A European regime against market abuse

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1. Investors are aware when market abuse is taking place. They see unexplainable increases in trading activity before the announcement of important corporate decisions, they perceive strange price movements at critical moments. And investors resent the unjustified enrichment which they perceive is obtained by those who practice market abuse.

   What the public does not see are the unavoidable legal complexities of regulation, the difficulties of actual enforcement. There are few areas in which there are wider discrepancies between public expectations and actual possibilities of enforcement, than in the area of market abuse (I use the Anglo-Saxon term of market abuse as a global concept comprising insider trading and market manipulation).

   The difficulties are exacerbated because in most jurisdictions the regulation is imperfect, outdated, unclear. This is specially true at European level, where the Insider Dealing Directive[1], in itself full of imperfections, has been incorporated in the different jurisdictions in widely different ways. As regards market manipulation, no common European legal regime exists at the present time.

2. But it is not only that the regulation is imperfect. It is also that enforcement is extremely difficult. And Battacharya[2] has proven that what matters is enforcement. It is not enough to have a law in the rule book: if the market does not perceive that the law can and will be applied and culprits sanctioned, the abuse will continue.

   The structure of supervision and the practice of enforcement in

[1] Council Directive 89/592 co-ordinating regulations on insider dealing.
[2] *The world Price of Insider Trading"* (with HazenDouk), forthcoming in *Journal of Finance*, available at *wwwubhattac@indiana, edu.*

Europe are not uniform. Some countries have one, others two or more enforcement authorities; actions are sometimes administrative, sometimes penal, sometimes alternatively or successively both. Scope of investigation powers and level of sanctions show wide differences. Rule of law and human rights issues rightly pose barriers to enforcement powers.

3. Tipification of market abuse offences is also difficult. The classic principle *nullum crimen, nulla poena sine previa lege* must of course also be applied in this area. The difficulties arise because the definition of market abuse wrongs is based on indeterminate legal concepts: "concrete information which if published would significantly affect prices"; "abnormal prices"; "fictitious devices". To construe what these concepts imply in the specific case is always a contentious issue. There is not one single market abuse case where the facts easily and undoubtedly fit within the legal definition of the offence.

   The burden of proof also lies squarely with the enforcement agency. The accuser must prove that the citizen has committed the wrong. Proof is specially difficult if the law requires that the subject act with certain intention ("with the purpose of manipulating the market") or within a certain state of mind ("with full knowledge of the facts").

4. What in practice happens is that regulators typically select for enforcement cases which involve small infractions by incautious and inexpert investors (what I call "boyfriend of the secretary" cases). The tendency is understandable, but the results are not equitable: This type of cases, due to their size, do not cause serious harm to the confidence of investors in the markets. Institutional investors and large financial institutions have the means to disrupts markets much more seriously. Offences by these types of institutions go mostly undetected and unpunished.

   The European Commission has released figures for market abuse throughout the EU: in the period 1995-2000 there were only 13 criminal sanctions for market manipulation and 19 for insider dealing[3].

[3] The figures for market manipulation refer to the whole EEA, those for insider dealing to Germany, France, Italy and Switzerland.

The numbers speak for themselves. But the problem of insufficient enforcement is not restricted to Europe: in the same period the Manhattan Court District, which covers Wall Street, only obtained 46 criminal convictions for insider dealing.

5. Summing up, most regulators share a general lack of satisfaction with the present regulation and practice of enforcement in market abuse cases. This situation is specially worrying, since the latest market developments are facilitating the means for and multiplying the possibilities of committing market abuse: Internet is a convenient medium for disseminating rumours and false news with the purpose of manipulating prices. The growth of the derivative markets permits offenders to reduce the level of investment and leverage the illicit gain. The huge increase in the order flow makes detection of irregular orders more difficult. Anonymity is facilitated by the use of off-shore vehicles and trust arrangements. Organized crime and terrorism may have spotted the possibility of using market abuse to take advantage of the financial effects of their crimes.

   All these arguments and lines of thought lead to a conclusion: Europe needs a common legal and regulatory regime, to ensure integrity of its financial markets, to establish common standards and to enhance investors' confidence.

An integrated European financial market

6. European countries have agreed in the Lisbon summit to create an integrated financial market by 2005. In March 2001 the Stockholm summit decided to increase the speed of reform, so that the most important measures could be approved no later than the end of 2003.

