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**The economics behind market  
abuse and a comparative  
analysis of the legal framework  
in Switzerland and the EU**

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## **Executive Summary**

The present paper intends to provide a concise overview of market abuse at a time when Switzerland's legal and regulatory framework seems to be undergoing a prolonged transition period. In Sections 2 and 3 of the paper we examine the two forms of market abuse, insider trading and market manipulation, from an economics perspective. Addressing this aspect seems indispensable in order to fully appreciate the issues related to market abuse and to be able to evaluate the optimal legal and regulatory solutions. Section 4 provides a synopsis of the legal framework in the European Union, as enacted by the Market Abuse Directive and its implementing measures. The analysis of the EU framework is motivated by the influence that EU law exerts on Swiss law and by the fact that the said framework is a complete and, by most accounts, a successful system that may be used as a benchmark by the Swiss legislator. Section 5 offers an overview of the two dimensions of the Swiss framework on market abuse, namely the penal provisions embodied in articles 161 and 161bis of the Swiss Penal Code and the administrative provisions materialised by the recent FINMA Circular 08/38. This section reveals some serious weaknesses in the Swiss system which have been emphasised by Swiss doctrine over the years but are being addressed at a rather slow pace, if at all, by the Swiss legislator. Section 6 examines the more practical aspects of the implementation of the FINMA Circular 08/38 from the standpoint of audit firms.

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## 1 Introduction

*Market abuse* is a generic term which describes two forms of economic behaviour that, in most developed markets, qualify as financial crimes: *insider dealing* and *market manipulation*. The two notions are distinct and autonomous, even though they both refer to practices taking place in the environment of the financial markets. *Insider dealing* refers to the exploitation of an *existing* advantage, namely inside information, by trading in the market on the basis of such information or by disclosing it to third parties who may then benefit by trading for their own account. *Market manipulation*, on the other hand, refers to the *active creation* of an inequitable, unfair and largely artificial condition in the market, especially at the level of market prices, which typically results in a transfer of wealth from other market participants to the perpetrator<sup>1</sup>. This general definition indicates the wide range of behaviours that fall under the meaning of market manipulation, in contrast with the well-defined and straightforward concept of insider dealing.

Which are then the similarities that motivate the use of a common term for two distinct economic behaviours? As we discuss in section 2.6, insider dealing and market manipulation are practices that are often combined and simultaneously present in cases of market abuse. But the answer mainly lies with the perceived consequences of these behaviours for the market, as indicated by the term “market abuse”. Both insider dealing and market manipulation are considered to be harmful to the market, with implications that extend to the market’s efficiency, its liquidity as well as its legitimacy in the eyes of investors. However, as we will see in section 2, the impact of insider dealing on market efficiency is still largely debated, with a large portion of scholars – mainly from the *law and economics*<sup>2</sup> discipline – insisting, on the basis of economic theory, that insider dealing is actually positive for market efficiency.

The gravity of market abuse as a financial crime derives mainly from the importance of the role of financial markets in modern economies. The degree of economic growth that has been achieved by the global economy would be inconceivable in the absence of financial markets. These ensure the adequate financing of large-scale productive activity and guarantee the efficient allocation of scarce resources. For these reasons, financial markets have acquired the status of a social institution, the orderly and lawful operation of which is

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<sup>1</sup> See Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 4.

<sup>2</sup> *Law and Economics* as a discipline is also referred to as *Economic Analysis of the Law*.

viewed as indispensable<sup>3</sup>. The extensive market abuse that took place during the dot.com bubble in the late 1990's, established once again the negative impact that such abuse may have on the market and led to regulatory activism that produced legislation such as the Sarbanes-Oxley Act in the US, the Financial Services and Markets Act (FSMA) in the UK and the EC Market Abuse Directive in the EU<sup>4</sup>. The scandals of Enron, Worldcom, Parmalat and others had severe consequences, not only for the financial markets which lost a lot of their credibility, but also for individual investors, shareholders and employees in the affected companies. Therefore, the idea that market abuse is a "victimless crime" has rightfully been dismissed.

The present paper has been motivated by the recent regulatory and legislative developments in the market abuse regime in Switzerland. It aspires to offer a concise overview of insider dealing and market manipulation from an economics perspective, in order to inform the reader on the issues underlying the regulation of these practices. It proceeds to review the legislative framework adopted by the EU by the introduction of the EC Market Abuse Directive and its implementing directives. The general view that the EU framework is fairly successful in achieving its objectives, the apparent repercussions of EU legislation on Switzerland and on subsidiaries of financial institutions from EU Member States in Switzerland, as well as the historical tendency of Switzerland to import legislation from the EU justify this analysis. We then examine the Swiss regime on market abuse, which includes penal as well as administrative provisions, and we attempt to evaluate its adequacy in its current state. Finally, we examine the role reserved for audit firms in the newly formed administrative framework introduced by the FINMA Circular 08/38, by providing an indicative set of controls which may be performed to ensure compliance of the audited entities with the Circular.

## **2 Insider dealing**

As we have seen in the previous section, market abuse has been established as the all encompassing term to describe two distinct but closely interrelated practices: insider dealing and market manipulation. In this section we attempt to define insider dealing and under-

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<sup>3</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, pp. 4-5.

<sup>4</sup> *Ibid*, p.6. The introduction of the EC Market Abuse Directive (Directive 2003/6/EC of the European Parliament and of the Council) at the same time as the increase of the awareness against market abuse was to a large extent coincidental, since the said directive formed part of the Financial Services Action Plan before the burst of the dot.com bubble and the subsequent revelation of the market abuses during that period. See Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 10.

stand the mechanics behind it as well as its impact on the market. We also take a brief look at the longstanding and multifaceted debate on the regulation of insider dealing, whereby notions of fairness, morality and ethics collide violently with economic arguments of market efficiency. Finally, we examine the links between insider dealing and market manipulation.

## **2.1 Definition of insider dealing**

*Insider dealing* or *insider trading* is essentially an economic phenomenon and we must first define it as such. From an economics perspective insider dealing is *the practice, whereby persons (insiders), with privileged access to non-public information (inside information) which relate directly or indirectly to financial instruments or to the issuers thereof, detect, on the basis of the inside information which they possess, discrepancies between the market price and the intrinsic value of such instruments and trade in order to exploit these discrepancies for financial gain*<sup>5</sup>. We see that, by definition, insider dealing is a classic example of an information asymmetry issue.

*Inside information* can be defined as any non-public information which relates, directly or indirectly, to a financial instrument or the issuer thereof and which could be expected, if it were disclosed, to alter investors' views on the value of that instrument and consequently affect its price. The possession of inside information results in an informational advantage over uninformed investors which might be exploited by the insider for his own financial benefit.

An *insider* is usually defined as a person who belongs to the corporate structure of the company which issues the financial instruments in question (such as an executive officer, key employee or director) but he can also be an outside party who is either associated in some way with the company (for instance a major shareholder) or has been granted privileged access to non-public information for the purpose of carrying out a professional function (such as the company's auditor). The definition of *insider* can be extended to include third parties who receive inside information in a derivative fashion from the insiders described above. A distinction could then be made between *primary* or *immediate* and *secondary* insiders. The term insider dealing is used to describe both the direct trading by primary insiders as well as the disclosure (*tipping*) to secondary insiders (*tippees*) who then capture the value of the informational advantage transferred to them by trading on it.

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<sup>5</sup> See Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, pp. 79 – 80.

For reasons to be examined shortly, most - if not all - developed financial markets have assigned legal and regulatory liability to insider dealing, prohibiting the practice and qualifying it as an offence. It must be noted that the definition of insider dealing as an offence may depart from its economic definition<sup>6</sup>. The reason for this is that a legal or regulatory definition is more concerned with optimising deterrence and punishment and achieving legal certainty than it is with accurately describing an economic phenomenon. In sections 4 and 5 we examine the legal definition of insider dealing under the EU and the Swiss regimes.

## **2.2 Insider dealing from an economics perspective**

From an economics point of view, insider dealing has primarily been analysed under two non-mutually exclusive forms: as an *agency* problem and as a *property rights* problem. In this section we examine insider trading from these two angles. The analysis from a welfare perspective and the debate regarding its regulation are examined in sections 2.3 and 2.4.

As *agency problem* we define the failure of a *principal-agent* relationship. Such a relationship arises whenever one party (*principal*) entrusts another (*agent*) with the performance of certain duties or services. If the interests of the principal and the agent are not sufficiently aligned, the agent might have incentives to promote his own interests over those of the principal. Such incentives become stronger under conditions of information asymmetry, where the performance of the agent's duties is costly to monitor. The relationship can therefore break down unless the agent is given adequate incentives to act in the way that the principal wishes. Agency problems under asymmetric information arise in two forms: as *adverse selection* and as *moral hazard* problems. *Adverse selection* (or *hidden information*) arises when the agent has more information than the principal and the principal cannot ascertain the truth of the agent's representations, which he tends to discount as a result. This might lead the principal to provide a discounted compensation to the agent for the services or goods which the latter offers. As a result only "bad" agents who offer services or goods of inferior quality tend to stay in the market. Adverse selection takes its name from the fact that information asymmetries make "bad" agents more likely to be selected<sup>7</sup>.

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<sup>6</sup> *Ibid.*, p. 75.

<sup>7</sup> The most frequently cited examples for adverse selection are, on the demand side, the market for used cars and on the supply side, the market for insurance. In the market for used cars, since customers do not know the quality of the cars on sale, they will expect to end up with an average car and will only be willing to pay an average price. This will exclude all good cars from the market, since their sellers will not be willing to sell at an average price. The consequent fall in the quality of cars in the market will be observed by customers who will revise their expectations and the price they are willing to pay downwards, driving even average cars

This can only be avoided if the principal discovers indirect ways to distinguish between “bad” and “good” agents and provide the “good” agents with adequate incentives to deal with them (and the “bad” agents with appropriate disincentives). *Moral hazard* (or *hidden action*) exists when the action undertaken by the agent is unobservable by the principal and it has a different value or cost for the agent than it has for the principal<sup>8</sup>.

One would be inclined to classify insider dealing as a moral hazard problem, because insiders tend to engage in covert conduct (trading in financial instruments) unobservable by the principal (the issuer of the said financial instruments) from which they draw benefits without bearing the full cost of their actions, which – to some extent at least – is borne by the principal. Accordingly, in its archetypical form, insider dealing is performed by a director or a key employee of the company that issued the traded instruments and might produce adverse effects on the interests of the company and its shareholders (reputational, financial or other)<sup>9</sup>. In this form, insider dealing might seem like a clear-cut case of an agency problem (moral hazard), the company being the injured principal and the insider being the agent. However, as we expand the definition of *insider* to include secondary insiders or even primary insiders who have no fiduciary duties to the company, insider dealing seems less of an agency problem, because there is no clear principal-agent relationship.

