

Newsletter – April 2010
FINANCIAL SERVICE LEGAL NEWS

Trading on inside information as analyzed by the Court of Justice of the European Union in the *Spector Photo* ruling

The case and proceedings in an outline. Legal effects of the Court's ruling

On December 23, 2009 the Court of Justice of the European Union (the “Court”) issued its judgment in case C-45/08 – *Spector Photo Group NV and Chris Van Raemdonck v Commissie voor het Bank-, Financien Assurantiewezen (CBFA)* (the “*Spector Photo*” case). A key aspect of the operative part of this judgment is the authoritative construction of Article 2 of Directive 2003/6/EC on insider dealing and market manipulation (market abuse) (the “Market Abuse Directive”, or the “Directive”). This is the first interpretation the Court gives of texts of the Directive, with focus put on clarifying the concept of “trading on inside information”. The Bulgarian legal provision corresponding to Article 2 of the Directive is Article 8 of the Act on Prevention of Market Abuse with Financial Instruments (the “APMAFI”).

Spector Photo is a Belgian public company which had adopted a scheme to incentivize its personnel by way of stock options. In order to implement the scheme the company needed to buy in 2003, through the Euronext Brussels stock exchange, a certain number of its own shares. *Spector Photo* disclosed publicly its intention to make such purchases on May 21, 2003. *Spector Photo* managed to purchase in total 27, 773 of its shares in the period May 28 through August 30, 2003. Within that period, the company purchased on August 11 and 13, 2003 in particular 19,773 shares at average price of 9.97€/share (the option exercise price was set at 10.45€/share). Those particular purchases were made based on orders placed by Mr. Van Raemdonck, one of the company's managers. Shortly thereafter, *Spector Photo* published certain information concerning its results and its business policy, including an intention to acquire control over a competitor undertaking through companies in its group. Then, the share prices of the company rose, reaching 12.50 € on December 31, 2003. The Belgian Commission, by decision dated November 28, 2006 categorized the purchases made on the basis of the orders of August 11 and 13, 2003 as unlawful insider trading and imposed fines of 80,000€ on *Spector Photo* and 20,000€ on Mr. Van Raemdonck. *Spector Photo* and Mr. Van Raemdonck then brought an action against that decision before the Court of Appeal of Brussels, which in turn stayed proceedings and referred to the Court a request for preliminary ruling by which certain texts of the Directive would be interpreted. The Court accepted to hear the case¹. The insider trading allegation by the Belgium Commission, the CBFA, affords the supposition that the purchases of own shares by the company which took place on August 11 and 13, 2003 were not carried out by *Spector Photo* independently of any knowledge of the later announcements about financial results and business policies (including the contempla-

¹ Regardless of certain legal and procedural peculiarities of the particular dispute (which are of greater relevance to practices in Belgium), the Court decided that it would be admissible to hear the case and to issue a preliminary ruling with construction of certain texts of the Directive.

For further information please contact our capital markets team:

Nikolay Bebov, Partner
Tel. +35929355134
nikolay.bebov@bg.landwellglobal.com

Maria Urmanova
Tel. +35929355122
maria.urmanova@bg.landwellglobal.com

Kamena Valcheva
Tel. +35929355127
kamena.valcheva@bg.landwellglobal.com

Hristina Gabrovska
Tel. +35929355100
hristina.gabrovska@bg.landwellglobal.com

ted take-over), and that such purchases would have been concluded at different, higher prices had they taken place after the disclosure of the inside information concerned.

The Court issues preliminary rulings² upon the request by national courts of member states. Preliminary rulings are one of the key means through which uniform application of the EU laws across the various member states is being achieved. This is because the national jurisdiction which has made a reference for a preliminary ruling to the Court is bound by the Court's interpretation but so are the courts of other member states which hear cases dealing with identical issues as those referred. It is not surprising that a large number of founding principles of the EU law have been laid down by preliminary rulings of the Court.

The above said, the judgment in the *Spector Photo* (the "Judgment" or "Judgment of the Court") is also a source of the law in Bulgaria. It contains an authoritative construction of Article 8 of APMAFI³.

Interpretation of Article 2 of the Market Abuse Directive

Article 2, paragraph 1 of the Directive sets out the general prohibition of insider dealing: "Member States shall prohibit any person referred to in the second subparagraph⁴, the so called "primary insider",⁵ who possesses inside information from using that information by acquiring or disposing of, or by trying to acquire or dispose of, for his own account or for the account of a third party,

2 Known since long in the practice of the Court, preliminary rulings are currently governed by Article 19 (3)(b) of the Treaty on European Union and Article 267 of the Treaty on the Functioning of the European Union (consolidated versions resulting from the changes introduced by the so called Treaty of Lisbon, which became effective on December 1, 2009).

3 As well as of some other texts based on the Directive, which are, however, outside the scope of this newsletter.

4 Which contains a list of the so called "primary insiders" – members of administrative, management or supervisory bodies of the issuer of financial instruments to which the inside information relates, persons with access to inside information by virtue of their holding in the capital of the issuer or voting power at general meetings (e.g. majority shareholder), and person with access to inside information on account of the exercise of employment, profession or duties (e.g. auditors, legal counsels, corporate finance consultants). The term also includes one other kind of primary insiders – those who have acquired information by criminal activities.

