators is that at a particular point in time a number 'rings' exist. Newspapers have from time to time even gone so far as stating a ring's name - but not those of the participants, of course. Typically, this would involve an individual (or a small group of individuals) who regularly have access to insider information, whether as members of corporate advisory teams advising on takeovers and mergers or even lower status employees with access to this information who pass it to a friend or relative or group of friends to invest. (The FSA has been critical of the unnecessarily large number of 'insiders' involved and privy to confidential information on a typical deal in a financial institution, how the financial institution and its IT system attempt to keep the information secret (FSA, 2007)). However, because they are aware of the implications, rings ensure that their tracks are covered and it has been very rare for a ring to be discovered and successfully prosecuted.

In a recent investigation by *The Sunday Times*, 6 June 2010, an acknowledged insider dealer described how rogue trading cells worked. 'There is one insider [dealer] and then there's a number of people in the chain of information. The person who actually trades is a long way from the source. Each member of the chain has an incentive to keep quiet because they receive a cut of the illegal transaction. The more links in the chain, the more difficult it is to get caught. If you have some guy [trading] who is only tangentially connected or not connected at all [to the insider], how would the FSA know?' Another convicted insider dealer said offshore companies and bank accounts were ideal for disguising the money trail that leads to a trade – and for throwing the FSA off the scent. 'You set up an offshore company in Belize, let's say, and maybe I use a bank in Malta or Gibraltar and I deal [in] the name of that company, there's no way they're going to find out who's behind that company'.

Two 'rings' have been successfully prosecuted under the criminal legislation.

Butt and others in 2004

This case centres on a city professional, Asif Butt, former vice-president of compliance at Credit Suisse First Boston. Butt was found guilty of using confidential information about clients over a period of about three and a half years (*The Times*, December, 21, 2004). Mr Butt worked in the secure zone of the bank known as the Compliance Control Room. This existed to ensure the secrecy of dealings. However, it gave Butt access to highly confidential inside information that was price sensitive relating to the status and performance of companies which the bank were advising. Mr Butt fed the information to friends outside the bank, Ian Beale, Alexander Coleman, Richard Judson and Daniel Masters who either bought shares or placed spread bets of up to £600,000 before important financial announcements.19 transactions were presented at the trial. Seven involved advance knowledge of profits warnings and 12 concerned confidential information that a company was about to become the subject of a hostile bid or recommended takeover. Companies included Chubb, EMI and Johnson Matthey, Charter, Grantchester, Sedgwick and Royal Bank of Scotland's bid for NatWest. The friends used a schoolboy code in correspondence in which Butt was 'The Walrus' and Masters 'The Jackal'. The total profits made were estimated at £388,488 and losses at £100,681, the net gain being £287,807 in which Butt's share was more than £237,000. It was claimed that as there were many other similar transactions not mentioned in court, the actual figure was probably much larger.

Gray, Liggins, Rowlands and Riding in 1992

David Gray was a stockbroker, William Liggins, a fund manager, Catherine Rowlands, an investment analyst, and Mark Riding, a fund manager (*The Times*, August 5, 1994). They were part of a 'network of friends' ready and willing to pass insider information between themselves. They were charged in respect of two separate incidents in 1988. The first was the planned takeover of two cellular phone companies by the Hawthorn Leslie Group Plc. The second was the Australian group Goodman, Fielder, Wattie's bid for Rank Hovis McDougall. The case resulted from a Department of Trade and Industry (DTI) investigation into dealings in shares of Pleasurama, a leisure group, at a time when Mecca Leisure was making a takeover bid. The DTI said there had been many other highly suspicious dealings in Pleasurama shares and not all the individuals involved had been charged.

However, more recently organised crime has been added to the list of likely perpetrators. In June 2010, the FSA warned of a new development - the targeting of insider dealing by organised crime and terrorists. The connections between organised crime, terrorists and insider dealing are not new. It was reported in *The Sunday Times*, September 18, 2001, that the CIA had asked the FSA to help investigate the short selling of an unusually large number of shares in airlines, insurance companies and arms manufacturers immediately before the terrorist attacks in the World Trade Centre in New York. The price of the shares dropped dramatically after the attack, enabling the short sellers to make millions of dollars. If the CIA could have traced the short sellers who had acting on the inside information of the forthcoming attack, this could have led them to the terrorists.

