MACFARLANES

IAN HANNAM MARKET ABUSE FINDING UPHELD

LITIGATION AND DISPUTE RESOLUTION

On 27 February 2012, the Financial Services Authority (FSA) imposed a financial penalty of £450,000 on Ian Hannam, the then Global Co-Head of UK Capital Markets at JP Morgan, in relation to two instances of market abuse (improper disclosure).

In 2013, Mr Hannam appealed this decision to the Upper Tribunal, an independent forum presided over by a High Court Judge.

The Upper Tribunal was required to consider a number of important points, each with clear practical repercussions:

- Had Mr Hannam disclosed "inside information"? In answering this question, the Upper Tribunal addressed (among other things) whether the information was sufficiently precise and whether it would have a significant price effect.
- If so, was that disclosure in the proper course of Mr Hannam's employment?
- If not, did Mr Hannam have a defence under section 123(2) that he reasonably believed that his behaviour did not amount to engaging in market abuse?

THE OFFENCE

Under section 118 FSMA, there are seven types of behaviour which can amount to market abuse. Mr Hannam was accused by the FSA of behaviour amounting to the improper disclosure offence. Section 118(3) FSMA provides that it is market abuse for an insider to disclose inside information to another person otherwise than in the proper course of the exercise of his employment, profession or duty.

Section 118C(2) provides that:

*"inside information is **information** of a **precise nature** which –*

(a) is not generally available,

(b) relates, directly or indirectly, to one or more issuers of the qualifying investments or to one or more of the qualifying investments, and

*(c) would, if generally available, be **likely** to have a **significant effect on the price** of the qualifying investments or on the price of related instruments."*

In its decision, the Upper Tribunal considered the correct interpretation and application of each of the highlighted elements of section 118C(2).

Section 123(2) FSMA provides a defence where there are reasonable grounds for the FCA, the FSA's successor) to be satisfied that:

a. the person believed, on reasonable grounds, that his behaviour did not amount to engaging in market abuse; or

b. he took all reasonable precautions and exercised all due diligence to avoid behaving in a way which amounted to behaviour constituting market abuse.

THE FACTS

Mr Hannam sent two emails on 9 September 2008 (the September Email) and 8 October 2008 (the October Email). Both emails were sent to Dr Ashti Hawrami, the Minister for Natural Resources in Kurdistan (the Minister), during the course of discussions regarding a proposed corporate transaction between the Kurdistan Regional Government of Northern Iraq (the KRG) and Mr Hannam's client at the time, Heritage Oil and Gas Plc (Heritage), which was conducting test drilling for oil in Uganda. The emails were sent with the implicit authority of the CEO of Heritage, Mr Buckingham, and in accordance with Mr Hannam's mandate to develop the Minister's interest in the proposed transaction and, ultimately, to broker a deal.

The emails were sent in the context of ongoing discussions between Heritage and the Minister. During these discussions, the Minister was informed by Heritage that it had received approaches from other interested third parties.

On 3 September 2008, Heritage announced that its test drilling for oil in Uganda had been successful. This had caused the other interested third party to re-engage with its negotiations with Heritage.

In order to update the Minister on the progress of these discussions between Heritage and the interested third party, Mr Hannam explained in the September Email:

"Dear Ashti [Dr Hawrami],

Following our drink last week and our telephone conversation yesterday, I look forward to seeing you next week. I thought I would update you on discussions that have been going on with a potential acquirer of Tony Buckingham's business. Tony, advised by myself, has deferred engaging with the client until Thursday of next week although we know they are very excited about the recent drilling results of Heritage Oil and today's announcement by Tullow. I believe that the offer will come in in the current difficult market conditions at £3.50 - £4.00 per share.

I am not trying to force your hand, just wanted to make you aware of what is happening.

Very best regards

Ian [Mr Hannam]"

On 18 September 2008, Heritage, at the request of the Takeover Panel due to movements in its share price, announced that it was in highly preliminary discussions with a third party. By 30 September 2008, Heritage announced that such discussions had been terminated and also that it had commenced drilling in Uganda. Heritage's shares rose by 34p.

In early October 2008, Heritage's daily drilling report contained positive technical/chemical indicators relating to the presence of oil (though it was far from suggesting that black oil was actually present or of a nature to be commercially viable for Heritage).

On 8 October 2008, Mr Hannam sent the October Email to the Minister and another noting that he was due to meet with Tony Buckingham of Heritage for lunch. Mr Hannam added at the end *"PS-Tony has just found oil and it is looking good"*. It is this post-script which the FSA contended was inside information. It conveyed the message that oil had been found and that Heritage considered this to be positive news. Indeed, on 21 October 2008, Heritage announced the discovery of oil.

