Chapter 1

Introduction

1.1 Background

Information is the most valuable commodity in the securities markets. Disclosure by an issuer of its financial position and outlook is a significant factor in determining the value of its securities. In the efficient market hypothesis the price of a security fully reflects all of the information available about its issuer and its business. In reality, the securities markets are not perfectly efficient, indeed if they were, there would be no incentive to collect information about an issuer as its securities would already be perfectly priced.

Asymmetry of information means that there is a risk that a security may be mis-priced and that certain adverse outcomes might result:

- Those with privileged access to information about the listed company may misuse that information. Although shareholders own a public company, the business is run by directors, who are appointed by them and with whom there may be potential misalignment of objectives and incentives. This misalignment, often referred to as the *agency problem*, can, amongst other things, be a factor in frustrating the supply of information about a company to the market. Directors and senior managers are frequently likely to have inside information[1] about the company that is not reflected in the share price and there may be nefarious reasons why the information is not disclosed promptly to the market, ranging from ineptitude and poor systems to a corrupt desire by insiders to preserve informational monopolies. For example, a director's continued employment or level of compensation may be contingent on share price performance

[1] As defined in Section 118C Financial Services and Markets Act 2000 ("FSMA").

which may incentivise him to withhold inside information capable of damaging the share price, or he may trade on, and/or disclose the information to another, before disclosing it to the market. Such incentives may lead to less efficient disclosure of inside information.

Many of the most notable and high profile corporate failures of recent years (e.g., Ahold, Enron, Parmalat, Tyco, Worldcom) had as a key feature the non-disclosure or ineffective disclosure of inside (usually financial) information by corrupt management. The market alone was incapable of reining in errant directors and managers of public companies, and properly aligning their interests with those of shareholders (or indeed, other stakeholders) and crises of confidence in the capital markets resulted.

- The overall level of market efficiency is compromised if investors withdraw from the market believing that they do not have equal access to information on which to base investment decisions. There is evidence that markets malfunction and suffer decreased liquidity where there is a lack of reliable information or asymmetric information, while those markets with stricter disclosure and insider dealing laws are more liquid. Insider dealing and poor disclosure causes some potential investors to refrain and others to demand an effective risk premium for their involvement in the market resulting in an increased cost of capital raising with attendant adverse consequences for macroeconomic development. In short, an efficient securities market inspiring public confidence and fostering economic development requires market integrity.[2]

A full exposition of the theoretical and empirically based arguments relating to inside information and its use is beyond the scope of this book and it suffices for our purposes to note that there is a wide diversity of views. Some academics, for instance, conversely suggest that trading by insiders of inside information enhances market efficiency because it enables the price of securities to adapt to the inside information more rapidly, and that it is an efficient form of managerial compensation because it reduces the conflict of interest between

[2] Paragraph 2 – Recital to MAD.

managers and shareholders.[3] Notwithstanding the diversity of views there is an increasing consensus that good standards of corporate governance can be effective both in protecting shareholders (and other stakeholders) and maintaining the integrity of the markets. The trend globally has been to both a broader regulatory remit and a stronger approach to regulatory enforcement. Ideally this is balanced with an appreciation that over regulation or inappropriate regulation can unduly inhibit entrepreneurial and legitimate risk taking and also add to the costs of raising capital.

In the UK there has long existed a requirement on listed companies to disclose to the market price sensitive information about itself, and corollary offences of insider dealing. In July 2005, the UK's official listing regime underwent significant reform, partly as a result of the implementation of the Market Abuse Directive ("MAD"). The most important new requirements in relation to inside information are found in the Disclosure Rules which replaced the rules on the disclosure of price-sensitive information ("PSI") in Chapter 9 of the previous Listing Rules. The new Disclosure Rules, inter alia, require listed companies to:

- publish inside information as soon as possible (unless a delaying provision applies);
- ensure there is proper control of inside information;
- keep insider lists of persons working for them with access to inside information; and
- ensure "persons discharging managerial responsibilities" ("PDMRs") (and their "connected persons") disclose transactions in the company's securities.

