JONES DAY

FEBRUARY 2012

FSA'S FINE OF DAVID EINHORN AND GREENLIGHT CAPITAL FOR INSIDER TRADING VIOLATION

On January 12, 2012, the United Kingdom's Financial Services Authority levied a fine on David Einhorn and his hedge fund, Greenlight Capital, Inc., in the total amount of £7,288,795 (approximately $11.6 million) in civil penalties for trading on inside information.[1] The FSA determined that the actions of Einhorn and Greenlight amounted to "a serious case of market abuse." This matter does not involve novel issues of law, but it does highlight a common fact pattern that multijurisdictional market participants must consider in the context of inside information.[2] In addition, it highlights certain differences between the laws of insider trading in the United Kingdom and the United States.

U.K. THEORY OF INSIDER TRADING

In the United Kingdom, insider dealing occurs where an insider engages or attempts to engage in an investment on the basis of inside information relating to that investment.[3] Inside information is information of a precise nature that is generally not available, relates to the investment, and "would, if generally available, be likely to have a significant effect on the price" of the investment. For example, information for purposes of insider trading is considered precise if:

- it indicates circumstances or events that exist or may reasonably be expected to exist; and
- it is specific enough to "enable a conclusion to be drawn as to the possible effect" of those circumstances or events.

U.S. THEORIES OF INSIDER TRADING

The U.S. federal securities laws prohibit the use of material, nonpublic information in connection with the purchase or sale of any security. In the context of insider trading, the U.S. Supreme Court has developed the "classical" and "misappropriation" theories of insider trading.[4]

Under the classical theory, trading on material, nonpublic information does not give rise to an insider

trading claim unless a duty to disclose arises from the existence of a fiduciary relationship. This duty exists, for example, when a director, officer, or other insider trades in the securities of his or her corporation on the basis of material, nonpublic information because the fiduciary relationship between corporate insider and the shareholders of a company creates the duty to disclose or abstain from trading.[5]

Under the misappropriation theory, a person violates the U.S. federal securities laws if he or she "misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information." The misappropriation theory protects against "abuses by 'outsiders' to a company who have access to confidential information that will affect the corporation's security price when revealed, but who owe no fiduciary or other duty to that corporation's shareholders."[6] For example, in the recent case against Mark Cuban, owner of the National Basketball Association's Dallas Mavericks, the SEC alleged that Cuban traded in breach of his duty to the chief executive officer and the corporation because he had received confidential information from the chief executive officer, agreed to keep the information confidential, and acknowledged he could not trade on the information.[7]

The SEC has also promulgated Regulation FD, which seeks to prevent issuers from making selective disclosure of material, nonpublic information to securities market professionals.

THE FSA'S ALLEGATIONS AGAINST EINHORN AND GREENLIGHT AND REASONING

In the Einhorn matter, the FSA alleged the following key facts:

- By June 2009, funds managed by Greenlight held approximately 13.3 percent of Punch Taverns Plc's outstanding equity.

- Punch's board of directors engaged an investment bank to enter into discussions with certain shareholders, including Greenlight, regarding a potential private placement of Punch's equity following the shareholders entering into a standard nondisclosure agreement—a so-called "wall cross" offering.[8]

- Einhorn declined to enter into the nondisclosure agreement but agreed to participate in a conference call during which he claims he stated he was to receive no inside information. During the conference call, Einhorn learned, among other things, that Punch was at an advanced stage of the process toward an equity offering, the principal purpose of which would be to repay Punch's outstanding convertible debt and create a cushion with respect to certain covenants in Punch's securitization vehicles.

- Immediately following the conference call, Greenlight began to sell its shares of Punch. During the three days following the call, Greenlight sold 11.65 million Punch shares, reducing its holding in Punch from 13.3 percent to 8.98 percent.

- Six days after the conference call, Punch informed the market of its intent to raise £375 million in an equity offering. The price of Punch's shares fell approximately 30 percent, which resulted in Greenlight avoiding losses of approximately £5.8 million by selling in advance of that public announcement.

The FSA concluded that Einhorn had engaged in market abuse by trading on the information learned during the conference call. Specifically, the FSA found that the information:

- indicated that "an equity issuance might reasonably be expected to occur";

- was specific enough to "enable a conclusion to be drawn as to the possible effect of the issuance on the price of Punch shares";

- was not public; and

- "was likely to have a significant effect on price."

