

## MARKET MANIPULATION: IS LEGISLATION NECESSARY?

**Summary:** Market manipulation has the capacity to damage the integrity of Europe's financial markets. There is growing public concern and criticism over the way in which financial crime has risen, and thus the reason for the recent Commission proposal for a directive to cover this area. The financial services sector still questions whether a directive is the most appropriate legal mechanism for addressing these issues, but remains strongly supportive of the overall objective of developing a more consistent and effective approach in dealing with market manipulation. The key controversial point in the proposal itself is the concept of intent/knowledge or recklessness in market manipulation instances. The primary target here is not those whose acts or omissions are purely accidental and unintended, but those who had knowledge of what they were doing. There are difficulties in proving this dishonest intent/knowledge, and one of the most effective ways of drawing suitable distinctions between deliberately dishonest behaviour and that which results from a genuine accident is to establish specific statutory defences and grounds for mitigating sanctions. Finally, the proposal for the first time applies insider dealing type provisions to market dealings in commodity derivatives, which some practitioners argue is inappropriate.

### Background

EU member state governments have rightly emphasized the importance of establishing an effective and consistent approach to defining and enforcing market manipulation as a "fundamental pillar" (to use the words in the Explanatory Memorandum to the Proposal) to establishing a wider European capital market. This need for a more effective process for dealing with financial crime has been driven by growing public concern and criticism over the way in which financial crime is (or, perhaps more accurately, is not) prosecuted - a concern which found frequent expression in newspaper stories and accusations about large amounts of public money being wasted on failed prosecutions, "fat cat" legal fees, legal incompetence by prosecuting authorities, derisory sentencing and questionable defence strategies.

In the circumstances, it is not altogether surprising that Commissioner Bolkestein made the emphatic statement, "Let me be clear: the European Commission has no truck with greedy financial cheats" and that the Explanatory Memorandum to the Proposal emphasized that one of the core objectives of the Financial Services Action Plan is to "enhance market integrity by reducing the possibility of institutional investors to rig markets...". There is no doubt that market manipulation has the capacity to damage the integrity of Europe's financial markets and the confidence of users of those markets, particularly in the current environment of significant growth in cross-border trading and fragmentation of trading platforms.

For its part, the financial services sector, while it may have questioned whether a directive was the most appropriate legal mechanism for addressing those issues, remains strongly supportive of the overall objective of developing a more consistent and effective approach in dealing with market manipulation. The fact that the Commission, in the interests of respecting FS Action Plan deadlines, issued this legislative proposal without the consultation recommended in the Lamfalussy report, has however caused some concerns.

### **Market Manipulation: the Mental Element**

In evolving a new approach, two conflicting public interest issues have to be accommodated (and accommodated fairly) – firstly, the need for regulatory authorities to have sufficient enforcement flexibility to be able to detect, discipline and sanction market abusers/manipulators on a consistent and effective basis; and, secondly, the right of individuals to be able to reasonably foresee the legal consequences of their acts/omissions (and to enjoy a reasonable degree of certainty in their market dealings).

The outcome of this conflict is dependent, in the main, on the firms/individuals to be targeted by this new approach, which, according to Commissioner Bolkestein, comprise “greedy financial cheats”. This is confirmed by the Proposal itself which, in its Explanatory Memorandum, refers to those who “rig markets” and which includes a number of examples, nearly all of which suggest intent/knowledge or recklessness. Indeed, that element of intent is endemic in the words “abuse” and “manipulation” which are used consistently throughout the text of the Proposal. The primary target is not therefore those whose acts or omissions are purely accidental and unintended, but those who seek to engage in market abuse or manipulation deliberately – and it is important that it is properly reflected in the Proposal.

The mental element of intent is a customary and accepted prerequisite to proving the commission of serious criminal offences in all major national criminal law systems and that evidential burden is rightly placed on the prosecution. On the other hand, it is recognized that many of the problems encountered by prosecuting authorities in both initiating proceedings as well as securing convictions for financial crimes stem from difficulties in proving dishonest intent/knowledge.

The core question therefore is whether the creation of an alternative administrative offence of market manipulation will adequately address the difficulties of the “prosecution” without requiring the removal, at least entirely, of the fundamental ingredient of intent/recklessness. In order to make that assessment, it is necessary to evaluate the consequences of that shift from a criminal offence to an administration offence. For example,

- ❑ it delivers a reduction in the evidential burden (particularly in the standard of proof) less than that which would apply in the case of criminal proceedings;
- ❑ it transfers the process of investigation and decision making from bodies lacking detailed financial services knowledge (eg juries of laymen) to authorities with specific financial service expertise who are more readily able to discern the issues in dispute;
- ❑ by incorporating the alternative element of recklessness, it will avoid the need of proving intent in the first place;
- ❑ the evidential burden may be simplified by setting out what constitutes “intent” in Tier Two legislation by defining it in the context of, for example, legal assumptions and evidential scenarios.

