A Bad Apple on the Hedge? Or the Thin End of the Wedge?

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The FSA market abuse enforcement proceedings earlier this year against GLG Partners LP ("GLG") and Philippe Jabre ("Jabre") attracted a great deal of publicity. The purpose of this article is to attempt to demystify the case by summarizing its facts and the FSA's findings and also to put it in the context of other related current FSA-regulatory developments and changes. The opinions and conclusions of the author are based on information derived from publicly available sources. No use has been made of non-public information in the preparation of this article.

As the FSA's first market abuse case against a hedge fund manager and one which involved a senior managing director who was a well known name in the hedge fund world, the FSA's enforcement proceedings against GLG and Jabre attracted much attention and a swirl of rumours. After the decision of the FSA's Regulatory Decisions Committee in March 2006 facts and result of the case were widely reported in the financial press – although there was not one word of public comment on the case from the FSA. What had happened was that the FSA's Regulatory Decision Committee ("RDC") had issued a Decision Notice on 28 February 2006. Jabre referred (appealed) the matter to the Financial Services and Markets Tribunal a month later and in late July the Tribunal decided against Jabre on the two preliminary issues he had raised. After that defeat, Jabre withdrew his appeal. At that point the FSA issued a "Final Notice" dated 1 August setting out and giving effect to the RDC's 28 February decision. Only then did the FSA comment on the case publicly and announce the result. One of the consequences of the fact that the FSA did not officially announce the result of the RDC hearing until late July was that the rumour mill continued to churn unchecked until that time.

Jabre was fined £750,000 (the largest fine that the FSA has ever imposed on an individual in an enforcement proceeding) for market abuse and breach of Principles 2 (due skill, care and diligence) and 3 (market conduct) of the FSA's regulatory Principles for Approved Persons. GLG was also fined £750,000 for market abuse and breach of FSA Principle 5 (market conduct) of the FSA's regulatory Principles for Businesses.

What happened?

The key facts, summarised from those set out at much greater length in the Final Notice (available at http://www.fsa.gov.uk/pubs/final/jabre.pdf) were as follows:

On 11 February 2003, as part of a pre-marketing exercise ahead of the announcement of a new issue of convertible preference shares in Sumitomo Mitsui Financial Group Inc ("SMFG"), a Goldman Sachs International ("GSI") senior salesman telephoned Jabre to explore Jabre's and GLG's interest in participating in the SMFG convertible preference share issue.

It is not entirely clear whether the GSI salesperson read in full to Jabre the GSI prepared script in which it was stated that the salesman wished to discuss with Jabre some information which was not yet public in relation to a proposed issue of securities. The prepared script continued by stating that if the information was passed on by the salesman, the recipient would be bound to keep it confidential and would not be permitted to trade in securities of the entity concerned nor engage in any other trading-related conduct in respect to those securities based on the confidential information. Those restrictions were to continue until the information was in the public domain. The sharing of information in this way is routine, the recipient is termed as having been "wall crossed" i.e. brought across to the "confidential" side of an information wall designed to prevent improper use of confidential price sensitive ("inside") information.

Jabre did not dispute that he agreed to be "wall crossed". There was, however, some dispute as to the precise details of his telephone communications with GSI with respect to the implications for Jabre of his having been wall crossed and in particular the possible effect on his ability to continue to trade in SMFG securities.

The RDC concluded that Jabre "clearly and unequivocally" accepted that he would be restricted in dealing with SMFG securities (and any linked derivatives and other linked investments) before he was given any information by GSI concerning the prospective issue and knew the usual and proper restraints on his investment activities which flowed from the restriction, that is to say: he could not trade in SMFG Securities at all.

Earlier in February, prior to being wall crossed, Jabre had short sold some SMFG ordinary shares. In the days following his being wall crossed (12-14 February), Jabre short sold a larger number of SMFG ordinary shares in a total of eight separate trades.

While Jabre did not consult GLG's own compliance department, he asked the GSI salesman to check with GSI's compliance department whether Jabre could continue to deal in SMFG securities in accordance with his "pre-existing trading pattern." There was some dispute as to the precise response Jabre received from GSI. It appears that GSI's compliance department indicated that there was no problem in Jabre leaving pre-existing orders to be filled but that no new orders could be issued. Jabre argued that he understood this to mean that he could maintain his prior trading pattern i.e. that he could continue to short SMFG stock.

When the new SMFG convertible issue was announced on 17 February 2003, Jabre made a profit of $500,000 for the GLG Market Neutral Fund, one of the funds he managed, on the short sales he had put on after being wall crossed. The FSA considered this a "substantial" profit.

What did Jabre do wrong?

1. Market abuse
2. Failed to consult his compliance department
3. Failed to observe proper standards of market conduct

1. What conduct constituted market abuse?

GSI gave Jabre confidential information concerning a forthcoming issue of securities. The information was provided to enable Jabre and GLG to decide whether to participate in the issue and on condition that Jabre and GLG did not trade in the relevant security based on their possession of the information. Jabre and a GLG fund which he managed did trade on the basis of this information. The test of whether this behaviour amounts to market abuse is whether a reasonable user of the market in question would consider it to fall short of the acceptable standards of behaviour in that market. The RDC had no doubt that:

- several aspects of Jabre's conduct would be judged by regular market users to fall short of the expected standard; and
- his conduct compromised the fair and efficient operation of the markets as a whole.