The FSA rejected Einhorn's assertion that Punch had not conveyed inside information because the discussion had been at a "conceptual level." The FSA concluded that "reasonable investors are expected to interpret comments made to them in an appropriate manner, which may sometimes mean understanding more than the precise words spoken,

or interpreting certain comments in light of the context." The FSA acknowledged that there was no single statement of inside information made during the conference call and that some interpretation was required to find that inside information had been imparted. Yet, the FSA found that the clear interpretation of the comments taken as a whole disclosed inside information because Punch management had "disclosed to Mr. Einhorn the purpose and anticipated size and timing of the issuance."[9]

ANALYSIS UNDER U.S. LAW

Under current theories of insider trading, it is questionable whether a U.S. court would conclude that Greenlight committed insider trading because Einhorn did not agree to keep the information confidential—in fact, he expressly declined to sign a nondisclosure agreement—and, therefore, owed no duty to the source of his information. This is in stark contrast to the facts alleged against Cuban, where the chief executive officer "preface[d] the call by informing Cuban that he had confidential information to convey to him in order to make sure Cuban understood—before the information was conveyed to him—that he would have to keep the information confidential."[10] Because Einhorn owed no duty to Punch, the source of his information, no classical theory of liability in the United States exists, and a successful claim under the misappropriation theory seems unlikely.

However, Punch's intentional disclosure of material, nonpublic information to Greenlight, without a nondisclosure agreement in place, would likely be considered a Regulation FD violation by the company in the United States in the absence of the simultaneous public disclosure of such information.

FINAL OBSERVATIONS

As noted above, the Einhorn matter does not raise novel issues of law, but it does highlight a common fact pattern that investors must consider when participating in these and analogous transactions.

Refusing to sign a nondisclosure agreement and communicating the desire to avoid receiving inside information does not mean that information received is generally available or is public information. Investors must make their own, independent determination regarding whether they have been provided inside information or material, nonpublic information. This determination may require analyzing the totality of many bits of information, understanding the nature of the communications, and consulting with counsel. For that matter, investors may wish to assess whether a company has complied with any agreement to provide a cleansing press release[11] or, in the United States, a current report on a Form 8-K, which is common in many private placement transactions.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

John C. Ahern
London
+44.20.7039.5176
jahern@jonesday.com

Marie Elena Angulo
London
+44.20.7039.5246
mangulo@jonesday.com

Daniel Bushner
London
+44.20.7039.5208
dbushner@jonesday.com

Alexander A. Gendzier
New York
+1.212.326.7821
agendzier@jonesday.com

Henry Klehm III
New York
+1.212.326.3706
hklehm@jonesday.com

Joan E. McKown
Washington
+1.202.879.3647
jemckown@jonesday.com

Harriet Territt
London
+44.20.7039.5709
hterritt@jonesday.com

ENDNOTES

1 The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS, *Decision Notice to David Einhorn*, Jan. 12, 2012, http://www.fsa.gov.uk/static/pubs/decisions/dn-einhorn-greenlight.pdf (hereinafter "*Decision Notice*").

2 In particular, in addition to the United Kingdom, market participants in other European jurisdictions should understand this fact pattern in the context of inside information.

3 Financial Services and Markets Act, 2000, c. 8, § 118. The FSMA implements the EU directive regarding insider trading. Council Directive 2003/6/EC, On Insider Dealing and Market Manipulation (Market Abuse), 2000 O.J. (L 96) 16. Because the FSMA follows the EU Market Abuse Directive, it is an open question as to whether the Einhorn case would have the same outcome in any other EU jurisdiction.

4 *United States v. O'Hagan*, 521 U.S. 642, 652 (1997) (citing *Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983)). In addition to the classical and misappropriation theories of insider trading, under the U.S. Supreme Court's "tippee" theory of insider trading, a tippee assumes an insider's duty if inside information was made available to him improperly and he knew, or should have known, of such impropriety.

5 *Id.* at 652.

6 *Id.* at 652-53.

7 *SEC v. Cuban*, 620 F.3d 551, 557-58 (5th Cir. 2010). The Fifth Circuit Court of Appeals in *Cuban* did not reach the issue of whether a confidentiality agreement is sufficient to create a duty to disclose or abstain from trading under the misappropriation theory. *Id.* at 555. The court merely held that Cuban agreed not to disclose any confidential information and, by extension, agreed not to trade on the confidential information he learned. *Id.* at 557-58 ("it is at least equally plausible that all sides understood there was to be no trading … that both Cuban and the CEO expressed the belief that Cuban could not trade appears to reinforce the plausibility of this reading."). The Fifth Circuit vacated the judgment dismissing the case and remanded the case back to the Northern District of Texas, where the case is currently pending.

8 The practice of "wall crossing" occurs when a company provides inside information to a third party, with the third party agreeing in a nondisclosure agreement to keep the material, nonpublic or inside information confidential and to trading restrictions. The wall-crossed party can resume trading either when the company makes the information public or through a cleansing statement, such that the company announces that a transaction was completed and discloses all related material, nonpublic information provided to investors, or that the offering was contemplated but not executed.

9 *Decision Notice*, at paras. 4.11, 4.12, 4.16, and 4.18.

10 *Cuban*, 620 F.3d at 555.

11 As noted above, a cleansing statement involves the company announcing that a transaction was completed and disclosing all related material, nonpublic information provided to investors, or that the offering was contemplated but not executed.