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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 154 – MARKET ABUSE DIRECTIVE REVIEW

Analysis of uncertainty around the insider dealing offence under the Market Abuse Directive arising from the judgment of the ECJ in *Spector Photo Group NV v CBFA*

c/o Bank of England

Threadneedle Street

London EC2R 8AH

www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 154 – Market Abuse Directive Review

Andrew Bagley	Goldman Sachs
Chris Bates	Clifford Chance LLP
Peter Bevan	Linklaters LLP
Carlos Conceicao	Clifford Chance LLP
Kate Haswell	CQS
Joanna Perkins	FMLC Director
Anne-Laure Condat	FMLC Acting Secretary

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INDEX OF DEFINED TERMS

"Commission" means the European Commission

"ECJ" means the Court of Justice of the European Union

"ESMA" means the European Securities and Markets Authority

"FMLC" or "Committee" means the Financial Markets Law Committee

"FSA" means the Financial Services Authority

"SEC" means the US Securities and Exchange Commission

1 INTRODUCTION AND EXECUTIVE SUMMARY

A. Introduction

1.1 The role of the FMLC is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2 This Paper, therefore, does not comment on policy issues other than as necessary to deal with issues of potential uncertainty or misunderstanding.

1.3 The FMLC considers that it is important that any revision of the Market Abuse Directive ("**MAD**") should address the uncertainty arising from the judgment of the ECJ in *Spector Photo Group NV v CBFA*.

B. Executive Summary

1.4 This Paper does not seek to address all ambiguities and uncertainties generated by the MAD; nor does it seek to identify exhaustively all potential concerns with respect to the issues raised. The purpose of this Paper is to highlight the uncertainty created by *Spector* for participants in the financial markets and to suggest ways in which the MAD may be amended or further EU legislation, or Technical Standards, adopted in order to remedy such uncertainty.

1.5 The FMLC's main area of concern is whether, for a person to commit the offence under article 2 of the MAD, that person must be dealing in the relevant financial instruments "on the basis" of inside information or merely "whilst in possession of" inside information.

2 ISSUES OF LEGAL UNCERTAINTY

Interpretation of article 2 of the MAD

Article 2 of MAD provides that:

> *Member States shall prohibit any person… who possesses inside information from using that information by acquiring or disposing of… financial instruments to which that information relates.*

Member States have, in general, implemented this prohibition in one of two ways.

1. Dealing "on the basis of" inside information. Some Member States (e.g. Ireland, the UK) have interpreted the prohibition as a prohibition on dealing in financial instruments on the basis of inside information.[1] Under this interpretation, a person carries on prohibited insider dealing where their decision to deal is influenced by inside information that they possess. A person would not be found to have engaged in insider dealing in circumstances where possession of the inside information did not influence their decision to deal, in other words where they would have dealt even if they had not possessed the inside information.

2. Dealing "in possession of" inside information. Other Member States (e.g. Belgium) would consider that a person is prohibited from dealing in financial instruments where he possesses inside information about those instruments. It is not relevant that he would have dealt anyway, and that the inside information had no impact on his decision to deal.

Requirement for defences and exemptions under the second approach

The second approach raises substantial practical problems and requires many more defences and exemptions to avoid injustice in its application and to allow markets to

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[1] The rules in the UK provide as follows:
- section 118(2) of the Financial Services and Markets Act 2000: "...where an insider deals, or attempts to deal, in a qualifying investment or related investment **on the basis of** inside information relating to the investment in question"; and
- the FSA's Code of Market Conduct (MAR) 1.3.4 : "In the opinion of the FSA, if the inside information is the reason for, or a material influence on, the decision to deal or attempt to deal, that indicates that the person's behaviour is "**on the basis of**" inside information."

function normally.

For example, the second approach gives rise to issues regarding company share buyback programmes. Listed companies frequently undertake regular share repurchase programmes, including through close periods when they are in possession of inside information, because they delegate trading discretion to an independent broker whose trading decisions are not made on the basis of the inside information. Under the second approach, companies would have to interrupt repurchase programmes for no externally apparent reason if they come into possession of inside information. The sudden interruption of a regular programme can give rise to false markets. Speculators can also take advantage of the fact that companies have to cease repurchase programmes when they have inside information in the run up to results announcements.