To add to the difficulty of labelling insider trading as a principal-agent issue, the identification of the disadvantaged principal is not always a straightforward task. It is quite often the case that the issuer of the traded securities and its shareholders are not harmed in any recognisable manner by the trading of its securities by insiders. In fact, the integrity of the financial markets and investors’ confidence are admittedly the most commonly cited victims of insider trading and not the issuing company. How could then one qualify a relationship between an insider (especially a secondary insider or a primary insider with no fiduci-

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out of the market and leaving only the bad quality ones or the so-called “lemons” (Akerlof, 1970). Similarly, in the market for insurance, low-risk customers will not be willing to pay an average premium and will exit the market, leaving only average and high-risk customers. The insurers will then realise that the market is more risky and they will increase their premiums, driving out even average-risk customers and leaving only the high-risk customers in the market. This process, which may arise when there is asymmetric information and quality heterogeneity in a market, is recursive and ultimately leads to complete unwillingness to trade and disappearance of the market. This can only be resolved if appropriate mechanisms can be found to distinguish the varying quality in the market.

<sup>8</sup> Again, the most commonly cited example of moral hazard is the insurance market, whereby a person insured, knowing that he will not bear the full cost of his actions, tends to exhibit more risky behaviour than he would have had he not been insured.

<sup>9</sup> See section 2.3.4 for details on the possible impact of insider dealing on the issuers of financial instruments.

ary duties or duties of trust) and the market as a whole or a loosely defined “investing public” as a principal-agent relationship?

Similar considerations apply if insider trading is analysed as a *property rights* problem. Inside information is an intangible commodity on which the company concerned may be granted property rights, much like it is for trademarks, copyrights and patents. Property rights on information can be assigned in either a *positive* form, in which case the owner is allowed to use the information for his benefit without disclosing it to third parties, or in a *negative* form, whereby the owner can prohibit the use of that information by third parties. Accordingly, negative property rights on inside information could be granted to the company concerned as the producer of such information<sup>10</sup>. In that respect, the analysis follows the same direction as in the principal-agent scenario, whereby sufficient incentives must be provided to insiders in order not to engage in insider dealing (contractual penalties for instance). However, in cases where the company itself is not harmed but the alleged victims are investors’ confidence, market integrity and the investing public in general, could insider trading be regarded as a simple private property rights problem?

The property rights approach treats information as a good which belongs (or should belong) to the private sphere of its creator and which needs protection through the assignment of property rights. Nevertheless, as it has been convincingly pointed out<sup>11</sup>, as much as information may occasionally be regarded as a private good and share a lot of common features with physical commodities for which markets have developed successfully, it also has unique attributes that merit a special approach. Because information is necessary for knowledgeable decision making, it is without question a valuable commodity. At the same time however, information presents the characteristics of a “public good”<sup>12</sup>, in the sense that it tends to be, at least to a certain degree, *non-rival* and *non-excludable*<sup>13</sup>. A good is *non-rival* (or *non-diminishable*) if, once produced, it can be consumed by additional individuals at zero or little marginal cost, i.e. without reducing availability to others. A good is *non-excludable* if the exclusion of individuals from acquiring the good, even the ones who have incurred no cost for its acquisition, is either impossible or very costly. The non-excludable property of public goods tends to create externalities. Externalities are either

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<sup>10</sup> Proponents of the deregulation of insider dealing argue that the issuer should be granted *positive* property rights over inside information and that it should be given the option to contractually reassign property rights to inside information to its insiders if it so wishes. We examine such arguments in section 2.4.1.

<sup>11</sup> See Krawiec, 2001.

<sup>12</sup> N.B.: The definition of a *public good* in economics is not that of a good provided by the state.

<sup>13</sup> See Krawiec, 2001, pp. 453-454; Arrow, 1962.

benefits (*positive externalities*) or costs (*negative externalities*) to third parties who are not involved in the production of the said goods.

If we consider inside information to be a public good or a public resource, it seems only natural that insiders should not be allowed to trade on it (and not just for the protection of the firm in question but for reasons of social welfare). This is the view of *information egalitarians*<sup>14</sup> who advocate equal access to market information. On the other hand, *information proprietarians*<sup>15</sup> argue that information is not a “pure” public good, as it may be non-excludable but it is also diminishable<sup>16</sup> and should therefore not be abandoned to the public sphere. If it is, then a problem known as the *tragedy of the commons*<sup>17</sup> will manifest itself resulting in the underproduction of valuable information by the issuers. Information proprietarians argue that the non-excludable nature of inside information should be mitigated through the assignment by the state of private property rights in favour of its creators. In that way, the argument goes, they would have sufficient incentives to produce and disseminate the socially optimal amount of information, much like in the reasoning of intellectual property law.

### **2.3 The welfare effects of insider dealing**

One of the major points of the debate around insider trading concerns its social welfare effects<sup>18</sup>. The main welfare effects associated with insider dealing are its impact on market efficiency, its implications for outside investors, its effect on liquidity and its implications for the issuers of financial instruments. We examine these issues in the following sections.

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<sup>14</sup> Krawiec, 2001.

<sup>15</sup> *Ibid.*

<sup>16</sup> A rival or diminishable good that is at the same time non-excludable is often referred to as a “collective good” or a “common-pool” good. See Krawiec, 2001, p. 451.

<sup>17</sup> The *tragedy of the commons* refers to the problems that arise when rights to a limited resource are common (shared) or when the responsibility to provide a resource is common (shared). The fact that each individual does not bear the full cost or the full benefit of his actions but shares it with the community leads to the “tragic” results of overconsumption or underproduction of resources. Mechanisms such as placing quotas on the consumption of resources or the privatisation/nationalisation of the said resources are regarded as solutions to this problem.

<sup>18</sup> Social welfare can be defined as the aggregate sum of the welfare of all individuals in society. “Neoclassical” welfare economists attempt to measure it in cardinal terms (by using as units of measurement the so-called “utils” or simply monetary value), whereas the “new welfare” economists assess it by means of ordinal efficiency tests such as the Pareto efficiency or the Kaldor-Hicks compensation test. *Pareto efficiency* is achieved when a new allocation of resources could not make an individual better off without making another worse off. *Kaldor-Hicks efficiency* is similar but less stringent than the Pareto efficiency, in the sense that allocations that do make an individual worse off to make another better off, but at the same time allow for sufficient compensation to the disadvantaged individual, are also considered efficient.

### 2.3.1 The impact of insider dealing on market efficiency

In order to appreciate the importance of this issue we need to understand why capital markets and their efficiency are important and how social welfare would be affected if it turns out that insider trading has indeed implications on market efficiency. Capital markets perform four fundamental functions<sup>19</sup>: First, they provide a reliable measure of value, since the continuous interaction of supply and demand produces a price formation (discovery) mechanism which outputs the resultant of investors' heterogeneous expectations and knowledge. Secondly, through that price discovery mechanism, financial markets promote allocative efficiency by directing scarce resources to the most efficient use (since the demand and the price of a security is indicative of its perceived quality). Thirdly, they provide a facility for issuers of securities to raise funds which can be invested in projects that create value and enhance productivity. Finally, capital markets provide opportunities for producers, financial intermediaries as well as investors in general to protect themselves against the risk of adverse price movements in financial assets and commodities alike.

For capital markets to perform their functions it is argued that they need to be efficient. We can say that efficiency in this context assumes three forms<sup>20</sup>: informational, allocative and technical. *Informational efficiency* refers to whether prices in the markets fully reflect information about the instruments traded on them. *Allocative efficiency* is concerned with the optimal allocation of scarce resources and is achieved in financial markets when capital is allocated to the best available investments<sup>21</sup>. In modern financial markets allocative efficiency is inextricably tied to informational efficiency. If asset prices are efficient then they also reflect the quality of these assets and therefore facilitate the allocation of capital resources to the best investments. If, on the other hand, prices do not reflect the quality of the assets, then resources are being wastefully invested on overvalued bad assets at the expense of undervalued quality assets. *Technical efficiency*<sup>22</sup> refers to the production of the maximum possible output for given inputs. Financial markets can be considered technically efficient when they facilitate transactions between investors by allowing them to perform the maximum amount of trading at the lowest possible cost.

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<sup>19</sup> See Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 23.

<sup>20</sup> See Hartmann, 1997-1998.

<sup>21</sup> Brunnermeier, 2001, p. 21.

<sup>22</sup> Sometimes referred to as productive efficiency.

We will first examine the impact of insider dealing on the informational and allocative efficiency of the market<sup>23</sup>. In order to do that, however, it is necessary to digress and analyse the meaning of informational efficiency from the perspective of the theory of reference in financial economics, namely the Efficient Capital Markets Hypothesis (ECMH)<sup>24</sup>. The ECMH was developed by Professor Eugene Fama and it remains, since the 1960s the starting point of financial theory, even though since the 1990s it has lost much of its credibility. The theory holds that capital markets are informationally efficient, meaning that the prices of the assets traded on them accurately reflect information regarding the value of these assets. The ECMH is divided in three forms, the *strong*, the *semi-strong* and the *weak* form. A market is considered *weak form efficient* if current prices fully reflect all information about past prices. In a weak form efficient market prices do not follow predictable patterns and forecasts based on historical data are useless. A market is said to be *semi-strong form efficient* if, not only all historical data is already reflected in current prices, but at the same time prices adjust instantaneously to any new publicly available information. In a semi-strong efficient market it is impossible to trade on new public information at a profit, due to the automatic adjustment of prices to that information. Finally, a market is defined as *strong form efficient* when prices fully reflect all relevant information on the traded instruments, regardless of whether that information has been made publicly available or remains undisclosed. That means that no one (not even insiders or analysts with a privileged vantage point) has the possibility to trade on new information and make excess returns, even if that information is non-public.

The speed with which the market adjusts to new information depends on its form of efficiency. In a weak form efficient financial market, insiders can achieve abnormal returns for themselves over a long period, although the price formation mechanism will gradually internalise the information in the insider's possession by decoding the insider's trades. In a semi-strong form efficient market, the same holds true, but the insider will only be able to outperform the market for a shorter period. A strong efficient form market already reflects all relevant information so the concept of profitable insider trading is excluded *ab initio*.

Insider dealing is usually motivated by new favourable or unfavourable information which, if released, or when it is released, will lead the market to revise its valuation of the asset

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<sup>23</sup> We examine the impact on informational and on allocative efficiency jointly, because as it was mentioned above, allocative efficiency depends on informational efficiency and cannot be achieved without it. The issue of technical efficiency is addressed in section 2.3.3.

<sup>24</sup> See Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 1970.

concerned toward its true value. The release of the said information in *any* form (even indirectly, through *signalling*) is bound to increase the informational efficiency of the market because it will eradicate any mispricing. Insider dealing typically provokes a rise in the demand or the supply of an asset thereby *signalling* a rise or a drop in its value, a signal that is bound to be picked up by the market's price and trade decoding mechanisms. If, as it is suggested by certain studies<sup>25</sup>, insider trading causes the market to rapidly revise the price of an asset to reflect its true value before the undisclosed information is even released, then that means that insider trading is beneficial to market efficiency. Little does it matter that the resulting efficiency gain is due to the market's ability to infer from the insider's trades the real value of the asset and not due to the insider's benevolent intentions.