2. Jabre's failure to consult his compliance department.

Jabre accepted in an interview which the FSA conducted as part of the enforcement proceedings that, with hindsight, he was wrong to fail to consult GLG's compliance department. He argued before the RDC that this failure was an "error of judgement" and should not be regarded as a basis for imposing disciplinary sanctions. The FSA roundly rejected that argument. In the RDC's view since Jabre had acknowledged (in an interview during the enforcement process) that the situation he had found himself in was "unprecedented," their conclusion was that in such a situation (one which Jabre himself considered to be "unprecedented") the only proper course of conduct was to consult GLG's compliance department before carrying out any trades.

In light of the above, the FSA concluded that Jabre's failure to consult GLG's Compliance Department was "a failure to take due care in the performance of [Jabre's] controlled function" and a breach of FSA's Principle 2 (due skill, care and diligence).

A finding of this type, if not itself unprecedented, is highly unusual. It certainly sends a powerful signal which places the compliance function front and centre. There is no doubt at all that this FSA decision enables a compliance officer to say to his firm's employees: in any situation where you are in doubt as to whether a certain course of action is permissible under FSA rules – or proper in accordance with FSA's principles – a failure to consult with us is a potentially serious disciplinary matter for you and the firm. Discussing the matter with a third party's compliance department and taking advice

informally from them makes your situation worse not better. Consulting us is not optional: it is essential if you are to be acting in accordance with the FSA's expectations of due skill, care and diligence.

3. What behaviour constituted Jabre's failure to observe proper standards of market conduct?
The answer to this question is straight forward. The RDC found that Jabre's short sales breached the FSA's market conduct rules and that was a failure to observe proper standards of market conduct and a breach of Principle 3 which requires approved persons to comply with such behavioural standards.

What did GLG do wrong?

1. Market abuse
2. Failed to observe proper standards of market conduct

1. What conduct constituted market abuse?
Jabre's seniority and authority at GLG were such that his market abuse was attributable to GLG.

GLG argued that no penalty should be imposed because it took "all reasonable precautions and exercised all due diligence" to market abuse. GLG's position was that its compliance procedures required employees to consult the Compliance Officer if they were in any doubt whether a particular transaction would be prohibited. The RDC stated that such procedures may have been sufficient, by the standards prevailing and expected in 2003 (the date of Jabre's SMFG short sales), to protect GLG from a general finding that its systems and controls were in breach of Principle 3 for Businesses ("A firm must take reasonable care to organize and control its affairs responsibly and effectively, with adequate risk management systems"). However, the RDC went on to observe that where market abuse occurs, higher standards are required in order to meet the standard of taking all reasonable precautions and exercising all due diligence.

The RDC made it clear that regulated firms' compliance procedures must require employees to report to or consult with their compliance department whenever they were wall crossed. Firms must also have a system of "stop lists" prohibiting, for example, prohibiting trading by anyone in the firm after any employee has been made an insider with regard to a prospective issue – or effective Chinese walls to insulate an insider from other employees.

The RDC made a finding that the risk of market abuse occurring would have been significantly reduced, if either or both of the precautions outlined in the previous paragraph had been in place at GLG. Therefore, GLG could not show that it had taken "all reasonable precautions" and exercised "all due diligence" in February 2003. It had therefore committed market abuse itself.

2. What behaviour constituted GLG's failure to observe proper standards of market conduct?
Based on the facts set out immediately above, the RDC considered that, in committing market abuse, GLG had also failed to observe proper standards of market conduct and was in breach of Principle 5 of the FSA's Principles for Businesses.

The Appeal

GLG accepted the RDC's penalty. Jabre appealed to the Financial Services and Markets Tribunal. As part of the appeal the Tribunal was asked to decide two preliminary points. Jabre lost on both of these. First, the Tribunal ruled that Jabre's short sales on the Tokyo market could constitute market abuse. Second and more significantly, the Tribunal also accepted the FSA's contention that it could add to the RDC's findings a decision that Jabre had breached Principle 1 (integrity) and was not a fit and proper person to be registered. The RDC had refused to make that finding. Although not expressed in such terms, the effect of the Tribunal decision is to give the FSA a right to appeal a "not guilty" finding if the defendant appeals any part of the RDC's decision.

What's Next?

In recent months, since the Jabre decision, the heads of enforcement of both the FSA and SEC have expressed concern about potential improper trading by hedge funds. Margaret Cole, the FSA's Director of Enforcement said in mid-October:

> *"Of particular interest to us in enforcement is the FSA's belief that some hedge funds may be testing the boundaries of acceptable practice with respect to inside trading and market manipulation. In addition, given their payment of significant commissions and close relations with counterparties, they may be creating incentives for others to commit market abuse."*

In mid-November, the SEC's Enforcement Director, Linda Thomsen, said:

> *"We keep learning and relearning. You need to follow the money. These days, the money is in hedge funds, and there is potential for abuse."*

So hedge funds are squarely in the sights of the enforcement departments of two leading regulators. If the conduct for which Jabre and GLG were disciplined proves to be an isolated example – a bad apple on the hedge – the focus will move elsewhere. Indeed there are already indications that the same regulators will focus their attention on private equity funds. If, however, the regulators' concerns translate into enforcement proceedings, and the Jabre/GLG case turns out to be the thin end of the wedge, the hedge fund community cannot deny that the case was a loud, clear wake up call.

Finally, the focus on the FSA's principles in the Jabre/GLG decision is in tune with the FSA's stated aim of moving to a more principle-based approach to regulation. Principle-based regulation is designed to increase the role of senior management in compliance. The FSA wants to ensure that compliance is not regarded as a matter for the compliance department alone to deal with. As the RDC told Jabre in clear terms, it is the responsibility of all employees to consult their compliance departments in any case of doubt or face the consequences. As Jabre and GLG found out, the consequences can be severe -- not just a large fine but a battering to your reputation.

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