This book addresses the law and regulation with respect to inside information found in FSMA, the FSA handbook, various exchange

[3] Henry G. Manne, Insider Trading and the Stock Market (1966); Insider Trading: The Value of Asymmetric Information created by Tradable Securities and its implications for Disclosure – Ashraf Jaffer – LSE Financial Markets Group; Dennis W. Carlton and Daniel Fischel, The Regulation of Insider Trading, 35 *Stanford Law Review*; cf Norman S. Douglas, Insider Trading: The Case Against the Victimless Crime Hypothesis, 23 *FIN REV* 127, 128, 139–141 (1988) (disproving Manne's propositions); Victor Brudney, Insiders, Outsiders, and Informational Advantages under the Federal Securities Laws, 93 *HARV. L. REV.* 322 (1979); A Comparative Empirical Investigation of Agency and Market Theories of Insider Trading – Laura N. Beny.

rules, the Takeover Code and civil and criminal law. It is intended to serve as a guide to a listed company's compliance with the UK regulatory environment relating to inside information, including systems and controls requirements and corporate governance standards. It also sets out the scope of US securities law and regulation insofar as it might apply to UK issuers. Most of the regulation deriving from the European Union's Financial Services Action Plan ("FSAP") directives apply only to companies whose securities are admitted to trading on a *regulated market*.[4] However, the book extends to rules which will be relevant only to companies with securities listed on markets which are not regulated markets for the purposes of the FSAP directives including AIM, OFEX or an Alternative Trading System ("ATS").

A number of recent enforcement actions bear witness to the fact that the FSA is taking a more draconian approach to those who breach laws and regulations relating to inside information. Given the increased enforcement risk, it is important that those subject to legal and regulatory obligations relating to inside information are aware of the FSA's investigative powers and the FSA's enforcement policy insofar as they relate to this area. Accordingly, as well as dealing with the substantive laws and regulations relating to inside information, there is a chapter on enforcement which is designed to provide an overview of the relevant investigative and information gathering powers, and the factors the FSA will take into account when deciding whether or not to take enforcement action. Given that a breach of the relevant legal and regulatory obligations could give rise to a variety of enforcement options on the FSA's part, ranging from criminal prosecution to actions for a breach of a relevant FSA rule, the enforcement chapter also looks at those factors which influence the FSA's choice of one enforcement option over another.

Where referring to a provision in the Disclosure Rules, Listing Rules or Prospectus Rules, these sections of the FSA Handbook will be abbreviated respectively to DR, LR and PR.

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[4] The provisions will also apply to where a request for admission to trading has been made – a regulated market is defined in the FSA glossary with reference to article 1 of the Investment Services Directive ("ISD") – a list of *regulated markets* notified to the European Commission by Member States pursuant to article 16 ISD is set out in SUP 17, annex 5. Currently the UK's regulated markets include certain markets operated by the London Stock Exchange and Virt-x.

1.2 Developments in the concept of inside information

The concept of inside information is very important as many regulatory duties now derive from it. A definition of inside information must be broad enough to ensure market integrity, while not so broad as to put unacceptable burdens on issuers, or disincentivise investment in the researching and processing of information which is also important to market efficiency.

The definition of inside information in Section 118C(2) FSMA, which has applied since July 2005, will be very familiar to those with knowledge of the application of the pre-existing Listing Rules regime. The relationship between the diverse obligations covering inside information is clearer since the adoption of a single definition of inside information which applies for both the new general obligation of disclosure in DR 2.2.1R and the market abuse offences in Section 118 FSMA. This allows for an easier treatment of the obligations with respect to inside information, less scope for anomalies and a more widespread appreciation of the attendant obligations (notwithstanding that, in general, the regulatory climate deriving from the FSAP directives has arguably become more complex for listed companies).

There had always been a strong relationship between the "positive" continuing obligations of disclosure, now in the Disclosure Rules, and the "negative" prohibitions on committing market abuse. It is in the interests of insider dealers to prevent market transparency, while the longer the time before disclosure of inside information, the more likely the wider dissemination of the information and the greater the potential for insider dealing or other misuse of that information.[5] An important means of preventing the misuse of inside information is to require it to be promptly, clearly and accurately disclosed. Meanwhile, the disclosure of inaccurate information by an issuer could constitute market abuse or an offence pursuant to Section 397 FSMA.

[5] MAD acknowledges this link in paragraph 15 – Recital to MAD.