However, there is anything but a consensus regarding this purported positive impact of insider dealing on market efficiency<sup>26</sup>. First, the findings of studies that support the positive impact hypothesis have been contested by studies that show that the effect of insider trading on asset prices cannot effectively be distinguished from regular trading<sup>27</sup>. Furthermore, it has been argued that insiders have an incentive to prevent price changes in the assets they deal in, in order to capture the full value of the information in their possession. They would therefore be expected to try to conceal their trades in order not to alert the market to the mispricing of the assets in question. Accordingly, they might attempt to undermine the market's trade decoding and price formation mechanisms by using nominee accounts, dividing their orders into small orders over several markets and trading on different types of financial instruments in order for the market to discount their trades as "noise" without managing to infer any valuable information from these trades. In other words, the observation of insider trades by the market, which supposedly is beneficial to market efficiency (because it motivates derivatively informed trading by other investors) and which is already a weak form of learning<sup>28</sup>, could be weakened even further by the actions of insiders that do not enhance but rather deliberately obstruct market efficiency. To take this one step further, it has been argued that insiders have strong incentives to *manipulate* the mar-

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<sup>25</sup> Meulbroek, 1992.

<sup>26</sup> See Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, pp. 80-82.

<sup>27</sup> See Chakravarty & McConnell, 1999.

<sup>28</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 81.

ket, and therefore disserve market efficiency, by delaying, for instance, corporate announcements<sup>29</sup>. These arguments are examined in sections 2.3.4 and 2.6.

Finally, some authors argue that the alleged efficiency gain is nothing but a redistribution of wealth, since insider trading may accelerate the process of attaining efficiency by a few days or weeks (until the inside information is disclosed to or inferred by the market) but it does nothing for the long-run attractiveness of the company as an investment<sup>30</sup>. In other words, even if the short-term informational efficiency of the market may be enhanced, this has no effect on the allocative efficiency, which should be the final goal.

### 2.3.2 The impact of insider dealing on outside traders

The question of whether insider dealing is a “victimless crime” is not only a legal one but also an economic one. Insider dealing can only be victimless if it has no negative consequences for social welfare, which, in the context of financial markets, can be defined as the aggregate sum of the welfare of individual investors<sup>31</sup>. In order to examine this question, it is useful to differentiate between the different classes of investors in the market, simply because we would expect the impact of insider trading to be different for each class.

We can classify investors into four groups<sup>32</sup>:

- i. Insiders: As defined in section 2.1, insiders can be either primary insiders who possess price-sensitive non-public information because of their association to the issuer or their professional function, or secondary insiders, namely third parties that gained access to the same kind of privileged non-public information in a derivative fashion.

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<sup>29</sup> See Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 97; Hartmann, 1997-1998.

<sup>30</sup> See Dolgoplov, *Library of Economics and Liberty: The Concise Encyclopedia of Economics*, citing Klock, 1994.

<sup>31</sup> We could also examine the effects on social welfare outside the narrow context of financial markets. As it was implied when we examined the functions of the capital markets (see section 2.3.1), it has been argued – rightfully – that capital markets are a public good, which produces externalities (meaning spill-over effects) for the whole of society and especially the economy. That is, since financial markets facilitate the flow of funds to the firms, which in turn generate investments and employment, these markets create externalities for the general public even if a fraction of that public invest in them. See Cinar, 1999, p. 348. We will not broaden the analysis in that direction but the reader should bear in mind that any conclusions reached regarding the impact of insider trading on the welfare of investors are only amplified when we consider the effects on the rest of the economy and society as a whole.

<sup>32</sup> See Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 83.

- ii. Information traders: This group includes investment analysts whose main occupation is to discover and interpret price-sensitive information<sup>33</sup>, as well as “stock pickers”, meaning those investors who are considered sophisticated (such as fund managers) and who strive to outperform the market by discovering undisclosed or hidden information<sup>34</sup>. Stock pickers who do not necessarily possess the same level of expertise as investment analysts, frequently employ the services of the latter.
- iii. Liquidity traders: These kinds of investors do not possess the expertise of information traders or the funds of stock pickers in order to successfully decode price related information. As a result, liquidity traders follow long-term or *buy and hold* strategies and hold well-diversified portfolios, having no aspiration to beat the market in the short-term but to match it in the long-term. This class of investors is also referred to as *time function* traders<sup>35</sup>.
- iv. Noise traders: Noise traders are often viewed as the black sheep of the financial markets. One reason for that is that they are susceptible to *herd behaviour* or acting together without planned direction, which is often identified as the principal reason for the creation of bubbles and market crashes. Noise traders often operate under the erroneous impression that they possess price sensitive information and they mimic the behaviour of information traders, creating unnecessary confusion in the markets. This class of investors is also referred to as *price function* traders<sup>36</sup>.

Before examining the issue of which of these traders’ classes are harmed – if any – by insider trading, we must ask the question if it is indispensable that someone should lose out from such trading. Many authors have argued that insider dealing is indeed a *zero-sum game*, meaning that for every insider that benefits there is a loser on the other side of the transaction<sup>37</sup>. However, many others have opposed this view by proposing that insider trading may very well be a positive sum game, since a gain by one investor does not necessarily translate to a loss for another<sup>38</sup>. In any case, most outsiders who traded with insiders

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<sup>33</sup> *Ibid.*, p. 83.

<sup>34</sup> *Ibid.*

<sup>35</sup> *Ibid.*

<sup>36</sup> *Ibid.*

<sup>37</sup> See Dolgoplov, Library of Economics and Liberty: The Concise Encyclopedia of Economics.

<sup>38</sup> The zero-sum debate exists regarding insider trading as well as the stock market in general. The debate is still open although the prevalent view seems to be that the stock market (or insider dealing for that matter) is not a zero sum game, except in relative terms (i.e. someone who won more than another can be viewed as a winner and the latter as a loser) or with regard to opportunity cost (i.e. picking an investment that provides a smaller return than another investment makes one a loser because of the missed opportunity to invest in the

would have done so anyway and it is just fortuitous that an insider was on the other side of the trade<sup>39</sup>. What is more, they would have probably traded at a worse price, since, if the insider's actions have an impact on the asset's price, then they would benefit from the price differential. If, for instance, an insider is selling stock, provoking a drop in its price, then the buyer of that stock is benefiting from that drop because he can buy at a lower price than he would have if the insider was not trading. Nevertheless, it has been acknowledged that, as there are gains, there are also losses incurred from insider trading, although such losses are likely to be diffused and not easily traceable<sup>40</sup>. The outsiders who lose are buyers on the margin, who would not have bought if the insider's trades hadn't brought the price down, as well as sellers who sold for less than they would have under other circumstances or were not able to sell at all<sup>41</sup>. If such a transfer of wealth from outsiders to insiders happens on a systematic basis, there is a risk for aggregate share prices to drop, raising the corporate cost of capital for the issuers<sup>42</sup>.

As we have seen, there doesn't seem to be a definite answer as to whether insider dealing is inherently harmful for the markets. At a first glance, there seem to be both winners and losers, without however anyone being able to determine their ratio. In order to provide an answer regarding the actual impact of insider trading on the welfare of financial markets, it is useful to examine its effects on each class of investors. Each class has a different role to play in the financial markets and if we can conclude that insider trading creates disruptions in fulfilling that role, then it can be dismissed as harmful for market welfare.

Insiders, as a class of investors, are evidently the ones that benefit from insider trading, so we do not refer to them. Liquidity traders, as we have seen, hold well-diversified portfolios and follow long-term buy and hold strategies. They trade irrespective of new information<sup>43</sup>, because they expect any short-term losses and gains from individual assets in their portfolio to cancel each other out and leave them with a positive balance in the long-term.

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better asset). The reason that the stock market is not widely considered as a zero-sum game is that the expected aggregate return of the stock market is positive and not zero. In other words wealth is *created* instead of just being *transferred* among investors. However, there is little argument that derivatives markets and foreign exchange markets, where the ground rule is that there is always a winner and a loser, are zero-sum games.

<sup>39</sup> Bainbridge, 1999, p. 785.

<sup>40</sup> See Dolgoplov, Library of Economics and Liberty: The Concise Encyclopedia of Economics citing Wang & Steinberg, 1997.

<sup>41</sup> Dolgoplov, Library of Economics and Liberty: The Concise Encyclopedia of Economics.

<sup>42</sup> See Mendelson, 1969 cited in Dolgoplov, Library of Economics and Liberty: The Concise Encyclopedia of Economics.

<sup>43</sup> Avgouleas, The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis, 2005, p. 83.

Therefore, the information asymmetry between them and insiders does not really affect them. Moreover, the probability that insider trading would have an impact on the timing of their transactions and the corresponding market price is low<sup>44</sup>.

Noise traders on the other hand are bound to be negatively affected when trading with insiders (or any other informed trader for that matter). However, some authors argue that noise traders, seeing that they have a disruptive effect on the market themselves, should not be deemed worthy of protection<sup>45</sup>.

Perhaps the most important question for market welfare is the impact of insider trading on information traders, because it is this class of traders which plays the most crucial part in the markets. Information traders are the principal source of market efficiency, feeding their sophistication into the market's trade and price decoding mechanisms. If insiders are present in the trading process, information traders, for all their sophistication, will not be able to distinguish between insiders and noise traders or deduce the origin of insiders' trades<sup>46</sup>. Their trade and price decoding techniques will fail them on a consistent basis and they will systematically lose to insiders<sup>47</sup>. This will inevitably lead to a fall in the number of information traders willing to enter or remain in the market<sup>48</sup>. An event like that will most certainly be detrimental to market efficiency, welfare as well as liquidity, seeing that information traders provide the bulk of the financing in capital markets. Nevertheless, this conclusion only has a theoretical basis and empirical studies tend to be inconclusive. This is a flaw that plagues all empirical research on insider trading, since precise data on illegal insider trading is hard to obtain and researchers are forced to rely on estimates or proxy variables.

### **2.3.3 The impact of insider trading on liquidity**

As we saw in the previous section, insider trading can be presumed – but has not been proven – to have negative effects on information traders who provide much of the liquidity in the financial markets. But the information asymmetry that exists in markets where insider trading is present, raises a further concern: in quote-driven markets<sup>49</sup> this can lead to

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<sup>44</sup> Manne, 1966.

<sup>45</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 84.

<sup>46</sup> *Ibid.*

<sup>47</sup> *Ibid.*

<sup>48</sup> *Ibid.*

<sup>49</sup> *Quote-driven or dealer markets* are markets where market makers operate as intermediaries between buyers and sellers. Market makers are financial institutions or professional traders who trade for their own ac-

an adverse selection problem for market makers and therefore an additional liquidity problem<sup>50</sup>.

Market makers are forced to provide liquidity in the market and they have to fulfil an order even when there is no opposite order to match it with. That involves using up (or increasing) their own inventory and exposes them to risk. This risk is all the more serious when insiders are known or suspected to be operating in the market. In an insider-free market, market makers make a gain from other investors by fixing a bid/ask spread. On the other hand, in a market where insiders operate freely, market makers will consistently lose to insiders, because the latter will never transact with them unless they know they will benefit – effectively playing a “heads, I win, tails, you lose” game<sup>51</sup>. Therefore, in order to make up for their increased risk and for the losses incurred in trades with insiders, market makers will need to revise their bid/ask spread upwards. This will reduce the market’s technical efficiency by increasing transaction costs, force some investors out of the market, reduce liquidity and increase the corporate cost of capital for firms. Such consequences have an obvious social cost and reduce overall market welfare<sup>52</sup>.