5 In this part of the text and hereinafter we use text in square brackets to rephrase, for convenience, certain original texts contained in documents officially published on Internet pages of the EU institutions (such as the legal portal of the EU, and the website of the Court). Underlined text is also to indicate our emphasis.

either directly or indirectly, financial instruments to which that information relates".

Article 8, paragraph 1 of APMAFI reads: "Any person who possesses inside information by virtue of his/her membership in the issuer's management or supervisory bodies, of his/her holding in the capital or the votes in the issuer's general meeting, of the access which he/she has to the information on account of the exercise of such person's employment, profession or duties, or of its acquisition by criminal activities or in another illegitimate way, shall be prohibited from using that information by acquiring or disposing of, or attempting to acquire or dispose of, for his/her own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates".

The Court focuses on the elements of which the activity consists, and more precisely on what "using" inside information stands for. Item 1 of the Operative Part of the Judgment reads: "On a proper interpretation of Article 2(1) of the [Market Abuse] Directive, the fact that a [primary insider who is] in possession of inside information, acquires or disposes of, or tries to acquire or dispose of, for his own account or for the account of a third party, either directly or indirectly, the financial instruments to which that information relates, implies that that person has 'used that information' within the meaning of that provision, but without [such interpretation prejudicing] the rights of the defense and, in particular, to the right to be able to rebut that presumption. The question whether that person has infringed the prohibition on insider dealing must be analyzed in the light of the purpose of that directive, which is to protect the integrity of the financial markets and to enhance investor confidence, which is based, in particular, on the assurance that investors will be placed on an equal footing and protected from the misuse of inside information".

The analysis of the Judgment of the Court in this part brings forward several important notions:

- The constituent elements of insider trading are objectively observable – "possession", or access to, inside information on the part of a primary insider⁶, and taking part in a transaction (acquisition, disposal) in financial instruments to which the information relates;
- The Court emphasizes, in the same spirit, that the Directive does not require, for it to be prohibited, a transaction to be carried out with

6 And on the part of "secondary insiders" in the situations covered by Article 10 of APMAFI.

full knowledge of the facts: Article 2, paragraph 1 of the Directive does not envisage as a constituent element of insider trading any subjective condition of the primary insider, such as an intention that drives him/her towards the material actions embodying the prohibited transaction (speculative intention, fraudulent intention, deliberate or negligent misconduct), does not set out expressly that it is necessary to establish that the inside information was decisive in the decision to enter into the transaction for acquisition or disposal, neither does it expressly provide that the primary insider had to be aware that the information in his/her possession qualifies as “inside”⁷.

- It can be observed that the Court links possession of inside information and trading in financial instruments to which the information relates with a certain presumption that such information – of and by necessity in the normal course of events – would be taken into account and thus “used” by the insider when making a decision to trade.
- This presumption is rebuttable – were it not, this could lead to infringing the fundamental right of defense of the person who allegedly breaches the law. To this point exactly, the fact that Article 2, paragraph 1 of the Directive does not expressly provide for a subjective element does not mean that this rule is to be interpreted in the sense that every primary insider in possession of inside information, trading on the market, automatically falls within the prohibition on insider trading. This would be an expansive construction of the Directive that would create the danger of widening the scope of the insider trading prohibition beyond what is appropriate and necessary to attain the objectives of the Directive (protection of market integrity and fostering of investor confidence). That is, this would risk imposing a prohibition on certain market transactions which do not necessarily infringe the interests guarded by the Directive. Accordingly, the Court continues, one must “distinguish ‘uses of inside information’ which are capable of infringing those interests from those which are not.... [T]he prohibition of [trading on inside information] applies where a primary insider ... takes unfair advantage of the benefit gained from that information by entering into a market transaction in accordance with that information”⁸.

- The Court reminds of the Preamble of the Directive and enumerates several such cases of use of inside information which is not prohibited, as such use is not of a nature that would cause it to infringe the protected interests: thus, the activities of market-makers, entities authorized to act as counterparties, and certain others, must not be considered to constitute prohibited insider trading, as such activities would normally be carried out through legitimate market transactions in line with market and statutory rules and practices. Similarly, access to inside information relating to another company-target and using it on the part of the bidder in the context of a take-over bid or a merger proposal “should not in itself be deemed to constitute insider dealing” – e.g. the launching of a take-over bid, after the bidder obtains from the target company yet undisclosed inside information concerning the target company, at prices higher than the market rates, cannot, as a matter of principle, be regarded as prohibited insider trading.

In a brief recapitulation, the Court’s interpretation is built on the presumption that each primary insider in possession of inside information uses it the moment he or she enters (or tries to enter) into a transaction in the financial instruments to which the information relates, thus consummating the prohibited insider trading. This would be so unless, by applying appropriate teleological construction, i.e. interpretation with a view of the purpose of the Directive (APMAFI), of the concept of insider trading, regard had of the particular facts, the presumption could be rebutted through the conclusion that the particular action (e.g. entering into a transaction) does not stand in the way of attaining the objectives of the Directive – protection of market integrity and fostering of investor confidence.