1.3 Practical measures

While the FSA is on record as stating that the new general disclosure obligation in force since July 2005 and the additional market abuse offences should not cause any practical changes to the way in which companies operate, new enforceable systems and controls and procedural requirements should cause listed companies to carry out a systematic internal review of their compliance with the relevant FSA regulations. In particular, the introduction of Listing Principle 2 puts a positive obligation on issuers (and their directors) to have adequate systems, procedures and controls in place to ensure compliance with the Disclosure Rules, Listing Rules, and Prospectus Rules ("the UKLA Rules") for which directors could be personally liable.

Recent FSA enforcement actions have shown that the FSA is increasingly concerned to ensure that issuers have adequate systems for assessing whether information is inside information and ensuring that such information is properly disclosed to the market. The existence of clear and effective systems and controls will be a critical factor for the FSA in deciding whether to take enforcement action against an issuer or director, and in defending any action. All issuers are advised to adopt a policy on the control and disclosure of inside information and review any existing policies which deal with its management.

An inside information and disclosure policy should seek to ensure compliance with the new procedural requirements in the Disclosure Rules on the control of inside information and demonstrate adherence to other relevant FSA rules. In particular, companies should review sources of potential inside information in their business and establish procedures and controls to ensure that such information is escalated, assessed and that accurate announcements are made as soon as possible where required, while also maintaining the confidentiality of the relevant information internally. Systems should be in place to ensure compliance with the requirement for insider lists as well as transaction reports by PDMRs and connected persons. Changes in internal company documentation may be required.

A policy should provide a basis and framework for the delegation by the board of responsibility for tasks related to compliance with the

UKLA Rules. Such a policy can go some way to satisfying an issuer's responsibility to communicate obligations to employees who have access to inside information. Further, as a policy will cover matters such as rumours, dealing with analysts, and 'no comment' positions, it may help an issuer to maintain a consistent line and so avoid inadvertent breaches of the Disclosure Rules, particularly if it is published.

Practical tips on compliance are provided throughout this book. The tips are not meant to be exhaustive and are only a guide, as each issuer should have procedures and controls tailored to its own circumstances. The procedures that an issuer puts in place should be realistic and workable as a failure in these controls may now amount to a breach of UKLA Rules in itself. Annexed to this chapter is a table of questions which an issuer may find helpful in guiding it as to its legal and regulatory obligations with respect to company information.

We take "procedures" to mean documented instructions as might be found in a compliance manual, whereas "systems and controls" is a broader concept and can include a wider variety of measures. However, in fact we recommend that all systems and controls are appropriately evidenced in documentation. Further, issuers should ensure that compliance with its procedures, and system and controls is monitored and that they are periodically tested and reviewed. Those with responsibility for operating the relevant controls should clearly understand the issuer's regulatory obligations.

1.4 The FSA Handbook

This book refers frequently to the FSA Handbook. The FSA provides assistance with the interpretation of its Handbook, in particular in the Readers Guide: An Introduction to the FSA Handbook.

Most of the rules in the FSA Handbook, indicated by a capitalised letter R, create binding obligations on firms. If a firm contravenes such a rule, it may be subject to enforcement action and, in certain circumstances, to an action for damages. The capitalised letter G is used to indicate guidance given under Section 157 FSMA. The guidance in the FSA Handbook relates to the operation of FSMA, the rules

in the FSA Handbook and other matters. Material published in vehicles other than the FSA Handbook or Guidance Notes, for example in newsletters or on the FSA's website, is not formal FSA guidance unless it says so explicitly.

FSA guidance is not binding and it need not be followed in order to achieve compliance with the relevant rule or other requirement. Accordingly, a firm cannot incur disciplinary liability merely because it has not followed guidance. Nor is there any presumption that departing from guidance is indicative of a breach of the relevant rule. Guidance is generally designed to throw light on a particular aspect of regulatory requirements, not to be an exhaustive description of firms' obligations. However, if a person acts in accordance with FSA guidance in the circumstances contemplated by that guidance, then the FSA will proceed as if that the person has complied with the aspects of the rule or other requirement to which the guidance relates. Guidance represents the FSA's view, and does not bind the courts, for example in relation to an action for damages brought by a private person for a breach of a rule, or in relation to the enforceability of a contract where there has been a breach of the general prohibition on carrying on a regulated activity in the UK without authorisation.[6]