### **2.3.4 The impact of insider trading on the issuers of financial instruments**

As suggested already in section 2.2, the issuers of securities are also on the list of potential victims of insider dealing<sup>53</sup>. The impact of insider dealing on outside investors and on the liquidity of the market, as well as the probable loss of investor confidence discussed in section 2.4.2 below, may have repercussions for any firm which depends on the capital markets for its corporate financing. The fact that some investors are forced out of the market reduces the supply of capital and therefore increases the cost of capital for issuers by provoking a drop in the aggregate prices of securities. Investors who stay in the market will

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count and post bid and offer prices (quotes) for a specific set of financial assets. Market makers are required to provide liquidity in those assets. To cover their risks and to compensate themselves, market makers use a bid/ask spread, which is the difference between the price they quote for selling an asset and the price they quote for buying it. *Order-driven* or *auction markets* are markets where investors interact directly with each other.

<sup>50</sup> See Dolgoplov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 2004; Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 85.

<sup>51</sup> Bagehot, 1971; Dolgoplov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 2004, p. 94.

<sup>52</sup> For an excellent overview of the debate whether insider dealing increases bid-ask spreads see Dolgoplov, *Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making*, 2004, where the author discredits part of the theoretical foundation as well as some of the empirical support of this thesis, without however rejecting it.

<sup>53</sup>For a more detailed analysis of the impact of insider dealing on the issuers see Bainbridge, 1999; Hartmann, 1997-1998.

tend to factor the increased risk – that they might be dealing with insiders when trading – in the prices that they are willing to pay for any firm’s securities. In other words, they will discount the value of firms in general because they will not be able to distinguish between “rigged” and ordinary trades<sup>54</sup>. The result will be a further increase in the cost of capital for issuers.

Apart from the increase in their cost of raising funds, issuers face further threats from insider dealing. An insider may delay the transmission of certain price-sensitive information to his superiors in the firm in order to trade on that information and capture its full value<sup>55</sup>. Another danger is that insiders may interfere with corporate plans such as takeovers, by buying stock in the target firm, thereby provoking an increase in its price and tipping off other investors to the imminent takeover (or even alerting the target company to take defensive action)<sup>56</sup>. Moreover the issuer may suffer reputational damage if its insiders are known or suspected to trade in the market. This will surely translate to financial damage as the price of the issuer’s securities will plunge and the cost of capital for the issuer in question will rise<sup>57</sup>. Insiders who make strategic decisions in the firm may also be inclined to undertake overly risky projects in order to increase stock volatility: If the risk pays off they can capture a portion of the gains in insider trading and, if the project flops, the shareholders bear the loss<sup>58</sup>. Insiders may also tend to be indifferent between bad and good news for the company<sup>59</sup>. They can benefit from good news by taking a long position in the company’s instruments and they can also benefit from bad news by going short in the same instruments. These kinds of problems, where insiders face incentives to go against the interests of their firm are also known as *perverse incentives*. Finally, there is a concern that insiders have strong incentives to manipulate their company’s stock price<sup>60</sup>, something we examine in section 2.6.

## **2.4 The debate on the regulation of insider dealing**

The United States has been the leading country in the establishment and enforcement of insider trading regulations and is also the country where the debate regarding the regulation of insider dealing was born. Insider dealing was first targeted in US federal legislation

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<sup>54</sup> This is a classic manifestation of an adverse selection problem.

<sup>55</sup> Posner, 1977, p. 308; Haft, 1982; Bainbridge, 1999, p. 787.

<sup>56</sup> Bainbridge, 1999, p. 788.

<sup>57</sup> *Ibid.*, p. 790.

<sup>58</sup> Easterbrook, 1981; Hartmann, 1997-1998. This is a typical example of moral hazard.

<sup>59</sup> Hartmann, 1997-1998.

<sup>60</sup> Bainbridge, 1999, p. 790.

by the New Deal Statutes of 1933 and 1934 (the Securities Act 1933 and the Securities and Exchange Act 1934). These statutes were introduced after the 1929 stock market crash, which had provoked a public outcry for decisive legislation to address the excesses of Wall Street that were, in the eyes of the public, responsible for the crash and the ensuing depression. The 1934 Act provided for restitution of short-swing profits made by corporate insiders from purchases and sales within a six-month period, required disclosure of past inside transactions and prohibited short-selling by insiders. However, the Securities and Exchange Act did not contain a general prohibition of insider dealing. Prosecution of insider dealing was uncommon until in the early 1960s, when the SEC started prosecuting cases based on the famous Rule 10b-5, a catch-all provision against fraud, which was established to implement section 10(b) of the Securities and Exchange Act. Prison sentences only started appearing in 1985. The legislative framework became more stringent with the Insider Trading Sanctions Act of 1984 and the Insider Trading and Securities Fraud Enforcement Act of 1988.

The debate on whether the prohibition of insider trading is indeed justified was sparked by Professor Henry Manne in his book “Insider Trading and the Stock Market”<sup>61</sup>. Manne, considered one of the founders of the *law and economics* discipline, effectively inaugurated the economic analysis of insider dealing, claiming that insider dealing was beneficial for the markets and the economy. Although someone uninitiated in the debate might instinctively believe that this is just an extreme and heretic view, it actually represents a fairly widespread opinion among neoclassical economists. Perhaps the most influential neoclassical economist and Nobel laureate, Milton Friedman, had claimed that insider trading is a made-up crime and that the prohibition should be revoked because it is harmful for the informational efficiency of the market<sup>62</sup>. In his words: “*You want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that*”<sup>63</sup>. In short, Friedman believed that insiders’ trades are valuable information for the market and he actually implied that the Enron disaster could have been contained, had insiders been allowed to trade<sup>64</sup>.

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<sup>61</sup> Manne, 1966.

<sup>62</sup> Hints, Tips, and Handcuffs, 2007; 75th Anniversary Celebration: Panel on An Ethic for the New Global Economy.

<sup>63</sup> Hall, 2007. For a transcript of Friedman’s interview on CNBC where he expressed his view on insider trading, see Ravindran, 2003.

<sup>64</sup> “*Here you’ve got a company like Enron which is doing fraudulent things. People on the inside know about it. One of the best ways to bring it out is to make it profitable, to make that knowledge profitable to them. A*

On the other side of the debate we find the proponents of the prohibition who discredit the arguments about the alleged positive effects of insider trading on efficiency. This group lends its focus to the moral perspective of the issue, as well as the implications of insider dealing for social welfare. In the following sections we attempt to capture the main arguments of the two sides and assess their validity.

#### **2.4.1 The arguments for deregulation**

The principal argument of the deregulation proponents is that insider trading enhances market efficiency. They argue that the market is able to decode the trades of insiders as new information and that the pressure which insider dealing creates on the market prices enhances their efficiency. We reviewed that argument in the relevant section 2.3.1.

The second argument proposed is that insider trading is a “victimless crime” and that investors are not really harmed by it. The stock market, according to this view, is not a zero-sum game that requires winners and losers, at least not on absolute terms. But even if one assumes that trading in general and insider trading in particular is a zero-sum game, insider trading is made possible merely because the insider’s counterparty would anyway have been willing to trade. The fact that an insider is on the other side of the trade is purely coincidental. In the end, if we need to acknowledge that someone loses, it will most likely be the noise traders who have a disruptive effect on the market and who do not deserve protection. We discussed the validity of this view in section 2.3.2.

Some proponents of deregulation use a different perspective to argue that prohibitions on insider trading should be revoked. They consider that inside information, as a valuable commodity, should belong to the private sphere of the firms and that insider trading should be addressed as a property rights matter. They reject the non-diminishable property of information, because they believe that information is a scarce and finite resource. They believe that, due to the non-excludable nature of (inside) information and the impossibility for the firms to protect such information on their own, the state should step in to assign private property rights to the firm. Failing to do so would lead to the underproduction of valuable information, as firms would have reduced incentives to produce such information

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*whistleblower takes a chance, doesn't gain anything by it. But a person on the inside who knows things are going wrong, who just engages in selling in Enron stock, can make money on it and at the same time serve the market purpose of driving down the price of the stock. And that alerts other people.”* (Milton Friedman on CNBC's “Power Lunch”, 12.03.2003).

seeing that they would not be able to exploit its full value<sup>65</sup>. This reasoning is reminiscent of the motivation behind the establishment of intellectual property law: it is widely held that, in the absence of intellectual property rights, inventions and literary works would be underproduced<sup>66</sup>.

From a Coasian<sup>67</sup> perspective some deregulators argue that insider trading should not be regulated but rather left to private contracting between actors (shareholders and executives) in the firms concerned<sup>68</sup>. Coasians believe that any initial allocation of property rights on inside information within the firm is irrelevant with respect to efficiency. As long as the parties are given the freedom to negotiate the property rights between them, this negotiation will lead to their consignment to the user who values inside information the most. This automatic optimisation process will result in the full exploitation of the value of inside information, which is the desirable and most efficient outcome. In short, Coasian deregulators argue that the state should endow firms with private property rights on inside information, granting them the option to reassign such rights within their structures as they see fit.

A closely related argument is that firms should be allowed to transfer their property rights on inside information to insiders *as compensation*, because insider trading “*is the only effective compensation*” for the managers’ entrepreneurial services to the company<sup>69</sup>. The rationale behind this is that managers – especially the risk averse kind – would be encouraged to innovate, search for and produce valuable information, as well as to take risks that increase the firm’s value<sup>70</sup>. The other advantage for shareholders is that property rights over inside information is a “cheap” form of compensation because it does not originate from the company’s profits.

A final argument presented by the deregulation camp is the *public choice* theory and is more of an anathema of the prohibition of insider trading than an argument in its own

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<sup>65</sup> Krawiec, 2001; Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 200.

<sup>66</sup> In traditional economics, the non-exclusive nature of public goods has been shown to lead to their overconsumption or their underproduction. See *supra* 17.

<sup>67</sup> The Coase theorem holds that, under certain conditions, whenever the initial allocation of property rights is not optimal, the parties concerned will have an incentive to negotiate in order for the property rights to be transferred to the individual who values them the most. In other words, Coase predicted that, in a market where there are no restrictions to free exchange, we can rest assured that the final allocation of property rights will be efficient (optimal).

<sup>68</sup> Hartmann, 1997-1998, Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 200.

<sup>69</sup> Manne, 1966, pp. 131 – 141.

<sup>70</sup> See Dolgoplov, *Library of Economics and Liberty: The Concise Encyclopedia of Economics*, where he cites Manne, 1966 and Carlton & Fischel, 1983.

merit<sup>71</sup>. According to this “public choice” perspective, the reason for the prohibition of insider dealing and the popular “brainwashing” that it is an evil act, has nothing to do with fairness or efficiency concerns. Rather, state regulators have acted as utility maximisers, seeking to further their own self-interest (just as any other individual) and not to serve the interests of the public. The prohibition of insider trading, according to this theory, is nothing but the result of a bargaining process between state regulators and powerful pressure groups of investment intermediaries (broker-dealers, securities analysts, floor traders, arbitrageurs and institutional investors) whose interests are best served by such a prohibition. Investment intermediaries are in fact the main winners because they are “next in line” (after insiders) for trading profits generated by their informational advantages over the average investor<sup>72</sup>.

