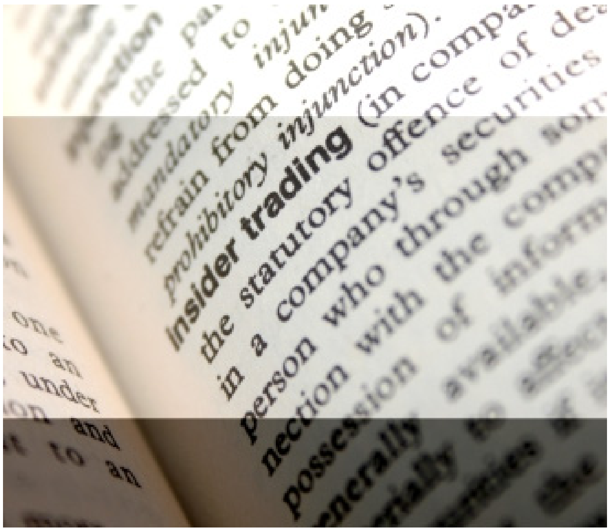
Tackling financial market abuse in the EU

SUMMARY *In response to the economic crisis and recent scandals involving financial institutions, the European Commission has proposed to update and strengthen the EU's legislative framework against market abuse.*

The Commission's proposals include the replacement of the 2003 Market Abuse Directive with a Regulation on Insider Dealing and Market Manipulation. This Regulation would broaden the scope, review definitions of insider dealing and market manipulation, clarify procedures for handling of inside information, and widen the responsibilities of national authorities.

The Commission has also proposed a Directive on criminal sanctions for insider dealing and market manipulation, seeking to establish a criminal-law regime for market abuse. The Directive treats certain forms of insider dealing as criminal offences and Member States would be required to sanction them as such, with minimum sanctions determined at EU level.

Whilst there is widespread agreement that this criminalisation is justified, its efficiency is still under debate. Critics of the proposals say the burden of proof required is high, and market complexity poses a challenge for regulators. There have also been calls for a more drastic solution such as the separation of commercial and investment banks.



In this briefing:

Context

Financial markets and economic growth

In search of the highest return on their capital, investors use all available information on companies to make investment decisions. In doing so, they are said to facilitate economic growth. However, if investors feel not all information is reflected in the price of a financial instrument, they will lose confidence in the market, invest less and render the market illiquid, which in turn drives up transaction costs and obstructs growth.

Types of market abuse

Market abuse occurs when the integrity of financial markets is intentionally harmed. Most commonly, abuse takes the form of insider dealing or market manipulation. With insider dealing, investors benefit from trading in financial instruments when relevant information is not yet available to other investors, and therefore not yet integrated in market prices. Manipulation concerns either influencing price-setting mechanisms (e.g. "wash trades", in which trading volumes are artificially driven up by the same person), or providing the market with misleading information (e.g. "bear raids" in which rumours are spread in an attempt to drive down prices).

Author: Willemijn de Jong
Contact: willemijn.dejong@ep.europa.eu

Recent market abuse scandals

Whilst banks are struggling to recover from the 2008 financial crisis and trying to lose their negative image, recent market abuse scandals have challenged the pace of this recovery. Before the Libor scandal (see box), JP Morgan's Ian Hannam resigned over a FSA fine he paid for illegally exposing client information, and, in the US, former Goldman Sachs director Rajat Gupta was embroiled in a similar scandal after leaking information to a hedge fund. The FBI, said to have doubled the number of investigations in the year to September 2012, is trying to work more closely with market regulators, and some believe there still is an active pipeline of professional trader cases.

> **Libor manipulation**
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> At the end of June 2012, a number of banks were revealed to have fraudulently manipulated the Libor benchmark interest rate (London Interbank Offered Rate). Manipulation of such benchmarks affects the prices of financial instruments and poses a systemic danger to the market. In response, the European Commission amended on 19 July its proposals, to include the application of criminal penalties to direct manipulation of such financial market benchmarks. For more information, see the EP Library Briefing on Libor manipulation and its consequences (10 Sep. 2012).

Tackling financial market abuse

Criminalising financial market abuse

The need to regulate market abuse has not always been widely accepted. Some say insider dealing would be an efficient way to compensate insiders for integrating information sooner in financial markets, especially with no real victims involved. However, recent scandals have made it commonly accepted that proper legislation is needed for markets that are not sufficiently transparent to prevent abuse. Being so closely related to the wellbeing of citizens, e.g. through their saving accounts and pension funds, the financial market is today as a whole considered to be the "victim" of such crime.