Similarly, the second approach gives rise to issues regarding the treatment of "Chinese walls" because the MAD prohibition applies to legal entities as well as to individuals. A bank or investment firm may possess inside information relating to an issuer (e.g. about a potential corporate transaction) as a result of the activities of its corporate finance department while at the same time the sales and trading department is engaged in trading that issuer's financial instruments for its own account and on behalf of clients. The first approach implicitly recognises the value of effective "Chinese walls" between the corporate finance and sales and trading departments. If the sales and trading department does not have access to the inside information, the bank or investment firm cannot be acting on the basis of that information. In contrast, the second approach would appear to prohibit the bank or investment firm from engaging in any trading activity through its sales or trading department, even though the personnel in that department are not aware of the information and even though it may be impractical for the firm to suspend trading in the financial instruments without tipping personnel and possibly clients about the potential corporate transaction.

This is particularly important given that "inside information" is not limited to relevant information about the issuer of the instruments, but can also include information on orders or other transactions in the market. For example, a brokerage firm dealing on behalf of clients will possess information about client orders or transactions in financial instruments which may amount to inside information in relation to those instruments. Under the second approach, the firm would not be permitted to trade in those

instruments on behalf of other clients even when acting on their specific instructions and would not be able to fulfil any market making obligations it may have in relation to those instruments.

The analysis in Spector

Two different interpretations of article 2 of the MAD, corresponding to the two approaches above, were considered in *Spector*.

In *Spector*, the ECJ held that article 2 defines insider dealing "*objectively without the intention behind such dealing being referred to explicitly in its definition*". The ECJ considered that the fact that article 2 does not provide for a mental element means that once the elements of insider dealing set out in article 2 are present, it may be assumed that the person dealing intended to deal on the basis of inside information. To this extent, the ECJ appears to favour the second interpretation.

However, the ECJ recognised that such an interpretation could lead to injustice and the prohibition of transactions that do not infringe the interests protected by the MAD.

As a result, the ECJ stated:

> *[T]he fact that a person as referred to in the second subparagraph of that provision, 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 prejudice to the rights of the defence 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 analysed 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.*

If the defence can establish that the use of inside information is in line with the purpose of the MAD, the presumption of prohibited insider dealing may be rebutted.

Legal uncertainty

The FMLC considers that this approach creates unacceptable legal uncertainty. It does not provide market participants with clear and certain legal principles on which to base the policies and procedures required to prevent insider dealing, or with legal certainty that they will not be committing prohibited insider dealing where they carry on business in compliance with their policies and procedures.

Market participants need clear guidelines as to what transactions are prohibited. It is not practical to apply a case by case analysis of the purposes of the MAD to day to day activities. The ECJ's approach gives the MAD the far reaching scope envisaged by the second interpretation but without a clear set of exemptions or safe harbours of the kind necessary to make that interpretation just and workable.

The FMLC considers that the current review of the MAD presents an opportunity to address this uncertainty and would welcome further consultation on the interpretation of article 2 of the MAD.

The Belgian court referring the case to the ECJ also requested the ECJ to consider whether the MAD is a maximum harmonisation measure or not. This point was not addressed by the ECJ. It would be useful if the review of MAD did address this point, as this would assist a uniform implementation of the MAD in all Member States and address some of the uncertainties inevitable where some Member States adopt super-equivalent provisions on insider dealing.

3 PROPOSED SOLUTIONS

The FMLC would like to suggest the following alternatives as potential solutions to resolve the legal uncertainty highlighted above.

3.1 The first alternative involves amending the MAD to make clear that it is legitimate for a person to deal in financial instruments where the inside information does not have a material influence on the decision to deal, as set out in the suggested drafting below:

Article 4a

Article 2 and article 3(b) shall not apply to a person who possesses inside information if that person establishes that the inside information was not the reason for, and did not have a material influence on, that person's decision to carry out the transaction in question or to recommend or induce another person to carry out a transaction.

The suggested wording draws on the provisions of Article 1(2)(a) of the MAD which also envisages that the person alleged to be involved in market abuse must establish that he has legitimate reasons for his actions, as well as the decision in *Spector* itself which suggests that it should be for the defence to establish that the trading was a legitimate use of the information.