#### **2.4.2 The arguments for regulation**

The proponents of the prohibition of insider trading rely mostly on discrediting the deregulators’ arguments regarding the purported efficiency gains from such trading as well as on fairness and morality considerations<sup>73</sup>.

A first argument refers to the rationale behind the famous “*disclose or abstain*” rule which was introduced by the judicial decision in *Re Cady, Roberts & Co.* (1961), a US insider dealing affair and reaffirmed in *SEC vs. Texas Gulf Sulphur Co.* (1968)<sup>74</sup>. According to this rule, when there exists a relationship for a corporate purpose that provides access to inside information, a person cannot take advantage of such information by transacting with an unwitting investor, because that is *inherently unfair*. Investors have a justifiable expectation that every party trading on an impersonal exchange has relatively equal access to material information<sup>75</sup>.

Other arguments focus on the negative impact of insider dealing on liquidity in the markets and the harm provoked to investors and to the issuers of financial instruments. We examined this issue in sections 2.3.2, 2.3.3 and 2.3.4 and we concluded that it is indeed likely

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<sup>71</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 201.

<sup>72</sup> Dolgoplov, *Library of Economics and Liberty: The Concise Encyclopedia of Economics*; Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 201; Bainbridge, 1999, p. 782.

<sup>73</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 201; Hartmann, 1997-1998.

<sup>74</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, pp. 197-198.

<sup>75</sup> *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (C.A.2 (N.Y.), 1968).

for insider trading to force some investors out of the market, reduce liquidity, increase transaction costs and hinder the technical efficiency of the markets as well as undermine the interests of issuers.

The regulator camp also points to the need to preserve investor confidence, which has been the primary goal and concern of much of the insider trading prohibition around the world. Legislators have realised that for reasons of social welfare, as well as for reasons of increased competitiveness of their respective financial markets, they needed to ensure that these markets function as a *level playing field*. Failing to establish that and convince the investing public that securities trading is not “rigged” will result in a heightened risk that investors will retreat from the financial markets and look for other investment options either in their home country or – even worse – abroad<sup>76</sup>. Taking into account the crucial role of financial markets in any modern economy, this would have devastating results for any country hosting financial markets which are perceived as unfair.

A stronger contention is that insider trading should be prohibited because it is a form of fraud<sup>77</sup>. In fact, as we saw in section 2.4, insider trading in the US is considered a form of securities fraud and the prosecutions of insider dealing have been founded on the famous Rule 10b-5, a general provision against fraud. The theory that insider trading is a form of fraud relies on the fact that the insider trades with his counterparty based on non-disclosure of material information which has been misappropriated from a source to which the insider owes a fiduciary duty. This illicit information advantage deprives the insider’s counterparty of his ability to make an autonomous decision. The similarities to fraud are indeed there and this has also been upheld in US case law<sup>78</sup>.

## 2.5 Conclusion

Most of the countries hosting developed financial markets have outlawed insider dealing, some only recently<sup>79</sup>. The "Objectives and Principles of Securities Regulation", published by the International Organisation of Securities Commissions (IOSCO) in 1998 and revised in 2003, state that investors should be protected against insider trading. This worldwide emergence of insider trading prohibitions has been attributed to various factors, such as the

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<sup>76</sup> Hartmann, 1997-1998.

<sup>77</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 202.

<sup>78</sup> See *O’Hagan vs US* 521 US 642 (1997), which endorsed the so-called *misappropriation theory*.

<sup>79</sup> For instance Hong Kong made insider trading a criminal offence in 2003 and the first prison sentence was only handed out in April 2009. See Mitchell, 2009; Lin, 2009.

globalisation of securities markets and the need for their harmonisation, the competition between the markets and their desire to appeal to outside investors, as well as the pressure exerted by the US on foreign legislators and market supervisors to increase the effectiveness of their regulatory and enforcement systems<sup>80</sup>. Undoubtedly, even though the theoretical debate rages on, the supporters of the prohibition have prevailed, at least for the time being.

This is hardly surprising. The view that insider trading enhances market efficiency fails to acknowledge that there are ways with fewer side-effects to achieve the same result. In particular, a combination of mandatory disclosure and regulated management transactions under conditions of transparency and absence of conflicts of interests achieve informational efficiency faster and more effectively than unchecked insider trading. In addition, the deregulation of insider trading would predictably lead to a breakdown of the price and trade decoding mechanisms of the market, as insiders would most certainly try to conceal their identities and confuse other investors. An environment of informational inefficiency is where insiders can thrive and extract maximum gains. If the market is ever transformed into such an environment, information traders, who cannot win against insiders, will depart from it, taking with them any insightful information they feed into the market. Reversing this situation provides the answer to the “public choice” theory of some deregulators. In a market free from insider trading, the number of information traders, who would indeed come out as the big winners of a relevant prohibition, would increase and one would be hard-pressed to find fault with that. More information traders would mean better supply of information and therefore a further push towards market efficiency.

The property rights approach which advocates assigning positive (re-assignable) private property rights on inside information to the firm that produces it in order to avoid the underproduction of information also presents fundamental flaws. First, the assignment of property rights to information introduces transaction costs into the marketplace, impeding the free flow of such information<sup>81</sup>. Secondly, serious questions could be raised about the

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<sup>80</sup>See Dolgoplov, Library of Economics and Liberty: The Concise Encyclopedia of Economics.

<sup>81</sup> Krawiec, 2001, p. 486. This is a problem related to the so-called *efficiency paradox*. According to this theory, the production of new information increases the efficiency of the market and should be encouraged by providing incentives for the production of such new information. At the same time however, providing these incentives can only reduce market efficiency, since a transaction cost must be introduced in market prices to compensate the producers of new information (otherwise the producers would receive no compensation and they would cease to produce). Therefore, market prices will never be able to reflect all available information. Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*,

purported information underproduction as a necessary consequence of the absence of private property rights on inside information. Such an assertion disregards the fact that issuers create valuable information about themselves in order to operate as a successful business and not necessarily with a view to trading profits<sup>82</sup>. In other words inside information may very well have multiple uses.

## **2.6 The links between insider trading and market manipulation**

Before proceeding to the section on market manipulation, it is useful to look how these two types of financial crime are connected. First, it is evident that they share a common economic objective, namely the maximisation of profits from trading at the expense of unwitting counterparties<sup>83</sup>. Another common feature is that they often involve the same type of actors: insiders, brokers, securities analysts and other financial professionals<sup>84</sup>. However, there is a marked difference between these two types of market abuse: whereas there are indications that insider trading may actually move market prices towards their true value, this is, by definition, not the case with market manipulation<sup>85</sup>.

One observation that we can make is that manipulations perpetrated by insiders tend to be the most dangerous kind<sup>86</sup>. Insiders often have direct access and control over corporate information and corporate financial reporting. They are at the most privileged vantage point to effect such manipulations. At the same time, they are often the ones with the strongest motives to manipulate the markets<sup>87</sup>. The manipulation of the market price of a security gives an insider the opportunity to create or widen the spread between the market price and the (known to him) intrinsic value of a security. Trading on such a spread can result in a significant financial gain for the insider. Accordingly, insiders may disseminate false information in order to profit from trading in mispriced securities or they may delay or conceal the transmission of corporate information in order to first trade on it.

Moreover, equity-linked compensation schemes often create conflicts of interests and provide corporate insiders with perverse incentives to manipulate the market price of the secu-

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2005, p. 46. This theory is attributed to Professors Grossman and Stiglitz. The efficiency paradox is one manifestation of the more general tension between social welfare and private incentives.

<sup>82</sup> Krawiec, 2001, p. 489.

<sup>83</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 96.

<sup>84</sup> *Ibid.*

<sup>85</sup> *Ibid.*

<sup>86</sup> *Ibid.*, p. 97.

<sup>87</sup> *Ibid.*

rity concerned<sup>88</sup>. The conflict of interest lies in the fact that the maximisation of the value of these compensation packages and the best interest of the company do not necessarily coincide. In an effort to pursue their own interests, insiders may use creative accounting, earnings management, income smoothing and whatever they can to raise the value of their compensation. If this compensation consists of options they may try to calibrate the exercise date to coincide with the release of positive news for the company (or they may delay the release of negative news)<sup>89</sup>. If no short-swing rules apply (establishing a holding period during which insiders cannot trade), insiders may also engage in a pursuit of short-term profits by using manipulating strategies at the expense of the long-term well-being of the company. In the case of option compensation packages, there is also a distinct moral hazard problem<sup>90</sup>: stock options reward the management<sup>90</sup> on the upside but they do not penalise them on the downside (as compensation in the underlying stock would).

We can therefore conclude that insider trading is a powerful motive and is often the end-game of market manipulation<sup>91</sup>. This hypothesis has been confirmed by empirical studies and can also be demonstrated by looking at one of the best-known financial scandals of our time. In the case of Enron, according to the SEC's civil complaint against Enron's CEO Kenneth Lay: "*Despite specific knowledge of Enron's deteriorating financial condition, Lay (Enron's CEO) continued to make false and misleading public statements about Enron's financial performance (...) In addition, Lay misled Enron employees when he informed them that he had purchased additional shares over the last couple of months. In making that statement, Lay concealed that he had made net sales of over \$20 million in Enron stock in the preceding two months*". Lay went on to sell Enron stock of a total value of \$26 million back to the company in August 2001 and another \$6 million in October 2001 and all the while he was propping up Enron's stock price. "*Enron's shareholders and employees did not find out about Lay's transactions until February 2002, over two months after Enron filed for bankruptcy protection*". The most tragic figures in the affair were the Enron employees who were not alerted to the collapse and had been encouraged by Enron executives to invest the entirety of their 401(k) retirement accounts in Enron stock.

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<sup>88</sup> *Ibid.*, pp. 98-99.

<sup>89</sup> *Ibid.*, p. 100.

<sup>90</sup> Gordon, 2003, p. 5.

<sup>91</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 101.

### 3 Market manipulation

The second type of financial crime that is covered by the term “market abuse” is market manipulation. Unlike insider dealing, market manipulation refers to a very wide and varied range of acts which makes its definition less straightforward. Another element that distinguishes market manipulation is that, unlike insider dealing, it is quite a common occurrence in commodity markets. In the following section we examine the attempts that have been made to define market manipulation and analyse the basic elements of such definitions.

#### 3.1 The definition of market manipulation

The difficulties encountered in defining market manipulation have led the US Supreme Court to refer to it as “*virtually a term of art*”<sup>92</sup>. Until the introduction of the EC Market Abuse Directive, it was uncommon for legislative texts to define or even refer to market manipulation by name<sup>93</sup>. Even the US Securities Exchange Act and the Commodity Exchange Act which explicitly target market manipulation, do not offer a definition for the term. Academic literature on market manipulation is also quite limited and does not offer many satisfactory definitions<sup>94</sup>.