   The Commission has drawn up a detailed plan - the Financial Services Action Plan - to achieve this aim. The Plan provides *inter alia* for a common European regime against market abuse. Rightly so, because equivalent levels of confidence are a prerequisite for a truly unified financial market.

7. But to create a common European regime against market abuse, and to do so in a timely and efficient manner, requires first a review of

the general system used by the EU to regulate and supervise financial markets. This task was entrusted by the Ecofin in July 2000 to the so called *Committee of Wise Men*, who issued their report in February 2001[4]. The report starts with a devastating description of the present situation: a mosaic of more than 40 regulators with different powers and competencies, laws of legendary ambiguity which are not properly enforced, and Kafkaesque procedures in which laws take dozens of years to be approved. To solve the present situation, the report proposes a four level approach:

- Level 1 would be framework laws, in the form of Directives or preferably Regulations, setting forth the general principles and objectives of securities regulations.

- Level 2 would be implementing legislation, to be approved by a European Securities Committee, in which member states are represented, and which draws its powers from the authorisation contained in the framework laws; the European Securities Committee would be advised by a European Regulators Committee.

- Level 3 would be guidance and interpretations to be issued on a harmonised basis by the European Regulators Committee.

- Level 4 finally would entail strengthened enforcement of EU law by the Commission itself.

The European Council in Stockholm approved the proposals of the Wise Men report, and requested that such measures be integrated into the Financial Services Action Plan and be implemented as soon as possible.

8. In May 2001 the European Commission published its proposal for a single European insider dealing and market manipulation ("market abuse") Directive. The initiative is one of the centre pieces of the Financial Services Action Plan and one of the first under the new

[4] *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, 15 February 2001; *www.europa.eu.int/comm/internal_market/en/finances/banks/wisemen.*

"*Lamfalussy*" format - distinguishing framework principles from implementing technical detail.

The proposed Directive has been approved by the Ecofin Council at the end of 2001 (given the traditional speed of the EU legislative process a remarkable feat) and it is expected to surmount the hurdle of the European Parliament in the course of 2002. (This of course is just an expectation: see what happened to the Public Tender Directive!).

The draft Market Abuse Directive proposes a new, high level definition of market abuse, to be complemented by secondary legislation to be issued by a Securities Committee and a Committee of Securities Regulators. It also provides for a single regulator in each country, with equal powers of investigation and enforcement, establishes administrative sanctions for market abuse and defines a number of preventative measures. The general philosophy and many of the details of the regulation are based on a report issued by a special working group of Fesco, the association of European securities regulators, published in July 2000[5].

Basic principles of the Directive

9. The draft Directive proposes that there should be one common European definition of market abuse, covering both insider dealing and market abuse (see art. 2 and 5). The concept is based on result, rather than intent: a conduct should be sanctionable if it results in a loss of confidence in the market. Specific references to the state of mind or intent of the actor are avoided (e.g. it is not required that the trade is made "on the basis of inside information" or that the action is performed "with the purpose of manipulating the market"). The traditional requirement that an insider act "with full knowledge of the facts" is suppressed for primary insiders, and only retained for secondary insiders (those who obtain a tip from someone in the know).

[5] *"FESCO's response to the call for views from the Securities Regulators under the EU's Action Plan for Financial Services*", dated 29 June 2000; *www.europefesco.org.*

The definition of inside information is based on the existing Directive, retains the distinction between primary and secondary insiders, and is extended to cover primary markets and derivatives.

Market manipulation is defined taking up the proposal put forward in Fesco's report, by differentiating the two basic types of irregular behaviour (art 1 (2)):

- abusive trading which gives false signals to other market participants, secures abnormal prices or implies deception, and

- dissemination of false or misleading information.

In order to provide users with a better understanding of the rather abstract and structural definition of market manipulation, the Directive contains in Annex B a non-exhaustive list of examples of manipulative behaviour.

The definitions of market abuse contained in the Directive remain at a high level, art. 19 envisaging that these general principles be complemented by secondary legislation emanating from the Securities Committee and by harmonized guidance issued by Securities Regulators Committee (Levels 2 and 3 of the *Lamfalussy* report).

10. The draft Directive has endeavoured to regulate a situation which arises frequently in practice, and which the present Insider Dealing Directive had failed to adequately address: the situation when the perpetrator of the market abuse is a legal person. The Directive clarifies that market abuse can be committed both by natural and by legal persons. It also states (art 2 (2)) that if a company possesses inside information, the prohibition to trade extends to the natural persons within that company who are in the know.

