

# WALL-CROSSINGS - MARKET ABUSE - A CAUTIONARY TALE?

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## FINANCIAL SERVICES

As highlighted by the *David Einhorn / Greenlight Capital Inc* FSA [Decision Notices](#) published yesterday **wall-crossings are again in the regulatory spotlight**. It might prudently be assumed that the regulator's focus on this aspect of market activity will only continue to intensify.

### BRIEF FACTUAL SUMMARY

David Einhorn was the President and sole portfolio manager of Greenlight Capital Inc (Greenlight), a US-based hedge fund. Several of Greenlight's funds held stakes in Punch.

On 15 June 2009, Punch announced a transaction to issue new equity in order to raise £375m (the "Transaction"). Prior to this announcement, Punch's broker, X, contacted and formally wall-crossed various Punch shareholders and potential investors, in accordance with specific wall-crossing procedures (which included the execution of a non-disclosure agreement by information recipients). On 8 June 2009, Broker X raised with Greenlight the subject of a possible equity issuance by Punch, and invited Greenlight to be wall-crossed. Mr Einhorn refused this request, but agreed to participate in a call on the following day with Punch's management on a non-wall-crossed basis. The call (the "Punch Call") took place on 9 June, during which, according to the FSA (but disputed by Mr Einhorn), inside information relating to Punch was divulged to Mr Einhorn - namely, that Punch was at an advanced stage of the process towards the issuance of a significant amount of equity, probably within a timescale of around a week, with the principal purpose of repaying Punch's convertible bond and creating headroom with respect to certain covenants in Punch's securitisation vehicles.

Immediately following the Punch Call, Mr Einhorn directed Greenlight's traders to sell the funds' entire Punch stake.

Following announcement of the Transaction, the price of Punch shares fell by 29.9 per cent.

### FSA VERDICT

Both David Einhorn and Greenlight were found to have committed market abuse (insider dealing) and were fined **£3.638m** and **£3.651m** respectively. Greenlight was sanctioned on the basis that "Mr Einhorn's behaviour is attributable to Greenlight", resulting in what may be regarded as something of a double-blow for Mr Einhorn. Further evidence - if it were needed - of the FSA's increasingly aggressive approach to enforcement in the market conduct arena; particularly given that Mr Einhorn "did not act deliberately or recklessly".

### PRACTICAL IMPLICATIONS

The Decision Notices contain a number of noteworthy findings, **of practical relevance to both buy-side and sell-side firms**, including:

#### Insider or not?

The FSA acknowledged that no single piece of information divulged to Mr Einhorn during the Punch Call, in isolation, amounted to "inside information". However, the FSA found that, when **taken together**, the pieces of information did constitute "inside information" - particularly, given that they revealed the purpose and anticipated size and timing of the issuance. In short, the Punch Call had to be viewed **in the round and in its proper context**; and on this basis, according to the FSA, Mr Einhorn had been made an "insider". Significantly, the FSA did not regard the assertions made during the Punch Call - that management were considering their options and that no formal decisions had been made - as detracting from the essence and import of the information divulged. In other words, that information was nonetheless: (i) sufficiently precise and indicative of an imminent equity issuance; and (ii) specific enough to enable a conclusion to be drawn as to the potential effect of the issuance on the price of Punch shares. This was despite Mr Einhorn's contention that the discussion was (as repeated by Punch management to be) purely conceptual and at a high level. In the FSA's view:

**"... reasonable investors are expected to interpret comments made to them in an appropriate manner, which may sometimes mean understanding more than the precise words spoken, or interpreting certain comments in light of the context. If it is sufficiently clear that a discussion is not, in fact, merely conceptual, then express words to the contrary will not prevent inside information from being given."**

Nor, it seems, was the FSA persuaded that: (i) Mr Einhorn's (undisputed) refusal to be wall-crossed; (ii) the failure by any of the various professionals participating in the Punch Call to raise any concern that "inside information" had been disclosed; (iii) the fact that none of the parties on the Punch Call considered that "inside information" had been disclosed; or (iv) the fact that Mr Einhorn was told at the end of the Punch Call that he had not been wall-crossed, were especially relevant in the circumstances.