However, attempts to define market manipulation may be classified under four broad categories<sup>95</sup>:

- 1) The *effects-based approach*, which focuses on the creation of artificial prices and/or misleading impressions. This kind of approach takes mainly (or only) objective elements into account to determine whether an action or a set of actions amounts to market manipulation. Such an approach is followed by the EC Market Abuse Directive<sup>96</sup>.
- 2) The *intent-based approach*, which concentrates on the subjective elements of an act or set of acts rather than the effect that this act or set of acts has achieved. Such is the approach adopted by the UK’s FMSA 2000 in sections 397(2) and, to a certain extent, 397(3)<sup>97</sup>.

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<sup>92</sup> Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976)

<sup>93</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 105.

<sup>94</sup> Fischel & Ross, 1991, p. 506.

<sup>95</sup> See Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 107.

<sup>96</sup> For the definition of market manipulation according to the Market Abuse Directive see section 4.3.

<sup>97</sup> Subsections 397 (2)-(3) of the FMSA 2000 provide that:

- 3) The combined approach, which requires the presence of both the effects (artificial prices and/or misleading impressions) and the intent of the perpetrator, with the further condition that the inducement of others to trade is proven. This approach has been adopted by the Securities Exchange Act of 1934 and US case law<sup>98</sup> and considers market manipulation to be a form of fraud.
- 4) The *market power approach*. Market power is an additional dimension, which applies primarily to commodity-related manipulations. In the US, the fact that commodity markets manipulation is regulated under the Commodities Exchange Act of 1936 and the supervisory authority is not the Securities and Exchange Commission but the Commodity Futures Trading Commission has led some authors to conclude that it is a distinct type of manipulation. However, from an economics perspective it presents the same characteristics, especially when one takes into account the increasing integration of financial markets and the similarities between commodity and financial derivatives<sup>99</sup>. Furthermore, even though it is rare, manipulative strategies that are typically associated with the commodity market have been employed in markets for purely financial assets, such as in the case of the “corner” of two-year treasury bills by Salomon Brothers between 1989 and 1991<sup>100</sup>.

In the following section we examine the elements of the effects-based and the intent based approach. The combined approach, as a mix of the two approaches, is not examined separately. The market power perspective will be addressed in section 3.2.3.3.

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(2) A person to whom subsection (1) applies is guilty of an offence if he makes the statement, promise or forecast or conceals the facts for the purpose of inducing, or is reckless as to whether it may induce, another person (whether or not the person to whom the statement, promise or forecast is made)—

(a) to enter or offer to enter into, or to refrain from entering or offering to enter into, a relevant agreement; or

(b) to exercise, or refrain from exercising, any rights conferred by a relevant investment.

(3) Any person who does any act or engages in any course of conduct which creates a false or misleading impression as to the market in or the price or value of any relevant investments is guilty of an offence if he does so for the purpose of creating that impression and of thereby inducing another person to acquire, dispose of, subscribe for or underwrite those investments or to refrain from doing so or to exercise, or refrain from exercising, any rights conferred by those investments.

Subsection 397 (3) is mostly a combination of the effects-based approach and the intent-based approach

<sup>98</sup> Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976): “the use of the word “manipulative,” virtually a term of art used in connection with securities markets, connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities”

<sup>99</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 106.

<sup>100</sup> See section 3.2.3.3.

### 3.1.1 The effects-based approach: *misleading impressions* and *artificial price*

The effects-based approach points to the creation of *misleading impressions* as one element of the definition of market manipulation<sup>101</sup>. *Misleading impressions* are created when the act or set of acts of the alleged manipulator leads to false or misleading signals regarding the demand, the supply or the price of a financial instrument. In order to assess whether misleading impressions were indeed created, a test needs to be established. A test that has been proposed is the so-called *regular user* or *reasonable person test*<sup>102</sup>. Using such a test could help us determine whether an average market user would have formed a mistaken perception as a direct consequence of the alleged manipulator's acts. We can take the case of Enron which was presented in section 2.6 to perform this test. Using the test of the reasonable user would lead someone to affirm that the element of misleading impressions was present in that case, since a reasonable user of the market would mistakenly deduce from Lay's statements and purported stock purchases that Enron was a financially healthy company – unless sufficient signals in the opposite direction alerted him to the actual situation.

The relative simplicity of verifying the creation of misleading impressions is in direct contrast with the complexity of determining the presence of an *artificial price*, which is considered as another element of the definition of market manipulation according to the effects-based approach. The International Organisation of Securities Commissions has defined price artificiality as “*the divergence of price from the legitimate forces of supply and demand*”<sup>103</sup>. However, isolating the price effect of any given manipulation can be an excruciatingly difficult exercise and can raise many causation-related questions<sup>104</sup>. Furthermore, estimating what the true level of supply and demand would have been in the absence of manipulation would largely depend on the model of backward prediction used by the researcher.

A solution that has been proposed for determining price artificiality is the use of historical data<sup>105</sup>, which can – according to this view – offer enough indications of what constitutes a “normal” as opposed to an “artificial” price or price variation. The tests based on this approach look for abnormalities by comparing current prices (or price changes) with prices

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<sup>101</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 108.

<sup>102</sup> *Ibid.*

<sup>103</sup> Technical Committee of the International Organization of Securities Commissions, 2000, p. 13.

<sup>104</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 109.

<sup>105</sup> *Ibid.*

(or price changes) during the same historical period. However these tests suffer from serious limitations. First, they cannot provide a solution when a price-related event has no satisfactory historical precedent, as in the case of IPOs<sup>106</sup>. Moreover, it is rightfully argued that current supply and demand do not necessarily follow the same pattern as they did in the past<sup>107</sup>. Assumptions of linear evolution of supply and demand are oversimplifications and fail to account for variations in the economic factors and future expectations that determine the actual level of demand and supply of an asset at any given time.

A second set of tests that has been suggested are the so-called *unusual price tests*<sup>108</sup>. These tests recognise the arduous and, to a certain extent, vain efforts to measure the forces of demand and supply with any reasonable accuracy. Instead, they concentrate on checking for perturbations in normal pricing relationships and mechanisms. This approach is more realistic than the historical data approach. The relationships on which this approach relies present the advantage of being relatively stable over time and do not have the dynamic properties of inter-temporal demand and supply. Moreover they tend to be less dependent on exogenous variables. Examples of these kinds of relationships include the well-established relationship between the price of a financial instrument and that of its underlying asset or between the prices of the same or similar assets in different exchanges. Unjustified perturbations in such relationships could indeed be regarded as an indication of market manipulation. Other instances of perturbations that could be attributed to market manipulation are significant price differentials between assets with maturities in neighbouring months, movements in futures markets without corresponding movements in the cash markets, as well as futures prices that reach a significantly higher or lower level than the corresponding cash price<sup>109</sup>.

For all their attractive rationale, the unusual price tests are not devoid of problems. The main complication of these tests is that it cannot always be known how many and which of the assets correlated with the asset that has allegedly been the object of manipulation, have suffered the same fate<sup>110</sup>. When conducting the unusual price test, there is a visible risk that the researcher (or worse still a regulator or a judge) is led to “cherry pick” pricing relationships between the allegedly manipulated asset and assets whose prices stand at a sig-

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<sup>106</sup> *Ibid.*, p. 110.

<sup>107</sup> *Ibid.*

<sup>108</sup> *Ibid.*

<sup>109</sup> *Ibid.*, p. 111.

<sup>110</sup> *Ibid.*

nificantly higher or lower level, arriving to the inevitable conclusion that manipulation has indeed taken place. Notwithstanding such issues, this kind of test remains a very useful guide in determining with a certain confidence level the presence of market manipulation. *Event studies*<sup>111</sup> could then be used to measure the price effect of the said manipulation<sup>112</sup>.

### 3.1.2 The intent-based approach

The proponents of this approach are critical towards any effort to include the element of artificial price in the definition of market manipulation and consider that courts and regulators should abstain from applying the market manipulation prohibition based on complex analyses of dubious validity. They argue that artificial price analysis for determining a manipulated price “*substitutes one unhelpful term for another*”<sup>113</sup>. They believe that the legal definition of market manipulation should concentrate on the elements of the manipulator’s behaviour, behaviour that would be *uneconomical or irrational* absent an effect on market price. Accordingly, this view establishes an ex-post “*but-for*” test: but for the price impact on the market, the alleged manipulator would not have behaved the way he did<sup>114</sup>.

However, this approach presents several difficulties. First, it is not always feasible to prove intent in market manipulation cases. Proof of intent is commonly circumstantial and manipulative intent must be shown inferentially from the conduct of the accused. Inferential intent for large-scale players in the physical commodity markets is difficult to prove<sup>115</sup>. For instance, a large long futures position could be built for either illegal manipulation purposes or with legitimate hedging or speculation intent.

Secondly, the “uneconomical or irrational” elements of the proposed “but for” tests could put anyone accused of market manipulation in a “no-win” situation. This has been illustrated in the Hunt’s Silver case, whereby the Hunt Brothers, who found themselves ac-

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<sup>111</sup> *Event studies* were introduced by Professor Eugene Fama (Fama, Fisher, Jensen, & Roll, 1969). In an event study on a case of market manipulation, the manipulative act (for instance the spread of misleading information about a financial asset) would be defined as the critical *event*. The researcher would then fix a certain *event window* within which the event is expected to have influenced market prices. Subsequently, an asset pricing model like the Capital Asset Pricing Model (CAPM) or the Arbitrage pricing theory (APT) would be used to predict the “normal” market price levels for the event window. The differential between the “normal” price levels and the actual observed price levels following the event would provide a measure of the price effect of the manipulation during the event window. This quantification of the effect that a manipulative act has had on market prices can be used by a court or a regulator to determine the losses of injured investors and award damages accordingly.

<sup>112</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p.

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<sup>113</sup> Perdue, 1987, p. 348.

<sup>114</sup> Kozinn, 2000, p. 267.

<sup>115</sup> *Ibid.*, p. 268

cused of attempting to corner the silver market, had used straddles (simultaneous long and short positions on a single investment) on silver on which they made losses<sup>116</sup>. These losses were used by the plaintiff as proof of the “uneconomic” nature of the corresponding positions, which could not be justified but for the existence of a wider manipulative scheme. However, had these straddles been profitable, the plaintiff would just as likely have presented them as part of the wider plan to manipulate the silver market. In other words the *ex post* rationale of the intent-based approach is fairly dangerous because it can lead to arbitrary judgements about the *ex ante* intent of some actions based on the *ex post* outcome<sup>117</sup>.

Finally, stripping the element of price artificiality from the definition of market manipulation removes the core objective element of the crime and spares the plaintiff from the obligation to prove the damage inflicted by the alleged manipulator. As a result, any suspicious activity, including any form of legitimate speculation, could be classified as market manipulation and punished accordingly<sup>118</sup>. And even though refinements of the intent-based approach have been attempted<sup>119</sup>, they still rely on “but for” circumstantial tests of subjective nature. The price impact of the alleged manipulator’s conduct must remain an element of the definition of market manipulation, even if it is only afforded a complementary role<sup>120</sup>.

### **3.1.3 A synthetic definition of market manipulation**

In an attempt to conciliate the different approaches that have been presented, a new definition of market manipulation proposes a synthesis of the elements examined above. According to this definition suggested by Avgouleas, market manipulation is described as: “*Behaviour effected through any one, or a combination of any of the following: misrepresentations and other false statements or concealments, artificial transactions, and trading*”

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<sup>116</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, pp. 112-113.