Practical implications of the Judgment

There are many possible questions which remain without an answer after the *Spector Photo* Judgment, as it proclaims principles and general criteria for identification of instances of “insider dealing”, but does not provide detailed, practicable and easily applicable tests of whether an insider enters into a prohibited or a lawful transaction. A number of commentaries of the practical implications of the Judgment point out that it is likely that the Judgment will untie the hands of EU member states supervisory authorities to the effect of investigating, proving and penalizing alleged insider dealing with greater ease. Such commentaries are not lacking in argumentation.

⁷ Paragraphs 31 and 32 of the Judgment.

⁸ Id. paragraphs 45, 46 and 53.

On the one hand, the interpretation of the Court tends to relieve supervisory authorities of the necessity to substantiate any subjective element (intention, knowledge, taking into account, weighing in the importance of a given information in the context of making a decision to trade) that would otherwise characterize the actions of primary insiders when trading. A possible but lesser difficulty for supervisory authorities would be to prove that, at a given point in time, the insider already “possessed” (had access) to inside information⁹, and another one – of course – to prove that the information qualifies in the eyes of the law as “inside”. On the other hand, the presumption, derived from the Judgment, shifts the burden of proof on the person who allegedly uses the inside information in breach of the prohibition, with such person having to rebut the presumption by proving and substantiating that the particular mode of “using of the inside information” cannot infringe the interests protected by the Directive (market integrity and investor protection). As the Judgment of the Court does not spell out clear safe harbors when those interests would not be infringed (except for the examples repeated from the Directive’s Preamble), rebutting the presumption looks like a complex evidentiary and interpretational exercise.

Which categories of market participants in Bulgaria would be advised to consider the effects of the Judgment? Rather, everyone in practice – from issuers to institutional investors and investment firms, since all of them (or their management or employers) could fall within the definition of primary insiders.

A practical advice to such participants that might be given at this stage, with certain reservations, could be this: to introduce and strictly observe (and be able to demonstrate such strict observance through appropriate evidence) reliable internal organizational procedures and mechanisms concerning the handling (including public disclosure) of inside information that is generated by such participants (issuers), or to which such participants gain access in the course of their business (e.g. investment firms). Such procedures would identify inside information yet “in the process of making”, would regulate access to it until its public disclosure, and would draw clear lines around the rights and obligations of insiders. By that token, clear regulation of the access to yet

⁹ Awareness on the part of the primary insider that such information qualifies as “inside” for the purposes of APMAFI is not required.

unpublished inside information¹⁰, only in favor of persons who need to know of such information prior to its disclosure (the so called need-to-know principle), would allow other persons within the same organization, separated from the insiders by way of information walls, to continue to carry out their normal legitimate business (e.g. brokering in financial instruments) without being tainted, and without the organization as a whole being tainted, with “possession” and/or such “using” of inside information which results in infringement of the interests guarded by the Directive¹¹.

The practice of introducing and abiding by rules on the handling of inside information has been known to more developed capital markets even before *Spector Photo* (for example, it is recommended in Germany (BaFin), the UK (FSA), Denmark, and other developed capital markets). Despite the inevitable additional administrative burden, adopting similar practices in Bulgaria could be feasible as a possible approach to address legal risk (in the light of the Judgment in *Spector Photo*), as well as a demonstration of a more mature market.

The Market Abuse Directive – what next?

The Market Abuse Directive is currently in the spotlight of the European Commission’s efforts to improve financial services regulations. The revision of the Directive began in 2009 with a call for evidence on the Directive’s problematic areas. This call for evidence was addressed to market participants at large and received numerous responses. As of today, the European Commission has stated that it intends to put forward for discussion draft amendments to the Directive around the middle of 2010, with the purpose to have the draft enacted by the EU institutions and published in the Official Journal before the end of 2010. It is quite possible that such amendments will also touch upon the concept of insider trading, by attempting to clarify it further.

There is, also, one other case pending before the Court, pursuant to a reference for preliminary ruling, this time originating from the Netherlands and involving the scope of the market

¹⁰ Article 13 of APMAFI envisages situations in which public disclosure of inside may legitimately be delayed, or a delay may result from certain organizational failures.

¹¹ In the *Spector Photo* context, it is thinkable, with the benefit of hindsight, that trustworthy internal procedures could have delineated (for the purposes of inside information handling) the activities of the human resources department from those of such other company officers who were in charge of the undisclosed insider information (the *Spector Photo* team working on the acquisition of the competitor undertaking).

manipulation prohibition under the Directive – IMC Securities BV v Autoriteit Financiële Markten (AFM). A judgment is expected within this year and is likely to provide another authoritative construction of the Market Abuse Directive's texts, probably of interest above all to investment firms.

Notes:

This newsletter does not address all elements of the judgment of the Court of Justice of the EU. We remain available to give further details of this judgment.

This newsletter does not constitute legal advice in respect of any particular situation and any actual issue. These may require competent legal consultancy by an appropriately qualified counsel, experienced in the relevant area of law.