Case Note: Market Abuse Proceedings in the High Court

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The judgment in *The Financial Conduct Authority v. Da Vinci Invest Limited* [2015] EWHC 2401 (Ch) was published on 12 August 2015, following a trial in front of Mr Justice Snowden. The case concerned allegations that the defendants engaged in market abuse through the practice of 'layering' and 'spoofing'. These proceedings are novel, being the first time the Financial Conduct Authority ("FCA") has invited the court to impose a penalty for market abuse in exercise of its powers under s. 129 of the Financial Services and Markets Act 2000 ("FSMA"). Typically the FCA has responded to market abuse by itself imposing a penalty through its enforcement process. Any decision it makes can be subject to a *de novo* review (by the Upper Tribunal (Tax and Chancery Chamber). The novelty of this case presented the Defendant with the opportunity to advance a spectrum of arguments, challenging the scope of the court's statutory power and testing the terms of an available defence. For the most part these arguments were far from compelling and hence the judgment is largely uncontroversial. However, given the judgment stands as the first judicial articulation of the scope and procedure of the court's power under s. 129 FSMA, it is worthy of consideration.

Layering and Spoofing

The case focused on Contracts for Difference ("CFDs"), a type of derivative investment, which were referenced to equities traded on the London Stock Exchange ("LSE"). CFDs allow investors to agree to pay or receive the difference in value of an equity between that listed at the date of the contract and the price at a future date. Although not required to do so, the CFD provider, with whom the investor contracts, invariably places its own order of shares, equivalent to the CFD, in order to hedge its own position. Accordingly, parties who place CFDs are considered, albeit indirectly, to effect transactions in the equity market. As such, if their behaviour gives, or is likely to give, a false or misleading impression as to the supply or demand of such investments it will fall within the scope of FSMA's definition of market abuse. *(See Swift Trade case [2013] EWCA Civ 1662 at paras 29-34 in which the principle was espoused.)*

The FCA alleged that the defendants had been involved in the practice of layering and spoofing in the CFD market. 'Layering' involves the practice of placing large orders on one side of an exchange's electronic order book, without a genuine intention that the orders will be executed. The orders are deliberately placed at prices unlikely to attract counterparties. The order creates a false impression ('spoofing') which affects the price of the relevant share as the market adjusts to an apparent shift in the balance of supply and demand. That fluctuation is then taken advantage of through the execution of a trade on the opposite side of the order book. The trade is in turn followed by a rapid deletion of the large original order. The process can then be repeated in the opposite direction.

The Defendants

There were six defendants in the proceedings. Defendants 4-6 were individual traders. Together they had previously traded in CFDs on behalf of Swift Trade Inc. Their accounts were suspended by Swift Trade in 2007, on suspicion that they were conducting manipulative trading through layering. The activities of Swift Trade prompted the publication of a number of notices by both the LSE and the Regulatory Authorities, which expressed concerns about the practice of layering and spoofing and cautioned firms about behaviour which was symptomatic of such conduct.

The traders subsequently became connected with the first defendant Da Vinci Invest ("DVI"), which agreed that the traders could trade using it financial resources on the basis of a profit-share arrangement. Trading under this arrangement commenced in 2010 and was effected through Direct Market Access ("DMA") services which DVI contracted for. It was through this arrangement with DVI that the traders embarked on a course of conduct which was found to be market abuse by way of layering and spoofing, as described above.

The statutory basis of the proceedings

The FCA can take action against market abuse through different avenues. Under s. 123 FSMA the FCA can impose a financial penalty for market abuse through its own regulatory enforcement process ("an enforcement action"). In pursuing an enforcement action the FCA is required to issue the subject of the investigation with a Warning Notice, the findings of which can be challenged through representations. A resulting Decision Notice can be referred to the Upper Tribunal (Tax and Chancery Chamber) for *de novo* review. Section 123(2) offers a defence to the subject if they can show that:

- they had reasonable grounds to believe that their behaviour did not constitute market abuse; or
- they took all reasonable precautions and exercised all due diligence to avoid behaving in a way which constituted market abuse.

Alternatively the FCA can seek an injunction from the High Court under s. 381 FSMA. On application for an injunction the FCA can then also request that the court impose a financial penalty on the defendant party under s. 129 ("a civil action"). In the present case the FCA pursued the Defendants for market abuse through a civil action.

Challenges to the procedure and the court's power

It was the interplay between these two avenues of statutory action—the enforcement action and the civil action—which gave rise to several jurisdictional and procedural arguments deployed by the first defendant (DVI), the only party represented at the proceedings. It was submitted that the FCA was acting unlawfully by requesting the court to impose a financial penalty under s. 129, without affording the defendant the right to be issued with a Warning Notice on which it could make representations. Unsurprisingly the Court rejected this argument: the processes through which the FCA could take action were distinct and independent of one another. There was no material difference and hence no unfairness to a defendant faced with an application under s. 129, rather than a decision by the FCA to impose a regulatory penalty under s. 123.

The Court also rejected the Defendant's argument that the power of a court to impose a financial penalty under s. 129 is *only* exercisable where it has *actually* granted an injunction under s. 381. The argument was based on the statutory wording, that the power to request the imposition of a financial penalty is available where it is made "on an application to the court" for an injunction. The Court accepted that, in circumstances where for example the claim for an injunction is struck out for lack of merit, the court's power under s. 129 may not be exercisable. Such circumstances were not present here however. *(See para. 101-2 of the judgment)*

The scope and terms of a statutory defence

A second area of considerable dispute in the proceedings concerned the mental element of market abuse for a determination under s. 129 and the terms and scope of the available defence. The judgment provides the following points of clarification:

- Behaviour amounting to market abuse (as defined in s. 118) does not require a mental element, but is referable only to objective conduct. *(See paragraphs 105-8)* A defendant's mental state can however be the basis for a defence.
- Although s. 129 does not contain express reference to any available defence, the defence in s. 123 (2) applies equally, including that the burden of proof is on the defendant. *(Paragraphs 89-94)*
- When determining whether a corporate entity is guilty of market abuse the general rules of attribution apply. The conduct will be attributed to the corporate if the individual responsible was acting as an agent of the company. It is not necessary that the conduct was committed by a 'directing mind and will' of the company.
- However, the corporate could still raise a defence under s. 123(2) by relying on the belief or actions of its directing mind. The defence could be raised notwithstanding the mental state of the individual agent responsible for the conduct. *(Paragraph 117)*
- In order to raise the first limb of the defence under s. 123(2) (showing reasonable belief) the defendant must have had some positive knowledge of the behaviour and a consideration of whether it amounted to market abuse. The defence is not available simply where the defendant is unaware of the behaviour. *(Paragraph 181)*
- In assessing the merits of DVI's defence under the second limb of s. 123(2) (taking all reasonable steps), the court rejected DVI's claim that its responsibility to monitor the traders' activities was diluted because no employment relationship existed between it and the traders. Similarly, it rejected the argument that DVI was entitled to rely on the monitoring systems of the firms providing DMA services. *(Paragraph 168)*

The judgment therefore helps to clarify some of the ambiguities in the statutory framework concerning a civil action against market abuse. Whether, the novelty of the FCA bringing an action through this channel marks any change in policy is difficult to discern. One would have thought that the procedure ensures a more expeditious outcome which, given that an enforcement action allows for a *de novo* review by the Tribunal (instead of an appeal limited to legal points), is less likely to be the subject of challenge.