<sup>117</sup> Williams, 1995, pp. 180-181; Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, pp. 112-113.

<sup>118</sup> Kozinn, 2000, p. 268.

<sup>119</sup> See Friedman, 1990, pp. 58-60, who suggests asking questions on what the alleged manipulator’s conduct would have been “if some aspect of reality were altered or disregarded” in order to reach a conclusion on whether a conduct constitutes manipulation or not. He proposes questions of the type: what would a trader have done had he not taken into account the price impact of his own conduct or what would he have done had the rules of the market not offered him the opportunity to exert pressures on demand or supply for an asset (as in the case of the futures markets whereby the manipulator can exploit the system of punitive sanctions for default to create short squeezes or corners).

<sup>120</sup> In that sense see Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 113.

*schemes, which are made or structured in such a way as to induce market participants to engage in the trading of financial investments or the exercise of rights in financial investments. Relevant trading must be in such a direction or the exercise of rights must be effected in such a way, as to either lead the price of these investments to an artificial level and/or enable the perpetrators of the behaviour to materialise, from interests held in the specific or related investments, financial gains that would not be possible in the absence of such behaviour”<sup>121</sup>.*

According to Avgouleas, this definition claims two fundamental advantages over competing definitions. First, it excludes attempted manipulations the repression of which is dismissed as “futile and wasteful”. Attempted manipulations can be carried out either through actual trades or through artificial transactions and dissemination of false information. In the case of unsuccessful manipulations based on actual trades, Avgouleas suggests that the majority of such schemes amount to harmless speculation (unless an additional element complements the scheme, such as market power, insider trading or subsidisation of the scheme through benefits from other positions)<sup>122</sup>. In the case of failed schemes based on artificial transactions or the dissemination of false information, the same author considers that such acts could be dealt with by other legal and regulatory provisions such as conduct of business rules or the law against misrepresentations. One would be inclined to view the exclusion of attempted manipulations from the definition of market manipulation as a welcome step towards narrowing down an already wide term. From a policy and a legal perspective the consequent limitation of enforcement costs, a more accommodating investment environment and an increase in legal certainty are also important advantages of such an approach.

Avgouleas argues that the second benefit of adopting this synthetic definition is that the “either...or” formulation would allow a court or a regulator, should this definition be adopted as a legal standard, to dispense with the burden of proving the condition of an “artificial price”. As long as the conduct of the alleged perpetrators consists of misrepresentations, artificial transactions or trading schemes structured in a way to induce market participants to trade and result in financial profit for the perpetrator, then the existence of market manipulation can be asserted without necessarily having to prove the artificial price

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<sup>121</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 116.

<sup>122</sup> We discuss this argument in section 3.3.2.

element. However, Avgouleas admits that price artificiality is a core element of market manipulation and he includes it in the definition in order not to sacrifice “good economics” for the sake of the legal certainty provided by the intent-based element. Accordingly, the inclusion of the intent-based element serves to provide judicial workability of the proposed definition.

### **3.2 Typologies of Market Manipulation**

The different types of market manipulation can be classified into three broad categories<sup>123</sup>:

- Information-based manipulations, meaning manipulation schemes based on releasing false rumours or on misrepresenting certain facts to investors
- Manipulations based on performing false or misleading transactions
- Price manipulations, which have a direct and immediate effect on the demand, the supply or the price of the manipulated asset

This distinction has also been adopted by the EC Market Abuse Directive. Price manipulations can be further distinguished into trade-based manipulations, market power manipulations and contract-based manipulations. Trade-based manipulations involve actual trades structured in such a way that they can affect, due to their volume or their timing, the price of the manipulated asset. Market power manipulations are based, as their name suggests, on the market share that the perpetrator holds in an asset or in related assets, which puts him in a position to control the supply or demand for that asset and therefore fix its price level at his convenience. Finally, contract-based manipulations are schemes in which the manipulator’s profit results from his ability to trigger a contractual right or benefit by trading<sup>124</sup>. Contract-based manipulations are not a separate form of manipulation as far as the nature of the manipulator’s acts are concerned, since they may be carried out under any of the aforementioned forms of manipulation (for instance as information-based or trade based manipulations). However they are mentioned as a distinct category because they contain an element of “trade subsidisation” which also constitutes the main motive for their execution. Allen and Gale<sup>125</sup> mention another form of manipulation which they refer to as “action-based manipulation”. This type of manipulation occurs when people having information or control over a firm’s operation take actions that change the actual or perceived

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<sup>123</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, pp. 118-119.

<sup>124</sup> Fischel & Ross, 1991, p. 523.

<sup>125</sup> Allen & Gale, 1991.

value of the firm's assets and they make a profit by trading in the respective direction. However we could classify these kinds of manipulations as special forms of market power manipulations<sup>126</sup>.

### **3.2.1 Information-based manipulations**

Typically, information-based manipulations are carried out by investment analysts or other market professionals, as well as the issuers of financial instruments themselves. A particularly dangerous form of information-based manipulation is the supply of misleading advice by brokers or investment advisers, as well as the release of misleading investment recommendations. The practice whereby the perpetrator increases the value of his own investments by releasing advice or recommendations in a direction that is favourable to his investment is known as *scalping*. However, misleading advice or recommendations are not necessarily motivated by investment profits but may result from various conflicts of interests. The issue of manipulation by market professionals and investment analysts arose with great intensity in the United States after the deflation of the "dot com" bubble in 2000. It became obvious that market makers have incentives to "hype" the securities in which they make a market or to offload securities which are marketed or underwritten by their firms<sup>127</sup>. At the same time, the burst of the bubble revealed that certain "star" investment analysts whose recommendations the investing public tended to follow in blind faith were in fact providing these recommendations under grave conflicts of interests. A disturbing manifestation of this was that in October 2001, just before Enron filed for bankruptcy, sixteen out of the seventeen Wall Street analysts covering Enron's stock, had preserved their "buy" or "strong buy" recommendations for Enron's shares. At the same time all the facts were pointing in the opposite direction: the company had already lost half of its market capitalisation, financial ratios were clearly indicating that the stock was overvalued and Enron's CEO had resigned in August 2001<sup>128</sup>. What is more, it is widely held that Merrill Lynch gave in to Enron's threats that it would be excluded from its investment banking business and fired John Olson, one of its investment analysts, who had failed to be positive enough about Enron's finances.

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<sup>126</sup> In action-based manipulations, the manipulator controls the value of the underlying asset of the manipulated securities, i.e. the issuing company itself. We could therefore consider that there is an element of market power in these manipulations and that for that reason they could be classified as market-power manipulations.

<sup>127</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 119.

<sup>128</sup> *Ibid.*, p. 91.

The conduct of Wall Street research analysts during the dot com bubble led to large scale investigations by the New York State Attorney General, the SEC, the NYSE and the NASD. Enforcement actions were taken against ten of the largest Wall Street banks and were settled in 2003 through the “Global Settlement”, which, in addition to historical monetary penalties, imposed a series of structural reforms on the banks which aimed at the complete separation of the banks’ investment banking and investment analysis business<sup>129</sup>.

The two best known information-based manipulations are the *pump and dump* and the *trash and cash* which are basically two sides of the same coin. *Pump and dump*<sup>130</sup> involves taking a long position in a security and then disseminating false positive information about the security with a view to increasing its price. Investors are lured into purchasing the security at an inflated price at which point the manipulator offloads his holdings. *Trash and cash* is the opposite scheme of pump and dump. It involves spreading misleading negative information about a security in order to drive its price down. Once the price has dropped the manipulator can buy the security at a low price and close out any short positions he may have taken. Two of the oldest and most famous examples of such manipulations are the *Re v De Berenger* case and the more disputed account regarding the banker Nathan Rothschild<sup>131</sup>. Both schemes were based on false information concerning Napoleon, the fate of which seemed to have a significant effect on the value of the British government’s securities in the early 19<sup>th</sup> century. In *Re v De Berenger*, members of the aristocracy conspired to bring false news of Napoleon’s death transmitted by a person disguised as a French officer. The nobles involved were then able to sell off their positions in government debt at an inflated price provoked by the ensuing euphoria. Rothschild on the other hand allegedly deceived investors by spreading the rumour that the Waterloo battle was lost. He therefore forced the price of government securities to drop while at the same time he was covertly purchasing securities, knowing, thanks to his system of courier pigeons, that Wellington was in fact winning the battle.

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<sup>129</sup> See Securities and Exchange Commission Press Release; Securities and Exchange Commission Factsheets.

<sup>130</sup> Some authors use the term *hype and dump* to describe this form of manipulation. The same authors use the term *pump and dump* to designate the practice of *pegging* which is a trade-based manipulation examined in section 3.2.3.1.2.

<sup>131</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 122.

Modern communications and the advent of the Internet have multiplied the opportunities for this kind of market rigging<sup>132</sup>. Aspiring manipulators have at their disposal an unlimited number of Internet bulletin boards, chat rooms and newsletters frequented by unsophisticated retail investors, through which they can spread false rumours and benefit from the reactions of these investors<sup>133</sup>. The use of the Internet presents unique advantages for manipulators: anonymity, absence of regulatory monitoring, as well as cross-border access to potential investors. The said investors may affect the supply or demand for a financial instrument through their sheer numbers, particularly when the instrument in question is issued by a firm of small capitalisation – the case of the so called *penny stocks*. Manipulations of this kind may be carried out by outsiders but they have also been known to be perpetrated by issuers themselves or, more accurately, their majority shareholders, members of their corporate structure or other insiders.

Another form of information-based manipulation is the concealment of ownership of a position in a financial instrument through a technique called *warehousing* or *parking*<sup>134</sup>. This type of manipulation may be executed through a series of transactions designed to disguise the path from the original seller to the ultimate buyer and conceal the real beneficiary of certain positions. This usually involves breach of disclosure requirements by the real beneficiary and false declarations by colluding parties who are made to appear as the beneficiaries of the said positions. Manipulations like these may be used to disguise ownership in the context of takeovers, in the context of market power manipulations<sup>135</sup> or in the context of artificial transactions such as wash trades<sup>136</sup>.

Instances of information-based manipulations may also be found in futures markets. Misleading information published or disseminated may pertain to the value or the supply and demand in the underlying assets or even to the availability of storage and transportation facilities. The first set of CESR guidance on the EC Market Abuse Directive specifically refers to such scenarios: “*an example might be the movement of physical commodity stocks*

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<sup>132</sup> *Ibid.*, p. 123.

<sup>133</sup> The ease with which one may commit market rigging over the internet has been demonstrated by the case of the 15-year old Jonathan Lebed who was charged with securities fraud by the SEC for his internet based “pump and dump” manipulations. See Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 127.

<sup>134</sup> See Steinberg, 1984, pp. 3-78, 9-31.

<sup>135</sup> See section 3.2.3.3

<sup>136</sup> See section 3.2.2

to create a misleading impression as to the supply or demand for a commodity or the deliverable into a commodity futures market”<sup>137</sup>.