The FSA concluded that "the information was likely to have a significant effect on price as it was information which a reasonable investor would be likely to use as part of the basis of his investment decisions". This represents an **effective**

**supplanting by the FSA of the “significant price effect” test with that of the “reasonable investor”** - replicating the (somewhat controversial) interpretation adopted by the FSA in the *Woolworths*, *JJB Sports* and (more recent) *Massey* cases. Whilst the legal efficacy of this interpretation may be open to some doubt, it is as well for market participants and issuers to understand that this is the interpretation being applied by the FSA in practice - and is likely to remain so unless and until a court rules, or EU legislation dictates, otherwise.

#### **Was the dealing “on the basis of” the inside information?**

It is interesting to note the FSA's finding that “[Mr Einhorn] has not rebutted the presumption that he dealt on the basis of that information ...”. Prior to the decision in the *Spector Photo* case in December 2009, it was generally accepted that it was for the FSA to prove that the possession of inside information materially influenced the decision to deal. However, *Spector* has been interpreted as effectively reversing the burden of proof by introducing a rebuttable presumption that the dealing was on the basis of the inside information. The FSA appears to have applied the *Spector* test to Mr Einhorn, notwithstanding that his actions pre-dated the *Spector* decision!

#### **“Reasonable precautions / belief” defence**

The FSA did not accept that Mr Einhorn took all reasonable precautions to avoid committing, or **reasonably** believed that he had not committed, market abuse:

“Although Mr Einhorn’s approach to the Punch Call is not criticised, following the call Mr Einhorn should have been aware that he had been given inside information, or at the very least that there was a risk of this. **He had a responsibility to consider whether the information received during the call constituted inside information** before instructing the sale of shares. **Given that the call took place following Mr Einhorn’s refusal to sign an NDA, Mr Einhorn should have been even more diligent than usual in considering whether inside information had been disclosed to him before selling.** Having received the information, although it is accepted that he did not believe that it was inside information, before dealing he should have taken steps to ensure that it was not before dealing, such as obtaining compliance or legal advice, or contacting Punch management again to specifically clarify whether the information he had been given was inside information. **Although he was entitled to give some weight to the fact that neither Punch...raised any concerns either during or immediately after the call, that does not remove the obligation on Mr Einhorn to remain alert to the risk, make his own assessment of any information he received, and take steps as necessary to confirm it ...”**

#### **FSA expectations**

If it was unclear before, little doubt can remain as to the FSA's current mindset, high expectations and low tolerance threshold in the market conduct sphere - as perhaps neatly illustrated by the very last finding in the Einhorn Decision Notice:

“Mr Einhorn did not act deliberately or recklessly. However, having been asked to and having refused to sign an NDA, with knowledge that the subject of the Punch Call with management and its advisors was the issuance of equity, **Mr Einhorn, a highly experienced market professional, should have recognised that there was a real risk of inside information being disclosed to him, and that extreme caution would be required before any trading following the call. His failure to apply the necessary care and rigour, while unintentional, was an extremely serious matter, and warrants a substantial penalty.**”

#### **Key “take-aways”**

The Einhorn / Greenlight case will be of particular interest to **brokers, fund managers and research analysts.**

On the sell-side, brokers are reminded that the **“improper disclosure of inside information” is also a form of market abuse.** Accordingly, brokers would be well-advised to heed these cautionary warnings and be especially vigilant when liaising with non-wall-crossed individuals / firms - crucially, the FSA will examine the **substance and totality of any conversation, including the context within which it is held.** Express disclaimer wording will not, of itself, suffice. Incidentally, it is understood that Broker X is being pursued separately by the FSA.

For the buy-side, whilst a clear advance indication (to the sell-side) of a desire not to be wall-crossed may be helpful to a degree, such a measure is unlikely to amount to an effective defence, in itself. Again, the FSA will have regard to the **substance, entirety and context** of the relevant dialogue. Accordingly, it is imperative that a portfolio manager or research analyst, harbouring any doubt as to whether they have been made an “insider”, consult with their internal legal / compliance teams at the earliest opportunity (and in any event before any related dealing is actioned). Those institutions for whom non-wall-crossed dialogue (of the kind which caught out Mr Einhorn) is not business critical may wish to reconsider whether the rewards justify the risks.

#### **CONTACT DETAILS**

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