Every provision in the FSA Handbook must be interpreted in the light of its purpose, which is to be gathered first and foremost from the text of the provision in question and its context among other relevant provisions. The guidance given on the purpose of a provision is intended as an explanation to assist readers of the FSA Handbook. As such, guidance may assist the reader in assessing the purpose of the provision, but it should not be taken as a complete or definitive explanation of a provision's purpose.[7]

1.5 Future developments

A number of developments will, over the next few years, impact disclosure by listed companies of information, including, inside information. Insofar as they impact the law surrounding inside information, the

[6] The Readers Guide: An introduction to the FSA Handbook.
[7] GEN 2.2.1R and 2.2.2R.

Takeover Directive is addressed in Chapter 7 and the Company Law Reform Bill in Chapter 8. Other areas which have the potential to impact the management and dissemination of inside information by listed companies are further developments in European Law, in particular the implementation of the Transparency Directive and the introduction of the Business Review, both considered below.

1.5.1 EU law and the Transparency Directive

The European Commission was, at the time of writing, consulting on its Company Law Action Plan (the "Action Plan") which was launched in May 2003 setting out priorities for as far ahead as 2009 onwards.[8] On 17 November 2005, Charlie McCreevy, the European Commissioner for Internal Market and Services confirmed that the two main guiding principles behind the Action Plan would remain improving transparency and empowering shareholders.

An important aspect of the Action Plan has been the ongoing modification of the fourth and seventh Company Law Directives. On 28 October 2004, the European Commission tabled some revisions to these directives, including measures in the area of corporate governance, inter alia, to confirm at an EU level, the collective responsibility of board members for financial statements and key non-financial information, and the introduction of a separate corporate governance statement. Measures will also provide for new disclosure requirements regarding off-balance sheet arrangements and related party transactions.

The eighth Company Law Directive which, at the time of writing, the European Parliament was considering, clarifies the duty of statutory auditors and sets out certain principles to ensure auditor objectivity and the accuracy of audited accounts. Notably, the Directive states that an audit firm must provide a description and a statement on the effectiveness of the company's internal controls although this would still fall short of the detailed assessment auditors are required to undertake of Securities and Exchange Commission ("SEC") registrants under US law. The Directive would also deal with the regulation of auditors

[8] The Action Plan on Modernising the Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward – COM.(2003)284 Final.

(including auditor rotation), require all listed companies to establish an audit committee (or a similar body), provide a basis for cooperation between regulators in the EU and regulators in third countries, in particular the US Public Companies Accounting Oversight Board ("PCAOB").

In March 2000, the Lisbon European Council adopted the FSAP which consists of a set of measures intended by 2005 to fill gaps in and remove remaining barriers to a legal and regulatory environment that supports the integration of EU financial markets. Most of the 42 pieces of the EU legislation associated with the FSAP have now been implemented or are in the process of being implemented, and the European Commission has begun an evaluation of FSAP and the legislative process that brought it about.

Many of the FSAP directives have been conceived to harmonise and enhance disclosure to investors about listed companies. The Prospectus Directive dealt with the initial disclosure requirements when securities are offered to the public and/or admitted to trading on a regulated market. Once listed, the ongoing disclosure requirements of, inter alia, MAD, the International Financial Reporting Standards[9] ("IFRS") and the Transparency Directive (to be implemented by 20 January 2007) apply.

The IFRS were implemented on 1 January 2005 and now all EU listed companies must prepare their consolidated financial statements in compliance with IFRS, which results in greater transparency, especially of Special Purpose Entities which miscreant companies have in the past made use of to hide losses.

The Transparency Directive will apply to all issuers with securities admitted to trading on an EEA regulated market. It is intended to enhance transparency in EU capital markets by improving the information available to investors and harmonising the requirements for issuers. The recitals of the Transparency Directive state that "the disclosure of accurate, comprehensive and timely information about security issuers builds sustained investor confidence and allows an

[9] Regulation 1606/2002/EC.

informed assessment of their business performance and assets. This enhances both investor protection and market efficiency".[10] Broadly the Directive covers financial reporting, disclosure of interests in securities, the dissemination of regulated information and the development of central mechanisms for storing regulated information.[11]