3.2 The second alternative involves amending the MAD to make clear that, notwithstanding the *Spector* decision, there are a number of specific circumstances where a person who has inside information should be able to deal in financial instruments. Suggested drafting for the second alternative is set out below:

New Article 4a

Article 2 and article 3(b) shall not apply to a person who possesses inside information where:

(a) that person is a legal person and the natural persons who made the decision on its behalf to carry out the transactions or to make the recommendation or inducement did not possess the information and the legal person had established, implemented and maintained adequate internal arrangements designed to ensure that those natural persons comply with the prohibitions laid down in articles 2 and 3;

(b) that person carries out transactions as a result of orders placed before he possessed the information;

(c) that person carries out transactions in accordance with a plan made by that person before he possessed the information specifying the amount of financial instruments proposed to be acquired or disposed of and the proposed dates and prices for the transactions (or a formula, algorithm or computer programme for determining those matters) or giving another person who does not possess the information the discretion to determine those matters;

(d) that person is a market maker or a body authorised to act as counterparty which is pursuing its legitimate business of buying or selling financial instruments or is a person authorised to execute orders on behalf of third parties which carries out an order dutifully;

(e) that person possesses inside information relating to another company and uses that information in the context of a public takeover bid for the purposes of gaining control of the company or proposing a merger with that company;

(f) the information concerns that person's prior decision to carry out transactions and he carries out or tries to carry out transactions based on that decision;

(g) that person establishes that he has another legitimate reason for using the information to carry out transactions or acting on the basis of the information to recommend or induce others to carry out transactions.

Paragraphs (a) to (c) of the draft provision draw on the provisions of SEC Rule 10b5-1 which addresses similar issues under US insider dealing law with respect to Chinese walls and transactions which take place pursuant to decisions which precede the possession of inside information.[2]

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[2] SEC Rule 10b5-1 and extracts from the SEC's adopting release are set out in the Appendix

However, the insider dealing provisions of the MAD are broader in scope and application than their US equivalents, in particular, because:

- US case law limits the application of insider dealing rules in certain cases where the person who possesses the information has not "misappropriated" the information,

- it appears that at least some EU regulators take a broader view of what amounts to inside information, and

- US law requires "*scienter*" (a mental element) as an essential element of the offence, whereas the court in *Spector* emphasises the strict liability nature of the prohibitions in the MAD.

Therefore, it is necessary to include a broader range of exceptions than reflected in Rule 10b5-1. Accordingly, paragraphs (d), (e) and (f) of the draft provision draw on recitals 18, 29 and 30 to the MAD to address issues relating to market makers and dealers, takeovers and persons who trade with knowledge of their own intentions. Finally, paragraph (f) is intended to reflect the court's decision in *Spector* by spelling out that there may be other circumstances in which it is legitimate for a person who possesses inside information to trade in financial instruments.

3.3 It would be possible to introduce either of the above provisions by direct amendments to the MAD. It would also be possible to address the issues by amending the MAD to confer on the Commission powers to adopt implementing acts, which could then be used (after appropriate consultation) to adopt implementing decisions along the lines of the draft provisions set out above. Alternatively, even if the above amendments were incorporated into the MAD directly, they might be combined with a general power for the Commission to adopt implementing acts so as to provide flexibility to address other unintended consequences or changing circumstances.

In order to ensure the uniform conditions of implementation/application of article 2(1) and article 3, powers are conferred on the Commission to determine cases where a person who

possesses inside information shall not be regarded as using that information by carrying out transactions or acting on the basis of that information to recommend or induce another to carry out transactions.

The draft implementing standards referred to in the first subparagraph shall be adopted in accordance with [Article 7e] of Regulation .../.... [ESMA Regulation.].

ESMA shall develop draft implementing technical standards for submission to the Commission by [date].]

4 CONCLUSION

4.1 It is not the role of this Committee to comment on policy questions in relation to the substance or application of the MAD. This Paper is intended to assist those involved in policy decisions by drawing attention to the legal uncertainty that arises out of the interpretation and application of the insider dealing offense under the MAD and to suggest potential solutions.