Somewhat ironically, the discovery of the September and October Email came about as a result of Mr Hannam's report to the Serious Organised Crime Agency regarding a third party's activities connected to a deal which Heritage was due to enter into.

THE APPEAL

On appeal, Mr Hannam argued:

- Neither the September Email nor the October Email contained or disclosed any inside information for various reasons, including:
  - the information conveyed in the emails was not accurate and could not therefore be inside information - for instance oil (as in black oil) had not been located at the time of sending the October Email, only the presence of liquid hydrocarbons which may indicate the presence of oil;
  - the mere fact that oil had been discovered, without knowing if it could be exported for commercial gain, would not have had an impact on the price;
  - the Minister was already aware of the information which was repeated in the September and October Emails.
- Even if the emails did disclose inside information, the disclosures made by Mr Hannam were made in the proper course of the exercise of Mr Hannam's employment and the performance of his duties to his client. This follows from the fact that both the September and the October Emails were sent:
  i. in furtherance of Mr Hannam's mandate to facilitate a corporate transaction between Heritage and the KRG;
  ii. with the implicit authority of Mr Hannam's client; and
  iii. on the understanding that the information was being received in confidence and would not be abused.
- Mr Hannam genuinely believed that his behaviour did not amount to market abuse and had reasonable grounds for holding this belief. The defence under section 123(2)(a) FSMA was therefore available to him.

Mr Hannam also sought a finding that the correct standard of proof in a market abuse case was the criminal standard: beyond all reasonable doubt; as opposed to the civil standard of "balance of probabilities".

THE DECISION OF THE UPPER TRIBUNAL

The nature of "information"

The information in question does not need to be wholly accurate in order for it to qualify as "information" under section 118C(2). It was necessary to consider whether the information, if wholly or partially inaccurate, was still sufficient to give a market participant an unfair advantage by nevertheless conveying an essentially accurate message. The Upper Tribunal appeared to be of the view that entirely inaccurate information could not be inside information.

When such information is "precise"

Nevertheless, the information, whether wholly accurate or not, needs to be "precise".

As to what is precise, section 118C(5) provides:

"Information is precise if it-

(a) indicates circumstances that exist or may reasonably be expected to come into existence or an event that has occurred or may reasonably be expected to occur; and

(b) is specific enough to enable a conclusion to be drawn as to the possible effect of those circumstances or that event on the price of qualifying investments or related investments."

It is likely that wholly inaccurate information would not be "precise" as it would fail to meet the test in section 118C(5)(a). However, it is quite possible that partially inaccurate information could meet this test. It would be for the authority to demonstrate which circumstances it believed to exist and to show how the information in question was capable of constituting inside information in respect of such circumstances.

The Upper Tribunal held that the meaning of "may reasonably be expected to come into existence" and "may reasonably be expected to occur" was to be interpreted as a realistic prospect that they will come into existence or occur. This has to be more than a fanciful chance, but not more likely than not.

Additionally, accurate or even only partially inaccurate information needs to enable the recipient to draw a conclusion as to the possible effect on price (section 118C(5)(b)) in order to be sufficiently "precise". The previous decision of *Massey v FSA* [1] considered, but did not decide, whether the necessary possible price effect is as to a movement in a particular direction or simply a mere movement. Unsurprisingly, both Mr Hannam and the Authority agreed (and the Upper Tribunal held) the information must indicate in which direction (although not the extent to which) the price might move.

However, the Tribunal rejected Mr Hannam's argument that reference to "the possible effect" meant that the information had to be of such a nature that an insider could assess with confidence that the price would move either up or down. Instead, the test was whether the price might move (in a known direction). In other words that there was a real prospect of a price movement in a known direction.

The information is "likely to have a significant effect on the price of the qualifying investments…" (section 118C(2)(c))

THE REASONABLE INVESTOR TEST

Section 118C(6) FSMA provides as follows:

> *"Information would be likely to have a significant effect on price if and only if it is information of a kind which a reasonable investor would be likely to use as the basis of his investment decisions."*

The Upper Tribunal clarified that the key test to consider was the reasonable investor test under section 118C(6) as if this test was met, it would follow that the information was likely to have a significant effect on price. Equally, in determining what a reasonable investor would take into account, one is to be guided by section 118C(2)(c): a reasonable investor would not use information which would have no prospect of significantly affecting the price. Though this is a useful clarification of the interaction between these two provisions, it is not a surprising outcome given the purpose of section 118C(6) is to clarify what type of information would be likely to have a significant effect on the price. This represents a welcome return from the somewhat contentious interpretation seemingly adopted by the Upper Tribunal in *Massey*[2].