3. The law: prevention and prosecution

The objective of the legislation is to ensure that there is a fair market in a company's shares and that everyone has full and similar information on which to make buy, sell and hold decisions. In order to achieve this the period during which 'price-sensitive' information exists but is not available to the general public is minimized. As a result, companies and their advisers have a major obligation to ensure that it is reported immediately and properly through a regulated information service.[6] In addition to these preventative measures, it is also, of course, unlawful to trade on inside information.

3.1. Prevention: the FSA's controls

Under the Financial Services and Markets Act 2000 (FSMA) section119, the FSA as the main UK regulator is required to produce a code. It is known as, 'The Code of Market Conduct' and specifies behaviour amounting to market abuse. This is to be seen in terms of what the FSA calls 'principles-based regulation' involving a set of broad principles, detailed rules resulting in various systems and controls that listed companies and advisory firms use and apply.

Effectively, the controls place stringent obligations both on the company (referred to as the 'issuer') and the financial advisers etc (referred to as 'firms'). Under the 'Listing Rules', a listed company must notify a Regulatory Information Service ('RIS') of any major or significant developments that are not already public knowledge and affect its financial position or expectations of its future performance that would lead to a movement in its share price.[7] (The Listing Rules were traditionally set by the

[6] For example, in September 2009, the FSA fined Mark Lockwood, a former trading desk manager at a retail stockbroking firm, £20,000 for failing to observe proper standards of market conduct (FSA, 2009b). Lockwood failed to identify and act on a suspicious client order that allowed the firm to be used to facilitate insider dealing.

[7] A RIS is an organisation or firm through which listed companies can release their regulatory announcements. Since 2002 listed companies have had a choice of RIS bringing to an end to the LSE's monopoly for the release of information through its own Regulatory News Service.

London Stock Exchange itself but are now administered by the FSA and effectively have the force of law). In certain situations, the issuer is allowed a short delay in making an announcement in order to clarify the situation when it is faced with an unexpected and significant event.

In respect of firms, the FSA attempts to ensure that inside information is properly managed and leaks prevented. Although the Code does not necessarily specify how, it is concerned that insider lists are properly maintained, information barriers are reasonable, information technology is secure, document access is secure and procedures are in place workable and effective and for Chinese Walls to be effective they should at least be geographically separated. There should be formal procedures in place for passing information to third parties. The FSA's 'Principles for Approved Persons' also relate to market conduct by firms. These require an approved person to act with due skill, care and diligence and apply proper standards of conduct. The FSA also requires firms to submit suspicious transaction reports (STR) if it believes there are reasonable grounds for suspecting a transaction involves market abuse. The FSA operates a computer system known as Sabre (Surveillance Analysis of Business Reporting) which includes a database of market transactions collected from authorized firms, regulated investment exchanges and settlement systems. It has recently developed Sabre II which has the ability to collect and analyze end-of-day transaction reports from investment firms.

3.2 Prosecution

3.2.1 Insider dealing as a criminal offence

Insider dealing was not made unlawful in the UK until 1980 when under Part V of the Companies Act 1980 it became a criminal offence in certain specified circumstances. These provisions were later consolidated as the Company Securities (Inside dealing) Act 1985 ('CSA') which was subsequently amended by the Financial Services Act 1986. The CSA provisions were superseded by the CJA which implemented the current EC Directive on Insider Dealing. The UK legislation has also been revised to incorporate the provisions of the 2003 European Directive on market abuse but it has not changed in any significant way, other than to extend the responsibility of the UK authorities to investigate individuals in the UK linked to market abuse conducted elsewhere in the EU.

Under the CJA it is unlawful for an individual to deal in stocks or shares with inside information which, if it were made public, would be likely to have a significant effect on their price. 'Inside information' is defined by the CJA as information which relates to a particular stock or share or a particular issuer of shares, is specific or precise, has not been made public; and, if it were made public, would have a significant impact on their price, i.e. is price-sensitive.

Most of the larger cases have been prosecuted under the CJA in conjunction with the Criminal Law Act 1977 Section 1 which makes it an offence to conspire to commit an act which would be a substantive offence in criminal law.