4.2 It is essential, if the application of the MAD across Member States is to be successful, that there is no doubt as to what constitutes an offence under it. Whilst this Paper has focused on the legal uncertainty issues around the insider dealing offense under the MAD, the FMLC is aware that a number of other ambiguities and uncertainties have been identified in submissions by other parties. The FMLC considers that every effort to resolve these issues of legal uncertainty should be made, either by amending the MAD or by inviting ESMA to adopt Technical Standards to this effect.

APPENDIX

SEC Rule 10b5-1
and extracts from the SEC's adopting release

SEC Rule 10b5-1

§ 240.10b5-1 Trading "on the basis of" material nonpublic information in insider trading cases.

Preliminary Note to §240.10b5–1: This provision defines when a purchase or sale constitutes trading "on the basis of" material nonpublic information in insider trading cases brought under Section 10(b) of the Act and Rule 10b–5 thereunder. The law of insider trading is otherwise defined by judicial opinions construing Rule 10b–5, and Rule 10b5–1 does not modify the scope of insider trading law in any other respect.

(a) General. The "manipulative and deceptive devices" prohibited by Section 10(b) of the Act (15 U.S.C. 78j) and §240.10b–5 thereunder include, among other things, the purchase or sale of a security of any issuer, on the basis of material nonpublic information about that security or issuer, in breach of a duty of trust or confidence that is owed directly, indirectly, or derivatively, to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.

(b) Definition of "on the basis of." Subject to the affirmative defenses in paragraph (c) of this section, a purchase or sale of a security of an issuer is "on the basis of" material nonpublic information about that security or issuer if the person making the purchase or sale was aware of the material nonpublic information when the person made the purchase or sale.

(c) Affirmative defenses. (1)(i) Subject to paragraph (c)(1)(ii) of this section, a person's purchase or sale is not "on the basis of" material nonpublic information if the person making the purchase or sale demonstrates that:

(A) Before becoming aware of the information, the person had:

(*1*) Entered into a binding contract to purchase or sell the security,

(*2*) Instructed another person to purchase or sell the security for the instructing person's account, or
(*3*) Adopted a written plan for trading securities;

(B) The contract, instruction, or plan described in paragraph (c)(1)(i)(A) of this Section:
(*1*) Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold;
(*2*) Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
(*3*) Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and

(C) The purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not "pursuant to a contract, instruction, or plan" if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities.

(ii) Paragraph (c)(1)(i) of this section is applicable only when the contract, instruction, or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the prohibitions of this section.

(iii) This paragraph (c)(1)(iii) defines certain terms as used in paragraph (c) of this Section.

(A) *Amount*. "Amount" means either a specified number of shares or other securities or a specified dollar value of securities.

(B) *Price*. "Price" means the market price on a particular date or a limit price, or a particular dollar price.

(C) *Date*. "Date" means, in the case of a market order, the specific day of the year on which the order is to be executed (or as soon thereafter as is practicable under ordinary principles of best execution). "Date" means, in the case of a limit order, a day of the year on which the limit order is in force.

(2) A person other than a natural person also may demonstrate that a purchase or sale of securities is not "on the basis of" material nonpublic information if the person demonstrates that:

(i) The individual making the investment decision on behalf of the person to purchase or sell the securities was not aware of the information; and

(ii) The person had implemented reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information. These policies and procedures may include those that restrict any purchase, sale, and causing any purchase or sale of any security as to which the person has material nonpublic information, or those that prevent such individuals from becoming aware of such information.

Extract from SEC adopting release:

http://www.federalregister.gov/articles/2000/08/24/00-21156/selective-disclosure-and-insider-trading#p-198

Rule 10b5-1: Trading "On the Basis Of" Material Nonpublic Information

1. Background

As discussed in the Proposing Release, one unsettled issue in insider trading law has been what, if any, causal connection must be shown between the trader's possession of inside information and his or her trading. In enforcement cases, we have argued that a trader may be liable for trading while in "knowing possession" of the information. The contrary view is that a trader is not liable unless it is shown that he or she "used" the information for trading. Until recent years, there has been little case law discussing this issue. Although the Supreme Court has variously described an insider's violations as

trading "on" or "on the basis of" material nonpublic information, it has not addressed the use/possession issue. Three recent courts of appeals cases addressed the issue but reached different results.