First legislation to tackle financial market abuse

The US started to regulate market abuse straight after the 1929 stock market crash. Before the EU started work on market abuse in 1989, some Member States already considered insider dealing to be a criminal offence. Others had codes of conduct, while some had no provisions at all. The Council Insider Dealing Directive (IDD) 89/592/EEC aimed to coordinate regulation on insider dealing, but did not cover market manipulation. Increasing complexity of the financial markets, e.g. through technological developments and the existence of intermediaries, has created more sophisticated, cross-border, forms of market abuse, leaving IDD insufficient. Market abuse was included in the 1999 EU Financial Services Action Plan, which sought to guarantee the efficiency of the EU (single) financial market.

Market Abuse Directive (MAD) 2003/6/EC

The Market Abuse Directive (MAD) 2003/6/EC was introduced to replace IDD, and has wider scope and stronger regulatory enforcement. MAD directly covers all financial instruments traded on EU markets, and affects all firms and individuals in regulated markets. Its aim is to guarantee confidence of investors in the integrity of European markets by prohibiting insider dealing and market manipulation. Member States are obliged to appoint a single authority with powers of investigation and sanction. But whilst such sanctions have to be reported to the European Securities and Markets Authority, they are not harmonised across the EU.

Insider dealing

Member States are to prohibit persons possessing inside information from disclosing this information to others. Issuers of financial instruments (e.g. debt securities such as corporate bonds) have to disclose any inside information as soon as possible to the public and hold a list of insiders. To avoid insider dealing, the senior management of such issuers are also obliged to disclose details of personal deals in their company's financial instruments.

Market manipulation
Secondly, Member States are to prohibit market manipulation. If a person (not limited to financial institutions and their employees) distorts the price-setting mechanism of financial instruments or disseminates false or misleading information, this constitutes market manipulation. In addition, issuers must report any deal they suspect to be market abuse.

Scope of MAD
MAD does not apply in several cases. Firstly, when actions concern the common interest, such as transactions related to monetary policy, exchange rates or public debt management by Member State authorities. Secondly, so-called "accepted market practices" such as buy-back programmes, which often actually stabilise markets, are excluded. Safe harbours also exist to protect contractual obligations made before inside information was available.

MiFID Regulation

The effect on market abuse of the Markets in Financial Instruments Directive (MiFID) 2004/39/EC is two-sided. On the one hand, the introduction of EU "passports" created a more integrated and complex market for companies offering investment services. The removal of the concentration rule, spurred the use of organised trading facilities and thereby possibilities for market abuse. On the other hand, MiFID requires transparency on pricing and disclosure of details of trades. Under review in parallel with MAD, the revised version seeks to regulate new markets such as high-frequency trading or so-called "dark pools", in which trades take place between institutional investors with prices only made public after deals are done (over-the-counter, or OTC, trading).

Challenges with current legislation

At a time when the crisis pushed regulators to review financial legislation, the Commission identified a number of issues concerning the implementation of MAD:

- The current legislation does not address new markets, platforms and over-the-counter (without involvement of an exchange) trading.
- Commodities and commodity derivatives (where the investor does not actually own the commodity behind the financial instrument) are not included in the current scope.
- Regulators have difficulties in enforcing MAD as Member States apply legislation differently, allowing regulatory arbitrage by financial institutions.
- A lack of legal certainty and clarity on certain key definitions undermines the effectiveness of MAD.
- Administrative burdens are heavy, especially for SMEs.

Commissioner Michel Barnier feels that a reinforcement of the current legislative market abuse framework and sanctions is necessary to keep markets "clean and transparent". This is in line with G20 findings, while the report by the High-Level Group on Financial Supervision in the EU concluded that conduct in financial services industry can only be sound and prudential if based on a strong supervisory and sanctioning regime.

Proposed legislation

In response to these challenges, the European Commission has presented proposals to review the EU's market abuse legislation.

Regulation on insider dealing and market manipulation
As a first pillar, the Commission adopted on 20 October 2011, a proposal for a Regulation on insider dealing and market manipulation (MAR). Strengthening the existing

framework, and replacing the MAD entirely, the Commission believes MAR will reduce regulatory complexity and offer legal certainty.

Insider dealing
When it comes to insider dealing, the Regulation would firstly revise its definition. Price sensitivity would no longer be a necessary condition in defining inside information. The new definition would also be applicable to spot commodity contracts (transactions in which the commodity physically changes hands) and derivatives (transactions in which the investor does not own the commodity on which its value is based). Furthermore, in line with MiFID, financial instruments are to include those traded on non-regulated markets such as platforms installed by investment firms for trading between multiple third parties, (e.g. multilateral trading facilities). MAR also introduces the acceptability of "Chinese walls" and other arrangements to avoid transmitting inside information within a company.

Secondly, disclosure requirements would change under the new Regulation. Issuers would be obliged to notify national authorities of delays in the disclosure of inside information. To reduce administrative costs, issuers' management would only have to report their transactions in own financial instruments above €20 000. As a further measure to reduce the administrative burden, issuers on SME markets would be exempt from keeping insider lists.