Although it has yet to be used for this purpose, market abuse and insider dealing are also likely to be found unlawful under the Fraud Act 2006 which became law in January 2007 and the new general offence of fraud, which can be committed in three ways: by false representation, by failing to disclose information, and by abuse of position. The latter has particular relevance to market abuse and insider dealing as it states that a person is in breach of this section if he: occupies a position in which he is expected to safeguard, or not to act against, the financial interests of another person, dishonestly abuses that position, and intends, by means of the abuse of that position to (i) make a gain for himself or another, or (ii) cause loss to another or to expose another to a risk of loss.

3.2.2. Market abuse as a criminal offence

Market abuse is made a criminal offence under Section 397 of FSMA which replaced section 47(2) of the Financial Services Act 1986. Section 397 makes it unlawful for a person to (i) make a statement, promise or forecast which he knows to be misleading, false or deceptive or (ii) dishonestly conceal any material facts whether in connection with a statement, promise or (iii) recklessly make (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive.

3.2.3. Insider dealing and market abuse as a civil offence

The CJA largely failed as a deterrent because of its reliance on the criminal law (Stamp and Jaggers, 2005). This was recognized by Parliament when it introduced civil penalties for inside dealing as part of its market abuse regime under the FSMA. FSMA extended the powers of regulators to combat market abuse and insider dealing as a form of market abuse. Section 118 of FSMA introduced two new civil offences of market manipulation: false or misleading impression and the distortion of the market. Here, it is unnecessary to show dishonest intention to commit market abuse. Negligent action or inaction may be sufficient. It is irrelevant where the behaviour occurred.

Section 118 states that there are seven types of market abuse. These are listed in Table 1. It also defines inside information (one of the seven types) in a slightly wider sense enabling prosecution under the civil law of cases falling just outside the criminal law, in addition, of course, to requiring a lower level of proof (balance of probabilities rather than beyond reasonable doubt).Inside information under the FSMA is defined as information of a ‘precise’ nature (omitting the additional ‘specific’ requirement under the CJA) which is not generally available, relates directly or indirectly to the stock or share and, if the information were generally available, would have a significant effect on its price.

Table 1
The seven types of market abuse (FSMA, 2000)

1. Insider dealing
2. Improper disclosure - of inside information to another.
3. Misuse of information - behaviour based on information that is not generally available that would affect an investor's decision about the terms on which to deal
4. Manipulating transactions -trading, or placing orders, to give a false or misleading impression of the supply or demand for an investments, raising its price to an abnormal level
5. Manipulating devices - trading, or placing orders, which employ fictitious devices or any other form of deception or contrivance
6. Dissemination - knowingly providing information that gives a misleading impression about an investment
7. Distortion and misleading behaviour - to gives a misleading impression or distorts the market in an investment

3.3. Criminal cases

3.3.1 Insider dealing

As Table 2 shows, 15 of the 30 cases relate to the fraudster either being a financial adviser or acting on information from an adviser as the two cases involving 'rings' described earlier also centred on advisers. The following three cases are of particular interest.

Smith, Spearman, Spearman, and Payne

In January 2004, three of the defendants were found guilty of conspiracy to commit insider dealing (SFO, 2004). Payne worked as a proof-reader at a firm of commercial printers where he saw drafts of prospectuses and offer documents prior to the announcement of a bid on the LSE. He passed this information on to the other defendants, who were not city professionals but business people working outside London, who bought shares. 27 takeover or merger transactions were presented at the trial. Profits earned by the defendants amounted to a total of £336,000. The Court of Appeal upheld sentences of 18 months' imprisonment for Smith and Catherine Spearman, and 21 months for Payne. Richard Spearman, who had pleaded not guilty, was found guilty on 4 June 2004 after a retrial and sentenced to 30 months' imprisonment. Substantial confiscation orders and cost orders were also made. Because of its size, the case was investigated and prosecuted by the Serious Fraud Office. The case was also significant for the use of telephone tapping by the investigators.

Porter and Daw

Although this was a small case, it is interesting because it was perpetrated by regulators (*The Telegraph*, September 12, 2000). Stephen Porter and Julian Daw were employees of the London Stock Exchange (LSE) in its Companies Announcements office handling price-sensitive information about listed companies before releasing them via the Regulatory News Service (RNS).