If these changes are regarded as significant (and they appear to be), then it does not seem unreasonable to question whether it is in the public interest and in keeping with the concept of natural justice to expunge entirely the key requirement for a mental element in an offence of this

nature (i.e. one that is both serious and which, by its very description, is founded on the presence of such an element) on the ground only that the authorities wish to have an even greater “carte blanche” in this area. It is by no means clear that such an approach would be acceptable under existing human rights legislation.

It is questionable whether a major legislative instrument such as a directive should seek to capture minor forms of market misbehaviour which are generated by acts of incompetence or by accident. Any such lesser “offence” could easily be addressed (and in many cases is already addressed) within the individual business conduct rules of each regulatory authority and the market rules of exchanges and could be covered as part of the process of rules’ harmonisation being undertaken by and through FESCO. There is no doubt that the use of credible self-regulatory practices and mechanisms for imposing market discipline has proved to be far cheaper, faster and more effective than criminal process through the courts. In this context it is worth recalling that the experience of the Insider Trading Directive has, by showing the inadequacies of official prosecution, delivered a strong argument for reinforcing self-regulatory practices.

### **Defences and Safe Harbours**

One of the most effective ways of drawing suitable distinctions between acts or omissions which merit “prosecution” and those which do not (eg behaviour which is deliberately dishonest from behaviour which results from a genuine accident) is to establish specific statutory defences and grounds for mitigating sanctions. These can be centred around the following questions:

- ❑ Has the individual/firm established proper systems and controls designed to prevent manipulative/abusive behaviour?
- ❑ Did the individual/firm in question act innocently and in the genuine belief (albeit erroneous) that the behaviour in question was legitimate (and was that belief supported by reasonable grounds)?
- ❑ Would the behaviour in question have been regarded as legitimate by those who regularly deal in transactions of a similar kind in the markets in question?
- ❑ Was the behaviour in question carried on by an employee where the information which, had it been known to that employee, would have constituted market abuse, but which, although known to the firm, was withheld from that individual because of the existence of a Chinese Wall or some other credible and effective “independence arrangement”?

### **Commodity Trading and Insider Dealing**

In the past, it has been universally recognised that, while insider dealing is entirely inappropriate for dealings in securities (largely because of the concept of announceable information and the existence of “issuers”), it would be economically inappropriate to apply the same concept to dealings in commodities and commodity derivatives (where such concepts do not exist) and the scope of application of EU and individual member state legislation has been limited accordingly.

This Proposal, for the first time, applies insider dealing type provisions to market dealings in commodity derivatives. The absence of any explanation as to the economic rationale appears out of line with the principles that stand behind the recommendations for greater regulatory transparency in the Lamfalussy Final Report.

Such dealings are in any case subject to:

- ❑ the general provisions in the Proposal (in their final form) which seek to prevent market manipulation and abuse; and
- ❑ the individual business conduct rules of member state competent authorities which are designed to prevent “front running” (i.e. trading ahead of customer orders).

Whatever the reason for this proposed extension, inappropriate disclosure obligations could put in jeopardy the management of price and other risks by commodity trade houses. The Explanatory Memorandum states on page 4 that, “in particular circumstances and for perfectly understandable economic reasons” exemptions (so-called “safe harbours”) will need to be allowed, where certain provisions would not apply”. In the absence of adequate economic and legal grounds for such an extension, consideration should be given to exempting dealings in commodities/commodity derivatives from the application of the proposals on insider dealing provisions (under Article VIII).

Briefing notes are prepared by the Industry Advisory Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Advisory Committee.

**Steering Committee**

Robert Goebbels, MEP  
Chris Huhne, MEP  
Giorgos Katiforis, MEP  
Piia-Noora Kauppi, MEP  
Alexander Radwan, MEP  
Peter Skinner, MEP  
Theresa Villiers, MEP

**Chairman Advisory Committee**

Paul Arlman  
Federation of European Securities Exchanges  
Rue du Lombard 41  
B – 1000 Brussels  
Tel: 0032 2 551 01 80  
Fax: 0032 2 512 49 05  
E-mail: arlman@fese.be

**Secretary**

John Houston  
Houston Consulting Europe  
Avenue de la Joyeuse Entrée 1-5  
B – 1040 Brussels  
Tel: 0032 2 504 80 40  
Fax: 0032 2 504 80 50  
E-mail: info@houston-consulting.com

Founding Members

Richard Balfe MEP	C.A. Gasoliba I Bohm MEP
Robert Goebbels MEP	Chris Huhne MEP
Othmar Karas MEP	Giorgos Katiforis MEP
Piia-Noora Kauppi MEP	Astrid Lulling MEP
Ria Oomen-Ruitjen MEP	Karla Peijs MEP
John Purvis MEP	Alexander Radwan MEP
Karin Riis-Jorgensen MEP	Olle Schmidt MEP
Peter Skinner MEP	Charles Tannock MEP
Theresa Villiers MEP	

Advisory Committee

ABN AMRO Bank  
Banco Bilbao Vizcaya Argentaria  
Barclay’s Bank plc  
Deutsche Bank AG  
European Banking Federation (FBE)  
Federation of European Securities Exchanges  
Futures and Options Association  
Goldman Sachs  
International Swaps and Derivatives Association  
San Paolo IMI Bank  
Société Générale  
Svenska Handelsbanken  
UBS AG