The Directive, however, fails to regulate the opposite situation: when an officer or a division of a company is in possession of inside information, and it is a different officer or division who takes the decision to invest, on behalf of the company, in the relevant security. This is a major failure, since the situation arises very frequently, specially among banks (e.g. the investment banking division has

inside information, the proprietary trading desk takes the decision to invest).

11. The draft Directive also aims at harmonising European regulatory structures. At present, the 15 European countries have no less than 40 different regulators responsible for securities matters. The powers of investigation, enforcement and sanctioning of each of the authorities varies widely from country to country. The lack of harmonisation makes co-operation difficult. For this reason, the Directive, following Fesco's proposal, rightly requires each State to designate a single administrative authority, to provide it with sufficient resources and standardized powers (which the Directive describes in detail in art. 12) and to establish each regulator's duty to fully cooperate with its European counterparts, creating a real "network of regulators" (see art. 16).

12. Experience has shown that the penal law approach to fight against market abuse has not been successful. Penal law is not an efficient tool to sanction wrongdoings defined on the basis of indeterminate legal concepts. Judges are at loss to apply laws which, by necessity, define crimes in generic terms, using economic concepts. The nature of market abuse wrongs is incompatible with the certainty required by penal law. *Res ipsa loquitur:* the handful of penal convictions in Europe to which I referred before is the best evidence of this reality.

    The Directive correctly requires States to introduce administrative sanctions for market abuse, and provides that such sanctions should be effective, proportionate and dissuasive, and imposed by the competent authority, with an appeal to the relevant Court (art. 14). Additionally penal sanctions can be applied by Member States to sanction serious infringements.

    A major step forward is the provision of art. 14 (3) of the Directive, which requires regulators to disclose sanctions (except if such disclosure jeopardises markets, or causes disproportionate damage). This rule will coordinate the present practices of different regulators, which vary significantly, and greatly enhance the dissuasive effect of sanctions (for listed corporations, publicity is a much stronger deterrent than even the highest pecuniary fine).

13. Even with a perfect law, with a single, powerful regulator provided with full investigation and sanctioning powers, enforcement of market abuse wrongs will continue to be difficult and haphazard. Most infringements will still remain undetected, or if detected, unsanctioned. Preventative measures, aimed at avoiding that market abuse can happen in the first instance, are extremely important. This conclusion was highlighted in Fesco's report and has been taken up -– at least in part - in art. 6 of the Directive.

    Issuers of securities are required to adopt procedures to keep inside information confidential until it is correctly disclosed to the market. In case of unintentional leaks, the issuer must make a prompt public disclosure. Failure to act correctly can be punished with an administrative sanction. Regulators will be able to focus their enforcement action on issuers, in order to guarantee that inside information is actually kept confidential, thus making any insider dealing impossible - a much better allocation of resources than trying to sift through thousands of single transactions, identifying participants and proving that they possessed inside information.

    The Directive also establishes a rule for analysts: they must take reasonable care to ensure that information is fairly presented and disclose any possible conflicts of interest. Finally, professionals must refrain from arranging or entering into transactions if they can reasonably expect that market manipulation is involved.

    The preventative measures now contained in the Directive may seem somewhat generic - they certainly do not cover all the aspects contained in Fesco's proposal. But art. 17 provides for the possibility that the Securities Committee issues guidelines in these areas, and it is to be hoped that, through this mechanism, a complete set of preventative measures to avoid market abuse in Europe is developed.

14. Summing up, I perceive that in Europe a broad consensus is emerging on the need of updating and improving securities legislation, supervision and enforcement. The proposed draft Directive on Market Manipulation is a step forward in the right direction. Preventative measures, a common legal regime for insider trading and market manipulation, a single regulatory authority in

each European country with equivalent powers, administrative sanctions, framework laws, secondary legislation, harmonised guidance and a network of regulators co-ordinating enforcement - these will be the cornerstones of an improved European market abuse regime.

What is important now is to convert these ideas and proposals into legal reality. Recent international developments have focused everyone's attention on the fact that, although the world is increasingly globalised, serious gaps remain in transnational supervision. In the wake of this new awareness, I am confident that the draft Directive will speedily be approved.

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