The requirements to publish preliminary statements of annual results and dividends, annual reports and accounts, and half-yearly reports found in LR 9.7–9.9, will be replaced by rules made to implement the Transparency Directive which provides for annual and half-yearly reports, and interim management statements[12] with shorter deadlines and more detailed content requirements. Article 4.2(c) of the Transparency Directive contains a requirement for a responsibility statement similar to that in the Sarbanes-Oxley Act 2002 ("SOX"), which states that "persons responsible" within the issuer confirm that information in the annual financial report gives "a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer . . . and that the management report includes a fair review of the development and performance of the business and the position of the issuer."[13] Article 7 provides that responsibility for financial information lies with the issuer or its administrative, management or supervisory bodies and that civil liability attaches to these persons.

Articles 21 and 22 of the Transparency Directive set out the framework for a system of dissemination and storage of "regulated information". Regulated information is defined as including financial information, inside information or other information demanded by more stringent requirements of a home Member State. Issuers will be required to disseminate regulated information in a fast, non-discriminatory manner on a pan-European basis and be available for central storage. For issuers for whom the UK is home competent authority the FSA proposes to retain the current regime of primary and secondary information providers. If securities are admitted to trading on a regulated market only in one Member State, regulated information must be disclosed in a language accepted by the competent authority in that Member State. If

10 Paragraph 1 Recital – Transparency Directive – 2001/34/EC.
11 The Transparency Directive replaces and updates parts of existing EU legislation in the Consolidated Admissions and Reporting Directive ("CARD").
12 Interim management statements only apply to issuers of equity.
13 This statement is not required in the quarterly reports.

securities are admitted to trading on a regulated market in both an issuer's home Member State and one or more host Member States, the issuer must disclose regulated information in a language accepted by the competent authority in the home Member State. In addition, the issuer can opt to disclose information in a language accepted by the competent authorities of the host Member States or in a language customary in the sphere of international finance. If an issuer has securities admitted to trading on a regulated market in one or more host Member States, but not in the home Member State, the issuer has a choice of disclosing the regulated information in either a language accepted by the competent authorities of those host Member States, or a language customary in the sphere of international finance.

All regulated information will need to be stored and be easily accessible and article 2(2) provides that each Member State ensures that there is at least one officially appointed mechanism ("OAM") to facilitate this. On 31 January 2006, the Committee of European Securities Regulators ("CESR") published a consultation paper seeking views on what should be covered in its advice to the European Commission in relation to the storage and filing of regulated information, in particular in relation to the development of national storage mechanisms and the creation of an EU network of those mechanisms. CESR has been asked to provide its advice to the European Commission by June 2006.

As it is a minimum harmonisation directive, home Member States may impose more stringent requirements than those provided for by the Transparency Directive and its implementing measures. As such, the selection of home Member State pursuant to the Prospectus Directive (to the extent that an issuer has a choice) becomes very significant.

1.5.2 The Business Review

On 28 November 2005, the Chancellor of the Exchequer, Gordon Brown, announced the abolition of the requirement for directors of listed companies to prepare an Operating and Financial Review ("OFR") for each financial year, starting with financial years beginning on or after 1 April 2005 (which would have seen OFRs being published from May 2006). The OFR would have supplemented company accounts, making provision for additional commentary to financial statements, including on the future prospects of the issuer, and

improving the flow of information to investors. Gordon Brown cited the OFR as an example of regulatory gold plating. Regulations repealing the requirement for OFRs came into force on 12 January 2006.

The Chancellor's decision was widely criticised by the business community as many had welcomed the OFR and preparations for its introduction were already well advanced. At the time of writing the DTI was consulting on the extent to which it might enhance company narrative reporting requirements in the context of the Company Law Reform Bill, which could result in OFR provisions being reintroduced. The Financial Reporting Council ("FRC") may, subject to the results of that consultation, expedite its planned review of narrative reporting in company accounts.