In July 1997, Mr Porter received information concerning merger talks between Capital Transport Rental Group (CTR) and General Electric Capital Corporation. He passed that information on to Mr Daw before putting out an announcement on the RNS. Mr Daw, who no longer worked for the LSE at the time, then passed the information on to a third party who arranged for shares in CTR to be acquired. The shares were sold the next day for a profit of £6,000, although there was no evidence that Mr Porter or Mr Daw profited from the sale. In November 1997, the process was repeated in relation to a potential takeover of Faber Prest but there was not enough time to buy shares before the announcement was made. Mr Daw was fined £1,000 for each of the two offences, plus costs of £3,000. Mr Porter was sentenced to six months in prison.

Calvert

Malcolm Calvert was a partner at Cazenove who received information from a mole at the firm on forthcoming deals (FSA, 2010). He passed on the information to a friend, Bert Hatcher, who bought shares in various companies about to be the subject of a takeover. Although the number of inside trades brought to court was relatively small, this case is of particular significance because of a policy shift in which Hatcher was allowed to receive immunity from prosecution in return for giving evidence against Calvert. Mr Calvert was found guilty and sentenced to 21 months' imprisonment.

Table 2

Criminal cases of insider dealing since it became an offence

Year	***Cases***	***'Ring'***	***Adviser or Information from an adviser***	***Director***	***Information from a director***	***Information from or as a Regulator***	***Not known***
1981	2		1	1			
1982	1		1				
1986	1			1			
1987	2		1		1		
1988	1			1			
1989	3		1	1		1	
1990	2				2		
1991	1				1		
1992	1	1					
1994	1		1				
1995	1		1				
1996	1		1				
2000	1					1	
2001	4				1	1	2
2003	2		2				
2004	1	1					
2009	3		2		1		
2010	2		2				
Total	*30*	*2*	*13*	*4*	*6*	*3*	*2*

3.3.2 Market abuse

There have been two cases (the AIT prosecuted by the FSA and the City Slickers case prosecuted by the DTI) since 1986 when it became an offence. Both of these occurred in 2005 and in both cases the five individuals concerned were found guilty, four of whom went to jail.

AIT

This case involved recklessly making a statement to the market which was misleading. AIT was a software design company listed on the LSE (FSA, 2005c). On 2 May 2002, AIT issued a trading statement which reported that its turnover and profit were going to be in line with the market’s expectation of £47m and £6.7m, respectively. This included revenue and £4.8m of profit from three contracts that had not yet been entered into so as to legally bind the parties which under normal accounting practice should not have been included. On 31 May 2002 an update was issued stating that the 2 May statement was no longer accurate because one of the contracts had not been confirmed, leading to a £1.1m shortfall in revenue and profit. The statement also noted that short term cash requirements were unlikely to be covered by AIT's current borrowing facilities and other cash resources. All this caused the share price to fall from 492.5p to 96.5p. On 13 June 2002 a further statement was issued announcing that AIT would not publish preliminary results that day because of issues that had arisen in the company's audit and that there would be a further shortfall in revenue and profit. The share price fell further from 105p to 38.5p. Following the announcements, the company was forced to restructure and seek new finance. Its CEO and CFO were charged with recklessly making a statement, promise or forecast which was misleading, false or deceptive contrary to the market abuse regulations in Section 397 of the Financial Services and Markets Act 2000. In August 2005 both were found guilty and AIT’s CEO at the time, Carl Rigby, was sent to jail.

City Slickers

This case involved two journalists and a friend operating what was effectively a ‘pump and dump’ scheme (*The Times*, 11 February 2006). James Hipwell and Anil Bhoyrul were financial journalists employed by *The Daily Mirror* to write a regular column entitled ‘City Slickers’. The column was devoted to reporting rumours and making recommendations to readers to buy and sell shares based on these. They discovered that the column was widely read and influential to such an extent that as a result of a tip, the share price invariably rose. They started buying shares prior to the tip appeared in their column contravening both the journalistic code and the law.

Table 3

Civil cases of market abuse since it became an offence

Year	Cases	The Seven Types of Market Abuse							Contrary To FSA Principles
		Insider Dealing	Improper Disclosure	Misuse of Information	Manipulating transactions	Manipulating Devices	Dissemination	Distortion & misleading behaviour	
2003	1				1				
2004	8	3	1				2	1	1
2005	5	3			1				1
2006	4	2	1						1
2007	2		1						1
2008	4	3	1						
2009	7	5	1						1
2010	6	3					1	2	
Total	37	*19*	*5*	*0*	*2*	*0*	*3*	*3*	*5*

3.4. Civil cases

3.4.1. Insider dealing and market abuse

As Table 3 shows, half of the cases relate to insider dealing offences, most of which (but not all[8]) for whatever reason could not have been prosecuted as criminal cases. For example, Arif Mohammed was an employee of PricewaterhouseCoopers and a member of its Delta plc audit team. In November 2002 he obtained confidential information that Delta intended to sell its electrical division and on 29 November 2002 he bought shares in Delta (FSA, 2005a). The sale of the electrical division was announced on 10 December 2002 whereupon Mr. Mohammed sold his shares, making a profit of £3,750.

