CENTRE DE DROIT
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Insider trading

Front running and the reasonable investor test

Par Yannick Caballero Cuevas le 12 March 2024

Do a fund manager's own plans and intentions constitute insider information if he engages in front running ? This is the question that the Criminal Affairs Court of the Federal Criminal Court is answering in a case involving a former manager of second-pillar pension funds for employees of the canton of St. Gallen.

In July 2022, the Office of the Attorney General of Switzerland (OAG) filed an indictment against a former employee of the Finance Department of the Canton of St. Gallen (from 2003 to 2014) and of the St. Gallen Pension Fund (from 2014 to 2018) with the Federal Criminal Court. In its indictment, the MPC alleges that the former employee coordinated his private transactions with the transactions he carried out for his employers, thereby engaging in front running between 1 May 2013 and 30 August 2018.

Although the judgment is interesting in several respects, we will focus exclusively on the issues relating to insider dealing. It is worth remembering that art. 40 aLBVM governed the offence of insider dealing until 31 December 2015. Furthermore, it is important to note that transactions carried out before 31 December 2013 are time-barred due to the former 7-year limitation period. Since 1 January 2014, the limitation period has been 10 years.

Art. 154 para. 1 let. a LIMF prohibits the use of confidential information to buy or sell securities in order to obtain a pecuniary advantage for oneself or for a third party. This applies in particular to primary insiders who buy or sell securities on the basis of insider information. For this to occur, there must be a link between the position of the primary insider and the acquisition of knowledge of the insider information, which means that the perpetrator's actual activity must lead to the acquisition of knowledge of such information. As a result of his activity, the author was likely to become aware of insider information.

To determine whether knowledge of the transactions falls within the definition of insider information (cf. art. 2 lit. j LIMF), the Federal Criminal Court proceeds in two stages.

Firstly, the Federal Criminal Court states that, in a classic case of front running, the manager obtains information about a future transaction from a third party. In this case, front running is atypical, as the investment decisions were taken by the manager himself, and the information was therefore internal to him. This raises the question of whether the primary insider's own plans and intentions constitute insider information. The Federal Criminal Court points out that this question remains controversial in the academic literature and has not been clarified by case

law. Despite this atypical constellation, it concluded that the fund manager was acting as a representative of the funds and was therefore carrying out transactions on behalf of a third party. Accordingly, the manager's investment decisions on behalf of the funds constituted confidential information, even if they were the result of his own plans and intentions.

It then examines whether the disclosure of the information was likely to have a significant influence on the price of the securities. This examination is based on an objective ex ante approach. It is necessary to ask whether a reasonable investor would use the information with considerable probability as a basis for his investment decision (reasonable investor test). In the case of uncertain facts, the analysis is completed by the probability magnitude test developed by the Supreme Court of the United States in Basic, Inc. v. Levinson (in particular, page 485 U.S. 238). In this case, the probability that the fund transactions would take place was 100 %.

Finally, the Court assessed the expected price variation at which a reasonable investor would consider insider information in making investment decisions. Given the nature of the manager's transactions, it set the threshold at 2.5 %. On the one hand, it takes into account the value at which it is possible to obtain a considerable daily or weekly return. On the other hand, it assesses at what lower value the expected profit does not appear to be a sufficient reason for the reasonable investor to include the insider information in his investment decision.

After analysing the expert report commissioned by the Federal Criminal Court, the Court concluded that the defendant had carried out 44 transactions with an expected price increase of 2.5 % following subsequent purchases by the funds. However, 5 transactions resulted in a loss, and in the case of 10 other transactions, the impact of the purchases in question on the profit generated was zero or negative. As a result, the gain realised amounted to CHF 175,758.80, and the defendant was found guilty of insider dealing. However, the qualified form of the offence was excluded, as the pecuniary advantage was less than CHF 1 million. In addition, the Federal Criminal Court found him guilty within the meaning of Articles 314 and 305bis (1) of the Swiss Criminal Code.

In conclusion, the Federal Criminal Court clarifies the doctrinal controversy surrounding acts of front running when they are based on the primary insider's own plans or intentions. Article 154 LIMF may be applied – and rightly so – if the perpetrator is acting as the representative of a third party. It should be noted that an appeal has been lodged with the Court of Appeal of the Federal Criminal Court. This case is to be followed.