The requirement to produce a *Business Review* as part of the directors' report, introduced under the same regulations that introduced the OFR requirements, to implement parts of the EU Accounts Modernisation Directive has been retained.[14] The Business Review will in fact be remarkably similar to the OFR although its provisions are more subjective, and there is less scope for forward looking commentary,[15] and no audit requirement (although an auditor must confirm that the directors' report is consistent with the accounts). The central requirements of the Business Review, which must be included in directors' reports for financial years beginning on or after 1 April 2005, require:

- a balanced and comprehensive analysis of the development, performance and position of the business;
- a description of its principal risks and uncertainties;
- analysis using appropriate financial and other key performance indicators (including information on environmental and employee matters[16]);
- disclosure of any information that is material to understanding the development, performance and principal risks affecting the business, including on environmental matters, employees, social

[14] Section 234 ZZB of the Companies Act 1985.

[15] The existing directors' report requirements provide for "an indication of likely future developments", paragraph 6, schedule 7, Companies Act 1985.

[16] 'Medium sized' companies do not need to include non-financial key performance indicators.

and community issues, and information about the company's policies and their implementation;[17]

- a report on significant environmental issues.

Some of this information would also be required by the Transparency Directive to be included in the management report.

Small companies (which satisfy two of the following criteria: turnover of not more than £5.6 million, balance sheet total of not more than £2.8 million, or not more than 50 employees) are exempt from the requirement to produce a Business Review as part of the directors' report. The Business Review will add to the information in the market on all but the smallest companies. One possible consequence of the Business Review is that companies may find themselves with an additional a duty to disclose pursuant to the general disclosure obligation in DR 2.2.1R, arising from an expectation that the market develops by reason of anything asserted in the review, if the grounds for that assertion change.

It is a criminal offence for a directors' report not to comply with the content provisions in part 7 of the Companies Act 1985 and every director who knew that it did not comply or was reckless as to whether it complied and failed to take all reasonable steps to secure compliance is guilty of an offence and liable to a fine.[18] Issuers that produce a voluntary OFR will be able to cross refer to the Business Review.

The main concern that many directors had concerning the OFR remained, to a lesser extent, in connection with the Business Review, which is the legal risk associated with director commentary, in particular any forward looking statements which are made. As discussed in Chapter 8, while there are real difficulties in a shareholder establishing a successful civil action against a director, the risk remains, especially where positive duties to comment arise. The Government appeared to have responded to such concerns and the argument that the Business Review, or other provision enhancing director commentary, would lead to defensive, minimalist reporting and on 3 May 2006 issued for consultation clauses in the Company Law Reform Bill

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[17] Companies will not be required to disclose information about impending developments or matters in the course of negotiation if the disclosure would be seriously prejudicial to the interests of the company.

[18] Section 234(5) Companies Act 1985.

which reduce the scope of issuer and director liability in the context of narrative reporting.[19]

Analysis of company information – key legal and regulatory issues to be considered

The checklist comprising questions and paragraph references set out below may assist a listed company in its analysis of information and the determination of legal and regulatory obligations arising. The checklist assumes that the company has put in place systems and controls, and that procedural requirements have been followed in relation to the inside information (concerning the timely identification, escalation and consideration of the information and the control of inside information)? (see paragraph 2.3.12 and Chapter 10).

Is the information of a type such that a specific Listing Rule disclosure obligation relates to it? (paragraph 2.3.14)

Is the information *inside information* for your company as defined in Section 118C(2) FSMA, and hence subject to the general disclosure obligation in DR 2.2.1R? (paragraph 2.3.3) Or does the information trigger the relevant disclosure obligation for AIM and OFEX companies? (Chapter 3)

Does the inside information relate to *negotiations in course* or *impending developments* which would be likely to be prejudiced by public disclosure and hence subject to the delaying provisions of the Disclosure Rules in DR 2.5? (paragraph 2.3.6)

If the information relates to a takeover situation, is an announcement required under the Takeover Code? (Section 7.3)

Will the disclosure of inside information constitute a non-exempt financial promotion and if so has it been approved by an FSA authorised person before its release? (Section 7.2)

Has the company taken all reasonable care to ensure that any statement it releases via an RIS (or makes available through the FSA) is complete, accurate, clear and does not omit anything likely to affect the import of such statement? (paragraph 2.3.5 and Chapter 8)

Is the RIS announcement laid out as required by the Disclosure Rules? (paragraph 2.3.5)

Are there any overseas legal or regulatory requirements in relation to the information? In particular is there an announcement obligation in an overseas jurisdiction? (paragraph 2.3.4 and Chapter 9)

[19] *See* Section 8.3.3.4 for discussion.