The largest case is that of Shell FSA (2005b). A £17m fine was imposed on Shell as a result of, what was described as 'unprecedented misconduct' in relation to misstatements of its proved reserves. When Shell first publicly revealed on 9 January 2004 that it had misstated its reserves, its share price fell 7.5 per cent, from 401p to 371p, reducing its market capitalisation by approximately £2.9bn. A number of factors made Shell's abuse of the market particularly serious. It had made false or misleading announcements in relation to its hydrocarbon reserves and reserves replacement ratios between 1998 and 2003. These announcements were made despite indications and warnings from 2000 to 2003 that they were false or misleading. Shell did not correct the information it had disclosed until the publication of its results for the period 9 January to 24 May 2004 when it announced the re-categorisation of 4,470 million barrels of oil equivalent, approximately 25 per cent of its proved reserves.

[8] See Footnote 5 above.

Table 4

Penalties imposed by FSA for breaches of the Listing Rules

Year	Cases	Fine
2003	2	Both censured
2004	2*	Companies: censured and £90,000 Individuals: £45,000,£10,000
2005	3	£450,000, £240,000,Censured
2008	1	£350,000
2009	2	£140,000, £245,000
Total	*10*	

*2 companies plus, in each case, an individual.

3.4.2. Penalties imposed by FSA for breaches of the listing rules

Since 2003, there have been ten cases. See Table 4. These relate to instances where a company has failed to inform the market of information likely to affect its share price. For example, the FSA fined Wolfson Microelectronics plc £140,000 for breach of the Listing Rules for a delay of 16 days in announcing inside information to the market (FSA, 2009a). On 10 March 2008, Wolfson was informed by a major customer that it no longer required Wolfson to supply it with parts for its product. Wolfson estimated that the loss of the contract would amount to a loss of $20 million (8% of its forecast revenue for 2008) but it did not announce the negative news until 27 March 2008.

4. The frequency of occurrence and likelihood of discovery of insider dealing and market abuse

The only ‘official’ estimate of the extent of insider dealing (and, therefore, the probability of discovery and prosecution) is that of the Trade and Industry Committee report to the House of Commons on 2 May 1990 (Trade and Industry Committee, 1990). It stated that since May 1988 the LSE had conducted about 240 investigations into possible insider dealing cases and had passed about two a month to the DTI. Between 1985 and 1990, 101 cases had been transferred in this way, inspectors being appointed in 41 cases which resulted in 19 prosecutions and ten convictions.

The FSA has attempted to estimate the amount of insider dealing at the time of a merger announcement (Dubow and Monteiro, 2006). They examined the share price change in excess of that which would be expected from the change in the market as a whole, around the date of the announcement - the pre-announcement window (two trading days prior to the day of announcement) and the post-announcement window (the day of announcement and the next trading day). Dubow and Monteiro called these informed price movements (IPM). They then computed a 'market cleanliness index' as the total number of announcements in which a statistically significant IPMs had occurred as a percentage of the total number of announcements in which there had been a statistically significant price change (SA), i.e. IPM/SA. Between 2000 and 2005, Dubow and Monteiro found that between a third and a quarter of all merger bids involved statistically significant price changes immediately prior to their announcement. For a significant pre-announcement abnormal performance to occur, there must have been some degree of insider dealing, possibly a considerable amount to eventually affect the share price. However, what is disturbing is that the study probably understates this occurrence for takeovers and mergers because it is using such a short window. A period of two days is clearly insufficient to measure the total share price adjustment prior to a merger announcement.

There have been studies by academics. Barnes (1996, 2009) used a much wider window than Dubow and Monteiro (2006): two months prior to the announcement. He found that share prices of target firms increased by 31 per cent over the period two months before the announcement to one month afterwards (it is usual for a premium of 30% to be offered to targets) and 23 per cent (almost three quarters of the total movement) occurred before the announcement. Further, there were significant price changes in more than 90% of the cases. In other words, rather than between a quarter and a third of merger announcements involve a significant share price movement prior to the announcement, implying insider dealing, when a wider window is examined, this occurs in almost every case.