As discussed more fully in the Proposing Release, in our view, the goals of insider trading prohibitions—protecting investors and the integrity of securities markets—are best accomplished by a standard closer to the "knowing possession" standard than to the "use" standard. At the same time, we recognize that an absolute standard based on knowing possession, or awareness, could be overbroad in some respects. The new rule attempts to balance these considerations by means of a general rule based on "awareness" of the material nonpublic information, with several carefully enumerated affirmative defenses. This approach will better enable insiders and issuers to conduct themselves in accordance with the law.

While many of the commenters on Rule 10b5-1 supported our goals of providing greater clarity in the area of insider trading law, some suggested alternative approaches to achieving these goals. In that regard, a common comment was that the rule should not rely on exclusive affirmative defenses. Commenters suggested that we should either redesignate the affirmative defenses as non-exclusive safe harbors or add a catch-all defense to allow a defendant to show that he or she did not use the information.

We believe the approach we proposed is appropriate. In our view, adding a catch-all defense or redesignating the affirmative defenses as non-exclusive safe harbors would effectively negate the clarity and certainty that the rule attempts to provide. Because we believe that an awareness standard better serves the goals of insider trading law, the rule as adopted employs an awareness standard with carefully enumerated affirmative defenses. As discussed below, however, we have somewhat modified these defenses in response to comments that they were too narrow or rigid, and that additional ones were necessary.

Some commenters stated that an awareness standard might eliminate the element of scienter from insider trading cases, contrary to the requirements of Section 10(b) of the Exchange Act, and that we therefore lack the authority to promulgate the rule. These comments misconstrue the intent and effect of the rule. As discussed in the Proposing

Release and expressly stated in the Preliminary Note, Rule 10b5-1 is designed to address only the use/possession issue in insider trading cases under Rule 10b-5. The rule does not modify or address any other aspect of insider trading law, which has been established by case law. Scienter remains a necessary element for liability under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Rule 10b5-1 does not change this.

2. Provisions of Rule 10b5-1

We are adopting, as proposed, the general rule set forth in Rule 10b5-1(a), and the definition of "on the basis of" material nonpublic information in Rule 10b5-1(b). A trade is on the basis of material nonpublic information if the trader was aware of the material, nonpublic information when the person made the purchase or sale.

Some commenters stated that a use standard would be preferable, or suggested that the rule instead state that awareness of the information should give rise to a presumption of use. As noted above, we believe that awareness, rather than use, most effectively serves the fundamental goal of insider trading law—protecting investor confidence in market integrity. The awareness standard reflects the common sense notion that a trader who is aware of inside information when making a trading decision inevitably makes use of the information. Additionally, a clear awareness standard will provide greater clarity and certainty than a presumption or "strong inference" approach. Accordingly, we have determined to adopt the awareness standard as proposed.

The proposed affirmative defenses generated a substantial number of comments. Some commenters suggested that the affirmative defenses in the Proposing Release were too restrictive, or that additional defenses were needed to protect various common trading mechanisms, such as issuer repurchase programs and employee benefit plans. Some of these commenters noted that the requirement that a trader specify prices, amounts, and dates of purchases or sales pursuant to binding contracts, instructions, or written plans left some common, legitimate trading mechanisms outside the protection of the proposed affirmative defenses. Additionally, some commenters questioned the Proposing Release's exclusion of a price limit from the definition of a specified "price." In consideration of these comments, we are revising the affirmative defense that allows purchases and sales pursuant to contracts, instructions, and plans. The revised language responds to commenters' concerns by providing appropriate flexibility to persons who

wish to structure securities trading plans and strategies when they are not aware of material nonpublic information, and do not exercise any influence over the transaction once they do become aware of such information.

As adopted, paragraph (c)(1)(i) sets forth an affirmative defense from the general rule, which applies both to individuals and entities that trade. To satisfy this provision, a person must establish several factors.

- First, the person must demonstrate that before becoming aware of the information, he or she had entered into a binding contract to purchase or sell the security, provided instructions to another person to execute the trade for the instructing person's account, or adopted a written plan for trading securities.

- Second, the person must demonstrate that, with respect to the purchase or sale, the contract, instructions, or plan either: (1) Expressly specified the amount, price, and date; (2) provided a written formula or algorithm, or computer program, for determining amounts, prices, and dates; or (3) did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who did exercise such influence was not aware of the material nonpublic information when doing so.