THE MEANING OF "LIKELY" IN SECTION 118C(2)(C)

The definition of "likely" informs what type of information the reasonable investor would use. The Upper Tribunal held that the word "likely" is to be read as meaning that there is a "real prospect" of the information having a significant effect on price (which in turn means having a more than de minimis effect). The Upper Tribunal declined to comment on when information would have a significant effect on price or provide de minimis movement which would be deemed trivial and therefore not significant, commenting that this is a highly fact specific determination.

The test is therefore to consider whether there is/was a real prospect that the reasonable investor would use the information. If so, then it is "likely" to have a significant effect upon price.

THE SEPTEMBER EMAIL

In applying the tests set out above, the Upper Tribunal found that the September Email contained inside information; the September Email plainly indicated that a third party was in discussions with Heritage and that an offer would be made for its shares (and so satisfied section 118C(5)).

The information contained within it, and in particular Mr Hannam's belief that an offer for the shares would be made, was of a type which a reasonable investor would likely use in making investment decisions (satisfying section 118C(6)).

The Upper Tribunal, with the benefit of hindsight, conducted a detailed analysis of the movements in Heritage's share price during the course of 18 September (which triggered the announcement), and thereafter, to ascertain whether or not the information in the September Email was likely to have a significant effect on price. The Tribunal (agreeing with the

[1] [2011] UKUT 49 (TCC)

[2] The Tribunal in *Massey* appeared to conceive that a reasonable investor might take into account information which would not have a significant effect on price and that, as a result, this would still be inside information because it fell within the reasonable investor test. It therefore followed that it was not necessary for the test in section 118C2(c) to be met if the test in section 118C(6) was satisfied, effectively extending the scope of the definition of inside information.

Authority's expert) found that the September Email contained information that:

a. Heritage and its advisers were in discussions with a potential acquirer;

b. the CEO of Heritage had decided to engage in those discussions in a matter of days (and in fact did so); and

a. Mr Hannam expected an offer to be made for Heritage. As to whether such information was likely to have a significant effect on price, the Tribunal was persuaded by the Authority's expert on such issues that it would (and indeed possibly did).

The Upper Tribunal dismissed the argument that it was necessary to consider the reasonable investor's reaction to reading the September Email itself and the context in which it was sent (which may have provoked a degree of scepticism, given Mr Hannam's motives for sending it). It held that one only had to consider the reasonable investor's reaction to the information that it contained (or which could be inferred from it). The background, context and source of the email and why it was sent were irrelevant to this test.

Finally, the Upper Tribunal held that the fact that information in the September Email had already been imparted to the Minister did not mean that the same information could not be disclosed again for the purposes of section 118C; for example, the repetition of information could add credence to it.

THE OCTOBER EMAIL

The post script in this email was deemed to be inside information. The fact that oil (as in black oil) had not actually been located at the time of sending this email did not detract from the fact that the post script indicated the presence of strong indicators of oil and that this was positive news for Heritage. It was this message, or information, which was to be subjected to the reasonable investor test. The Upper Tribunal's assessment of the facts demonstrates the risk in disclosing overstated or generic information if specific inside information could nevertheless be inferred from it.

PROPER COURSE OF EMPLOYMENT

As another plank of his defence, Mr Hannam argued that he did not, in any event, fall foul of section 118(3) as his conduct was in the proper course of his employment. He relied upon the FCA's guidance as to what behaviour should be taken to amount to market abuse (The Code of Market Conduct (the Code) – such guidance has evidential effect). The Code lists a number of factors to be taken into account in determining whether or not the disclosure was made by a person in the proper course of the exercise of his employment, profession or duties. These include:

> *"whether the disclosure is accompanied by the imposition of confidentiality requirements upon the person to whom disclosure is made and is reasonable and is for the purpose of facilitating any commercial, financial or investment transaction (including prospective underwriters or placees of securities - although such persons will then become insiders themselves and will not be able to deal freely as a consequence)".* (emphasis added)

This guidance contrasts with the judgment of the European Court of Justice (ECJ) in *Grøngaard and Bang* [3] that *"the disclosure of such information is justified only if it is strictly necessary for the exercise of an employment, profession or duties and complies with the principle of proportionality."* This focuses the test on necessity, rather than reasonableness. The Authority relied upon the ECJ ruling rather than its own guidance.