Generalising from these empirical studies, assuming that there are about 150 takeover bids a year and about 50 profit warnings (these will, of course vary considerably according to economic conditions) and if on average there are five people trading on inside information,[9] this means there are 1,000 instances of insider dealing a year. This compares with on average between one and two criminal prosecutions per year. The chances of being caught are, therefore, one in 500 at least.

Now that there is a reporting system of suspicious transactions, this is possible. Between 2005, when the system began, and June 2010, there have been 1,485 STRs, although the majority did not trigger an investigation (*The Sunday Times*, June 6, 2010). On the basis that since then seven individuals (in three cases) have been found guilty of insider dealing, the chances of discovery and criminal conviction are one in 200.

There have been fewer estimates of the extent of market abuse although if the number of criminal and civil cases is indicative, whilst it may not be so common, it may have a serious impact. The principal study is also to be found in Dubow and Monteiro (2006) who also examined FTSE 350 companies' regulatory disclosures, trading announcements under such headings as "trading statement", "trading update", "contract award" or "drilling report". They showed that IPMs also occurred. These results are in line with two other unpublished studies of relating to profit warning announcements by Bulkley and Herrerias (2002) and Bulkley et al (2002) who found

[9] This estimate is based on the belief that there is a significant of insider dealing so as affect the company's share price in almost every case.

a significant amount of abnormal share price performance during the five days prior to the warning announcement.

5. Conclusions

We have attempted to review the UK's experience in relation to market abuse and insider dealing since they effectively became unlawful. The cases that have been successfully prosecuted need to be seen in the context of the severity of the offence and the frequency of the abuse. Clearly, insider dealing and other forms of market abuse undermine the efficiency of the stock market. If left unchecked, this would lead to a belief that the stock market in the UK is unfair allowing investors with inside information to take advantage of those without it. Further, companies and individuals are able to rig and manipulate the market. Both forms of market abuse discourage investors and investment and, for this reason, it is in the public interest to regulate against such behaviour.

Although insider dealing was made unlawful as long ago as 1980 in the UK, it was not until 2000 and the passing of the FSMA and the creation of the civil option and the formation of the FSA as the principal regulator that it and market abuse could be pursued rigorously. Since then, the FSA has been the principal prosecutor and, with just two exceptions, been responsible for the investigation and prosecution of most of the civil cases. Although, before 2000 many of the cases brought (mainly by the DTI as the principal enforcing agency) failed, the FSA has been successful in all but one of the criminal cases[10] it has brought to court.

The general impression is that insider dealing and market abuse have not been eliminated over the last decade but probably continue today at a similarly high, if not higher rate. They are now also seen as symptoms of the malaise in the markets over the period leading up to and during the 2007-9 financial crisis. Nevertheless, perpetrators must now be more aware of the real risks they take. Even though probabilistically these may be slight, the penalties are high, involving imprisonment in most of the criminal cases and high fines in the civil cases. On top of these are the disgrace and loss of career. The typical case that goes to court is of either a company director (or his associate) or an employee of an advising merchant bank being caught in a quite minor case yet as a consequence his career is ruined

The criticism of the FSA's record is not just that there have been relatively few cases or that it has been unsuccessful bringing proceedings, but that it has failed to catch a large ring or City professionals operating on a grand scale. Since 2005, there have been just seven criminal convictions in the UK for insider dealing[11] plus five more for other forms of market abuse[12] whilst in the US there were 534.[13] Whilst the US stock

---

[10] The case of King, McFall and Rimmington in 2010.

[11] See Table 2. Two cases involved four individuals, two each.

[12] Two cases, both of which are mentioned in the text: the City Slickers case involving three individuals and the AIT case involving two.