- Third, the person must demonstrate that the purchase or sale that occurred was pursuant to the prior contract, instruction, or plan. A purchase or sale is not pursuant to a contract, instruction, or plan if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan or entered into or altered a corresponding or hedging transaction or position with respect to those securities.

Under paragraph (c)(1)(ii), which we adopt as proposed, the exclusion provided in paragraph (c)(1)(i) will be available only if the contract, instruction, or plan was entered into in good faith and not as part of a scheme to evade the prohibitions of this section.

Paragraph (c)(1)(iii) defines several key terms in the exclusion. We are adopting, substantially as proposed, the definition of "amount", which means either a specified number of shares or a specified dollar value of securities. We have revised the definition of "price" and added a definition of "date." As adopted, "price" means market price on a particular date or a limit price or a particular dollar price. "Date" means either the specific day of the year on which a market order is to be executed, or a day or days of the year on which a limit order is in force.

Taken as a whole, the revised defense is designed to cover situations in which a person can demonstrate that the material nonpublic information was not a factor in the trading decision. We believe this provision will provide appropriate flexibility to those who would like to plan securities transactions in advance at a time when they are not aware of material nonpublic information, and then carry out those pre-planned transactions at a later time, even if they later become aware of material nonpublic information.

For example, an issuer operating a repurchase program will not need to specify with precision the amounts, prices, and dates on which it will repurchase its securities. Rather, an issuer could adopt a written plan, when it is not aware of material nonpublic information, that uses a written formula to derive amounts, prices, and dates. Or the plan could simply delegate all the discretion to determine amounts, prices, and dates to another person who is not aware of the information—provided that the plan did not permit the issuer to (and in fact the issuer did not) exercise any subsequent influence over the purchases or sales.

Similarly, an employee wishing to adopt a plan for exercising stock options and selling the underlying shares could, while not aware of material nonpublic information, adopt a written plan that contained a formula for determining the specified percentage of the employee's vested options to be exercised and/or sold at or above a specific price. The formula could provide, for example, that the employee will exercise options and sell the shares one month before each date on which her son's college tuition is due, and link the amount of the trade to the cost of the tuition.

An employee also could acquire company stock through payroll deductions under an employee stock purchase plan or a Section 401(k) plan. The employee could provide oral instructions as to his or her plan participation, or proceed by means of a written plan. The transaction price could be computed as a percentage of market price, and the transaction amount could be based on a percentage of salary to be deducted under the plan. The date of a plan transaction could be determined pursuant to a formula set forth in the plan. Alternatively, the date of a plan transaction could be controlled by the plan's administrator or investment manager, assuming that he or she is not aware of the material, nonpublic information at the time of executing the transaction, and the employee does not exercise influence over the timing of the transaction.

One commenter noted that the proposed Rule 10b5-1 defenses were not co-extensive with exemptions from liability and reporting under Section 16 of the Exchange Act. The Section 16 exemptive rules do not provide any exemption from liability under Section 10(b) and Rule 10b-5. The adoption of Rule 10b5-1 does not change this principle. However, we have drafted the Rule 10b5-1 defenses so that their conditions should not conflict with the conditions of the Section 16 exemptive rules.

The proposal included an additional affirmative defense available only to trading parties that are entities. In response to comments, the rule as adopted clarifies that this defense is available to entities as an alternative to the other enumerated defenses described above.

Under this provision, an entity will not be liable if it demonstrates that the individual making the investment decision on behalf of the entity was not aware of the information, and that the entity had implemented reasonable policies and procedures to prevent insider trading. The American Bar Association commented that the use in this rule of the term “reasonable policies and procedures * * * to ensure” against insider trading differed from the standard provided in Section 15(f) of the Exchange Act, which requires a registered broker or dealer to establish, maintain, and enforce written policies and procedures “reasonably designed” to prevent insider trading. As we noted in the Proposing Release, we derived this provision from the defense against liability codified in Exchange Act Rule 14e-3, regarding insider trading in a tender offer situation. Rule 14e-3, which pre-dates Exchange Act Section 15(f), also used the “to ensure” language.

We are not aware, however, nor did commenters suggest, that use of that language has created any problems of compliance with Rule 14e-3. We believe, in any event, that the standards should be interpreted as essentially the same.

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