Market manipulation
Likewise, MAR clarifies the definition of market manipulation. In addition to a broadened scope of financial instruments, the definition now provides for descriptions of market manipulations, including algorithmic trading and use of electronic systems. Market manipulation need no longer concern a particular order or transaction, but could also include general conduct, "attempted manipulation" as well as cancellations of transactions.

For both insider dealing and market manipulation, regulatory authorities' powers would be reinforced. Amongst other things, they would be allowed to enter the premises of investment firms and seize documents, and obtain data records from telecommunications operators. Sanctions imposed by Member States should include certain measures imposed by MAR (e.g. licence withdrawal of the investment firm or asset freezes). Fines should be no less than €5 million for individuals and 10 percent of annual turnover for legal entities. The purpose is to ensure that the fines are not less than the profit made from market abuse.

Directive on criminal sanctions for insider dealing and market manipulation

Demonstrating how serious the EU is about dealing with market abuse, the proposed Regulation is accompanied by a proposal for a Directive (CSMAD), complementing the civil offences covered by the Regulation with criminal penalties. With criminal law at the heart of national sovereignty, this would be only the second time criminal penalties are set out in EU legislation, using the legal basis of Article 83(2) TFEU to establish minimum rules. Whilst the civil offences are similar to those from MAR, insider dealing or market manipulation (or its incitement) has to be committed intentionally. CSMAD requires Member States to ensure the sanctions imposed are "effective, proportionate and dissuasive", and are enforced.

Scope of the new legislation

Other than covering a broader range of financial instruments, the new scope will include the full range of emission allowances qualifying for the European Emissions Trading System. The Regulation imposes obligations to disclose inside information and insider lists on participants in emission allowance markets. In this way,

Author: Willemijn de Jong
Contact: willemijn.dejong@ep.europa.eu

the European Commission hopes to enhance confidence in the carbon market.

Remaining controversy

Whilst most agree criminalisation of market abuse is justified, some doubt the efficiency of doing so. Criminalising market abuse enables Member States to impose tougher punishments. However it remains to be seen how many actual convictions will be achieved, since the burden of proof required under criminal law is heavier. This adds to the technical complexity of financial markets with which regulators will have to deal, as well as the potential reach of market abuse beyond EU borders. As a result, it is possible that transactions in financial instruments will have to be documented more extensively, driving up transaction costs and conflicting with the drive for efficiency. Finally, some observers doubt whether legislation can keep pace with rapid innovation in financial instruments.

As for other solutions to market abuse, some propose a clear-cut separation of commercial and investment banking. "Megabanks" may lead to a contamination of culture from investment banks to commercial banks. In practice, however, splitting the two activities is complex as there are few interested buyers for the investment arms of big banks, and the operational challenges are high.

Next steps

Before they can come into force, both proposals need to be adopted by the European Parliament and the Council. Once approved, the Regulation would apply after two years, by which time Member States would also have to transpose the Directive into national law.

European Parliament
On 9 October 2012, the EP's Economic Affairs Committee voted in favour of the MAR and the CSMAD. The Committee's text goes further than the Commission proposal and supports a maximum prison sentence of at least five years for the most serious infringements. Less serious cases of insider dealing and market manipulation would be subject to at least a two-year minimum. The Committee has also called for intention (reckless, attempted or committed) to be disregarded when it comes to punishments and for public naming of fraudsters.

Council
Although some Member States felt there was a need for more explicit minimum sanctions, most governments supported the proposed measures. Indeed, in early December, the Council agreed on a general approach for both the Regulation and the Directive. These will serve as the basis of the Council's negotiating position with Parliament.

However, the UK has decided not to "opt in" to the Directive up to now. The City of London plays an important role in the UK economy and the government judges it appropriate first to examine the impact of the legislation, and its match with other financial regulation. Moreover, Britain's own market-abuse regime is said to be (along with Ireland's and Luxembourg's for example) more stringent. With a handful of other Member States (Greece, Ireland and Poland), it has the power to effectively undertake criminal prosecution of market abuse. However, as do around half of the Member States, the UK currently has no minimum penalties defined for insider dealing (like, e.g., Denmark and France) or for market manipulation (as with, e.g., Finland and Sweden).

Banking union
On 12 September 2012, the European Commission put forward a roadmap towards a banking union. As part of the Commission's financial regulation agenda, the market-abuse proposals are considered to be part of the single rule book, one of the four pillars of a banking union along with integrated supervision, protection of bank

Author: Willemijn de Jong
Contact: willemijn.dejong@ep.europa.eu

depositors and a crisis management framework.

Further reading

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Author: Willemijn de Jong
Contact: willemijn.dejong@ep.europa.eu