[13] For a discussion of the US experience see Brody (2009).

market is larger, it is not that much larger. The market value of stocks on the NYSE is \$12 trillion compared with \$2.4 trillion on the LSE. With the exception of the March 2010 raid mentioned in the Introduction, despite regular claims by financial commentators of the existence of ‘rings’ there have been no large prosecutions in the UK since the Butt and others case which came to court in 2004. In the US there have been a number of large cases, beginning with Ivan Boesky who was fined \$100m and sentenced to 42 months and Ebbers at WorldCom who was sentenced to 25 years. The most recent is that of Joseph Naccio, former CEO of Qwest Communications who was fined \$71m and jailed for six years (*The Sunday Times*, June 6, 2010). The longest UK prison sentence has been 30 months. Until it has been able to successfully prosecute a large City ring, the FSA or its replacement will continue to receive criticism for allowing most cases of insider dealing undiscovered and not prosecuted.

References

Barnes, P. (1996) 'The Regulation of Insider Dealing in the UK: Some Empirical Evidence concerning Share Prices, Merger Bids and Bidders' Advising Merchant Banks', *Applied Financial Economics*, 6:383-391.

Barnes, P. (2009) *Stock Market Efficiency, Insider Dealing and Market Abuse*, Aldershot, UK, Gower.

Barnes, P. and D. Sharpe (1999), *The Fraud Report*, Association of Certified Fraud Examiners, Leicester.

Brody, S. (2009) 'Criminal Insider Trading: Prosecution, Legislation and Justification', *Journal of Applied Economy*, 4: 85-100.

Bulkley, G. and R. Herrerias (2002) 'Stock Returns following Profit Warnings', University of Exeter working paper.

Bulkley G., R.D.F. Harris and R. Herrerias (2002) 'Stock Returns following Profit Warnings: A Test of Models of Behavioural Finance', University of Exeter working paper.

Doig, A. (2006). *Fraud.* Cullompton : Willan

Fidrmuc, J., M. Goergen, and L. Renneboog, 2006 'Insider Trading, News Releases and Ownership Concentration', *Journal of Finance* 61: 2931-2973.

Hannigan, B. (1988). *Insider Dealing*, Kluwer, London.

Hirshey, M., and J. Zaima, 1989 'Insider Trading, Ownership Structure, and the Market Assessment of Corporate Sell-offs,' *Journal of Finance*, 44: 971-908.

Lakonishok, J., and I. Lee, 2001, 'Are Insider Trades Informative?' *Review of Financial Studies* 14: 79-111.

Levi, M. ed. (1999) *Fraud: organization, motivation and control*, Aldershot, Ashgate.

Dubow, B and N. Monteiro (2006). *Measuring Market Cleanliness*, FSA Occasional Paper, March 2006.

Faulks., S. (2010). *A Week in December*, London, Hutchinson.

FSA (2007) 'Thematic review of controls over inside information relating to public takeovers' *Market Watch*, 21.

Moore, C. (2009) *City of thieves*, London, Sphere.

Stamp, M. and T. Jaggers (2005) 'United Kingdom' in Stamp, M. (ed.) *International Insider Dealing*, Old Woking, City & Financial Publishing.

Trade and Industry Committee (1990) *Third report, Company Investigations* (House of Commons Session 1989-90, 2 May, 1990) HMSO, London.

Werhane, P.H. (1989) 'The Ethics of Insider Trading', *Journal of Business Ethics*, 8(11): 841-45.

Web references

FSA (1999) http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter15.pdf

FSA (2005a) http://www.fsa.gov.uk/pages/library/communication/PR/2005/pr034.shtml

FSA (2005b) http://www.fsa.gov.uk/pages/library/communication/PR/2005/074.shtml

FSA (2005c)http://www.fsa.gov.uk/pages/library/communication/PR/2005/091.shtml

FSA (2009a) http://www.fsa.gov.uk/pubs/final/wolfson_20jan09.pdf

FSA (2009b) http://www.fsa.gov.uk/pages/library/communication/PR/2009/091.shtml

FSA (2009c) http://www.fsa.gov.uk/pubs/other/short_selling_FAQs_V2.pdf.

FSA (2009d) http://www.fsa.gov.uk/pages/library/communication/PR/2009/066.shtml

FSA (2010a) http://www.fsa.gov.uk/pages/library/communication/PR/2010/041.shtml

FSA (2010b) http://www.fsa.gov.uk/pubs/hb_releases/rel27/rel27glos.pdf.
SEC (2010) http://www.sec.gov/investor/pubs/pump.htm
SFO (2004) http://www.sfo.gov.uk/press_room/latest-press-releases/pressreleases-2004.aspx
SFO (2010) http://www.sfo.gov.uk/fraud/what_is_fraud/corporate-fraud/share-ramping. aspx.