Mr Hannam relied upon an understanding or inference that the Minister would keep information of the type he disclosed confidential, following a meeting he had with the Minister. There was no clear evidence that the issue of confidentiality had specifically been discussed. Furthermore, there was no evidence to suggest that at the time of sending the emails Mr Hannam gave any thought to whether the Minister understood that he would be under an obligation to keep the information confidential. Further, the October Email was inadvertently sent to another third party with whom Mr Hannam could show no understanding of confidentiality.

The Upper Tribunal held that such an assumption of confidentiality was not sufficient to ensure that the information was carefully protected. The Upper Tribunal agreed with the focus on necessity in the judgment of the ECJ. However, it also recognised that this is a stricter approach than that envisaged in the Code, which only requires a test of reasonableness. Ultimately, and disappointingly, it declined to answer which test was to take precedence as the Heritage deal was subject to the Takeover Code, which applied a stricter test of necessity and strict confidence in any event. The Upper Tribunal took the view that if the disclosure breached the Takeover Code then it could not also be in the proper course of employment. The Upper Tribunal concluded that *"it can never be in the proper course of the exercise of an employment to divulge an offer or contemplated offer to a third party without giving him a warning that he is about to be made an insider".*

[3] Case C-384/02) [2005] ECR I-9939

The Upper Tribunal did not doubt that Mr Hannam's actions were legitimate and appropriate in the context of meeting his mandate. However, the Upper Tribunal was clear that in the absence of an appropriate (and sufficiently apparent) confidentiality restriction, it will be difficult to demonstrate that disclosure is in the proper course. It also considered that Mr Hannam's actions were unreasonable (referring back to the Code), due to:

i. the lack of an explicit confidentiality restriction;

ii. the disclosures not being a reasonable or proportionate way of achieving the objective of the communications; and

iii. the fact that Mr Hannam failed to consider whether he could properly disclose the information at the time.

An understanding of confidentiality is key. However, there are varying possibilities of imposing a "requirement" from a formal written agreement to an informal understanding based on prior dealings. The Upper Tribunal recognised that the norm is to be explicit about confidentiality when inside information is disclosed and to ensure that this is recorded in writing (whether through formal agreement or in a file note). The Upper Tribunal was also prepared to recognise that there could be sufficient restrictions in place as a result of prior discussions and dealings where an understanding of confidentiality was already established. It is important to demonstrate that a confidentiality restriction is in place, that the recipient understands that the information he receives is confidential, and that the insider knows that the recipient is aware of these restrictions. Clearly the safest course is to have this properly documented each time inside information is disclosed.

THE STANDARD OF PROOF

The standard of proof for market abuse offences remains the civil test: on the balance of probabilities. The Tribunal did not perceive allegations of market abuse as tantamount to allegations which constitute criminal offences as argued by Mr Hannam.

SECTION 123(2)(A) DEFENCE

In order to rely upon this defence, Mr Hannam needed to demonstrate that he believed he was not engaging in market abuse and that his belief was reasonable. What proved fatal for Mr Hannam in relying upon this defence was his inability to demonstrate that he gave any thought to the implications of information he was sharing. The reasonable belief had to be so held at the time of making the disclosure.

FINAL OBSERVATIONS

The following facts perhaps made this an unusual market abuse case:

- there was no dispute that Mr Hannam was acting in the interests of Heritage in sending the September and October email;
- Mr Hannam's integrity and honesty was not doubted;
- Mr Hannam did not make any personal gain as a result of the alleged disclosures (though this is not a requisite element of the offence);
- there was no evidence that anyone dealt in shares or other financial instruments on the basis of the September Email or the October Email (again this is not a requisite element of the offence);
- it is not suggested that it was intended, or even contemplated, that there would be any dealing on the back of the provision of those emails, or that any inappropriate conduct whatsoever was intended to ensue from the sending of them; and
- Mr Hannam's activities in blowing the whistle to SOCA demonstrated that Mr Hannam was willing to and did pursue his client's commercial interests as far as he was properly able to, but he was not willing to broker a deal at any cost, and certainly not where it involved any contravention of the law by anyone at all.

Nevertheless it is an important reminder and indeed a useful clarification of the complex market abuse regime. The practical outcome of this decision is relatively simple: take great care and act with caution when selectively disclosing any information which could be inside information and ensure that appropriate confidentiality restrictions are in place when doing so.

CONTACT DETAILS

If you would like further information or specific advice please contact:

LOIS HORNE
DD: +44 (0)20 7849 2956
lois.horne@macfarlanes.com

JUNE 2014

MACFARLANES LLP
20 CURSITOR STREET LONDON EC4A 1LT

T: +44 (0)20 7831 9222 F: +44 (0)20 7831 9607 DX 138 Chancery Lane www.macfarlanes.com