

FSA publicly censures bond traders: failure of the reasonable grounds defence

Oct 08 2009 [Toby Robinson](#) recommended

After an investigation that began in the summer of 2007, culminating in hearings before the Regulatory Decisions Committee, the Financial Services Authority has today issued final notices in relation to two bond traders, Darren [Morton](#) and Chris [Parry](#), finding that they had each engaged in market abuse in connection with a debt issue. In an unprecedented step, (perhaps reflecting the representations that the conduct reflected accepted market practice at the time and was in line with internal compliance guidelines), the findings were not accompanied by fines or prohibition orders.



Toby Robinson

What happened?

A number of calls were received by a Dresdner structured investment vehicle known as K2 in order to test likely appetite for a new issue of debt by Barclays. At no point during the calls was it by any means certain that the issue would proceed, although the levels of uncertainty, particularly as to timing, varied as the calls proceeded. Having received the calls, K2 dealt in an existing debt security of the same issuer.

The key issues

Pre-marketing calls of this nature play an important part in the debt markets but (in contrast to the equity markets) Morton represented that they have generally been regarded by market participants as being neither specific nor price sensitive for market abuse purposes, leaving them free to deal following receipt of the call. Indeed, as the final notice against Morton states, the Dresdner compliance guidelines indicated that K2 (which regularly received similar calls) was "not routinely privy to price sensitive non-public [information]". Today's decisions send a clear message that this analysis is incorrect. The debt markets will have to reconsider their practices. The principles underlying the decision are also relevant to other OTC markets, which may need to reconsider their own accepted practices.

The FSA repeats its view that price sensitivity should be assessed by reference to whether the information will be relevant to an investor's decision to buy or sell the securities (a test for which an actual or expected price movement may not be an essential element). But where a price movement is envisaged it should not be disregarded solely on the basis that it is expected to be temporary — if a brief peak or drop is expected while the market digests the news, this may be enough if it is otherwise "significant".

In the Morton case, the RDC considered the market abuse defence, which excuses behaviour if the individual believed on reasonable grounds that his behaviour did not amount to market abuse. The FSA stated that reliance on a combination of guidance from the Dresdner compliance department and market practice at the time was not sufficient to establish the reasonableness of Morton's belief. Despite such guidance and market practice, a person nevertheless had "a responsibility to consider whether the information was capable of being inside information". This arguably creates an almost insurmountable barrier before the defence can be relied on and would also appear to be far more restrictive than the draftsman intended.

Lessons to be learned

Firms will need to re-visit the analysis of their activities in the debt and other non-equity markets. Parallels should be drawn with the more considerable body of analysis in the equity markets, where appropriate. Training should be provided which is tailored to business models: firms should not assume that staff will apply the necessary (or correct) read-across to examples designed for different business models or markets. Compliance guidelines should be reviewed and updated if necessary.

Comment

There are a number of unusual aspects to these cases. It was argued that the conduct conformed to accepted market practice and that there was a genuine belief that the behaviour was not abusive. The RDC accepted that Morton believed that his behaviour did not amount to market abuse (although it did not agree that this belief was reasonable). It also found that the behaviour was neither deliberate nor reckless. It therefore seems extremely harsh to make examples of two individuals, who were also complying with internal guidelines, when FSA guidance would have sent the same message to the market. This is the first time that the market abuse defence has been analysed in any detail in any reported decision. Unfortunately, the comments in relation to the defence send a clear signal that the FSA has set the "reasonable belief" test almost impossibly high. It is exceptional for the FSA to issue a finding of market abuse but not to impose either a fine or a prohibition order, particularly given the FSA's credible deterrence policy, most recently articulated by Margaret Cole in her [speech](#) at the recent Fraud Advisory Panel AGM.

In a sense, however, the fact that both Morton and Parry were publicly censured, despite the fact that neither of them was found to have acted deliberately, recklessly or in breach of compliance guidelines, sends a deterrent message. The sanctions imposed can perhaps be best explained as reflecting the lack of actual culpability on the part of the individuals involved. These decisions raise questions in relation to the FSA's stated intention to impose a minimum fine of £100,000 on individuals found to have engaged in market abuse (see the recent consultation paper on Enforcement Financial Penalties (CP09/19)). It seems clear that a £100,000 fine would have been entirely inappropriate in a case such as this.

Toby Robinson advised Darren Morton.

TRAVERS SMITH

Toby Robinson is a partner in Travers Smith's litigation department and a member of the firm's regulatory investigations group. His practice covers a broad range of contentious work, predominantly in the financial services area, including FSA investigations.

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