### 3.2.2 Artificial transactions

The second type of market manipulation involves schemes based on artificial transactions. Manipulations based on artificial transactions were very commonplace in the US during the 1920s<sup>138</sup>. The notorious *Wall Street pools* engaged routinely in operations of compromising the ticker tape records by entering orders in which, either the pool operator acted as both buyer and seller of the same stock, or the buyer and the seller were different but colluding “confederates”<sup>139</sup>. These schemes are similar to information-based manipulations in the sense that their objective is to feed false or misleading information to the market. The difference is that, in the case of manipulations based on artificial transactions, the manipulator relies on the trade and price decoding mechanisms of the market to interpret false signals of trading on an asset as legitimate, leading the market to revise its estimates of the value of that asset accordingly.

Artificial transactions can take the form of *wash trades* or *improper matched orders*. A *wash trade* is a practice whereby a transaction does not result in a change in the beneficial ownership of the traded asset or a transfer of the related market risk<sup>140</sup>. Alternatively, the change in beneficial ownership or the transfer of the market risk might take place between parties which are acting in concert or collusion<sup>141</sup>. *Improper matched orders* are offsetting orders of purchase and sale in the same asset entered by different but colluding parties with the aim of affecting the liquidity or the price of the said asset. When there are multiple colluding parties this practice is also known as a *daisy chain*.

A related practice is known as *painting the tape* whereby the manipulators engage in a series of transactions reported on a public display facility in order to give the impression of activity or price movements in the targeted asset<sup>142</sup>. Another manipulative technique called *spoofing* involves placing large fictional orders (typically in an electronic system) at a price higher or lower than the current market price, with no intention of executing them.

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<sup>137</sup> The Committee of European Securities Regulators, 2004, p. 13.

<sup>138</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 130.

<sup>139</sup> The Yale Law Journal Company, Inc., 1937, pp. 626-627.

<sup>140</sup> The Committee of European Securities Regulators, 2004, p. 11.

<sup>141</sup> *Ibid.*

<sup>142</sup> *Ibid.*

The orders are then withdrawn at the last minute<sup>143</sup>. The objective of this scheme is to mislead investors into believing that there is demand or supply of the targeted asset at the price at which the order was entered into the system. A variant of this form of manipulation involves placing orders of small size in order to insure oneself against the risk of large losses in case these orders cannot be withdrawn on time<sup>144</sup>.

Fictitious takeover bids also fall within the category of artificial transaction schemes<sup>145</sup>. In principle, a takeover bid increases the demand and the price of the target company's stock. A manipulative scheme could potentially involve increasing the manipulator's shareholding in a company and then announcing a bid that the manipulator cannot or does not intend to see through. Insufficient funds on the part of the bidder, sales of his holdings in the target company shortly after making the announcement and the limited probability of success of the bid would constitute strong indications that the bid is manipulative<sup>146</sup>.

### **3.2.3 Price manipulations**

Price manipulations constitute a direct "assault" on the integrity of the market's price formation (discovery) mechanism<sup>147</sup>. They can be further classified into the following classes of manipulations: trade-based manipulations, contract-based manipulations and market power manipulations<sup>148</sup>. We examine each of these categories in the following sections.

#### ***3.2.3.1 Trade-based manipulations***

A trade-based manipulation occurs when a trader attempts to manipulate the market simply by buying and then selling, without taking any publicly observable actions to alter the value of the targeted asset or releasing false information to change its price<sup>149</sup>. The objective of this scheme, which is based on the performance of *actual trades*, is to push the price of an asset up (or down) so that the manipulator can at a later time offload his position at an inflated price (or increase his holdings at deflated prices). The Wall Street "bear" and "bull" pools acquired notoriety through the exaggerated trade-based manipulations they

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<sup>143</sup> *Ibid.*

<sup>144</sup> *Ibid.*

<sup>145</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 131.

<sup>146</sup> *Ibid.*

<sup>147</sup> *Ibid.*

<sup>148</sup> *Ibid.*

<sup>149</sup> Allen & Gale, 1991, p. 505.

effected in the 1920s and their schemes are often identified as the main reason for the introduction of the New Deal Statutes in the United States<sup>150</sup>.

### 3.2.3.1.1 The issue of profitability of trade-based manipulations

Trade-based manipulations are probably the only form of manipulation that has created serious controversy regarding its nature, the economic analysis of its mechanics, as well as the need to regulate it. First, it has been argued that, unlike other forms of manipulation which can be better understood as a form of securities fraud, trade-based transactions involve actual and legitimate trades and the only objectionable element is the intent of the trader. According to this view, absent an objectively wrongful conduct, there is no harm and no loss<sup>151</sup>.

Secondly, it has been argued that trade-based manipulations by uninformed manipulators based on mere purchases and sales of assets have a very low probability of success in the absence of any additional facilitating elements<sup>152</sup>. Specifically, for a manipulation to be profitable, there are two conditions that need to be satisfied: (a) the trading must cause the price of the security to rise (or fall), and (b) the manipulator must be able to sell (buy) at a price higher (lower) than the price at which he purchased (sold), taking transaction costs into account<sup>153</sup>.

The first condition of profitability of such schemes might seem obvious to anyone familiar with the mechanics of supply and demand and their effect on prices. However, although it is commonly assumed that trading affects prices, the actual relationship between the two when it comes to securities markets is heavily debated<sup>154</sup>. There are four theories that address this issue. The *substitution hypothesis* relies on the findings of portfolio theory that suggests that the demand and supply for financial instruments is almost perfectly elastic and therefore any increase in the demand or the supply of an asset does not affect its price<sup>155</sup>. According to this hypothesis, investors hold securities solely for the stream of future income that they provide and are indifferent between combinations of securities that

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<sup>150</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, pp. 132-133.

<sup>151</sup> Fischel & Ross, 1991, p. 511.

<sup>152</sup> “On the face of it, it would seem that trade-based manipulation cannot be profitable. The argument is simple. When a trader tries to buy a stock, he drives up the price. When he tries to sell it, he drives down the price. Thus, any attempt to manipulate the price of a stock simply by buying and selling requires the trader to “buy high” and “sell low.” This is the reverse of what is required to make a profit.” (Allen & Gale, 1991, p. 506)

<sup>153</sup> Fischel & Ross, 1991, p. 512.

<sup>154</sup> *Ibid.*, p. 513

<sup>155</sup> *Ibid.*, p. 514

can provide comparable income streams. Therefore, the substitution hypothesis posits that the limitations of demand and supply which can provoke price changes through trading do not apply in securities markets due to the near-perfect substitutability of financial instruments.

On the other hand, the *information hypothesis* considers that the price of any security is the meeting point of investors' expectations on its future value<sup>156</sup>. Therefore, trading by investors who possess new information and revise their expectations accordingly may reveal this new information to the market and cause prices to adjust to it. This hypothesis is supported by empirical studies that show that trading by investors who are believed to have superior information provokes significant price changes. The *liquidity hypothesis* similarly holds that trading has an impact on prices because of the costs that arise whenever an investor wants to liquidate his positions immediately (or inversely acquire a large block of an asset) and there are not enough market participants willing to stand on the other side of the trade at the current market price<sup>157</sup>. In order to induce market participants who are unwilling to trade at the market price, the investor has to sell at a discount (or inversely pay a premium). Finally, the *price pressure hypothesis* holds that securities do in fact possess unique characteristics, rejects the perfect substitutability of financial instruments and maintains that trading in an asset moves its price level because of its relative scarcity<sup>158</sup>.

Seeing that all four theories are supported by a considerable amount of empirical evidence, the difficulties associated with successful trade-based manipulations become apparent. The substitution hypothesis tells us that the first condition for the manipulation to be successful simply cannot be fulfilled. The information hypothesis on the other hand implies that the manipulator will need to look informed at the first stage of the scheme when he is building up his position, yet appear uninformed in order not to affect prices when he is offloading his holdings at the final stage<sup>159</sup>. The liquidity hypothesis posits that the manipulator will incur prohibiting transaction costs both when he builds up his position and when he attempts to unwind it. In addition, the implication of the price pressure hypothesis is that the price impact at the first stage of the manipulation will be offset by the depressing prices at the second stage when the manipulator sells off his positions. In conclusion, satisfying both conditions for the profitability of a trade-based scheme, namely having an impact on prices

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<sup>156</sup> *Ibid.*, p. 515

<sup>157</sup> *Ibid.*, pp. 515-516.

<sup>158</sup> *Ibid.*, pp. 516-517.

<sup>159</sup> *Ibid.*, p. 518.

simply by engaging in trading and ultimately realising a positive balance on such trading, appears extremely difficult<sup>160</sup>.

Some financial economists argue that profitable trade-based manipulations by uninformed traders are possible and they propose models where these traders mimic the trading patterns of informed traders making the market unable to distinguish between manipulators and informed traders<sup>161</sup>. Other models rely on investor irrationality or departures from market efficiency to demonstrate the potential profitability of these schemes<sup>162</sup>. However, in principle, trade-based manipulations are loss making and thus largely self-defeating, unless they are combined with other elements, an issue that we examine in section 3.3.2. Below, we mention some instances of trade-based manipulations.

#### 3.2.3.1.2 Forms of trade-based manipulations

*Marking the close* is the technique of buying or selling securities near the close of the market in order to affect the closing price of the said securities<sup>163</sup>. By ensuring that the last trade on the market is a purchase order, a trader can enhance the value of a long position, or lower the burden of a short position when the last trade is a sell order<sup>164</sup>. Such manipulations take place primarily on dates such as future/option expiry dates, quarterly/annual portfolio valuation dates or index reference/valuation dates<sup>165</sup>. In these cases however, due to the presence of underlying contracts, we must classify them as contract-based manipulations, a form examined in the following section. A related technique known as *marking the open* involves placing purchase orders at slightly higher prices or sales orders at slightly lower prices to drive up or suppress the price of the targeted securities when the market opens<sup>166</sup>.

Another form of trade-based manipulation is called *advancing the bid* or *successive bids*<sup>167</sup>. This practice consists of purchasing at successively higher prices in order to force the price of the targeted security above its current level. In the futures market this practice

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<sup>160</sup> *Ibid.*, p. 513.

<sup>161</sup> Allen & Gale, 1991.

<sup>162</sup> Jiang, Mahoney, & Mei, 2005, p. 148.

<sup>163</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 137.

<sup>164</sup> *Ibid.*

<sup>165</sup> The Committee of European Securities Regulators, 2004, p. 11.

<sup>166</sup> Cumming & Johan, 2008.

<sup>167</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 141.

is called *reaching*<sup>168</sup>. However, unless the manipulator manages to create a momentum of overreaction by other investors, such schemes can turn out very costly. Other well-known forms of trade-based schemes are the manipulations known as *ramping*, *capping* and *pegging*. *Ramping* involves trading in order to move the price of a financial instrument away from its normal level and to the direction desired by the manipulator. *Capping* is a form of ramping where the manipulator trades in order to keep the price below a certain level and *pegging* is the inverse technique of fixing the price above a certain level by creating a floor in the price pattern. These manipulations are often used when another position in the derivatives market is held and the manipulator wants to control the price of the underlying in order to make a financial gain or to avoid making losses<sup>169</sup>. Pegging in particular is a technique that might be used by the issuer of financial instruments, in order to keep the price of these instruments from dropping, which might have negative consequences for the issuer's share or credit ratings<sup>170</sup>. Share buy-backs can also be regarded as a form of pegging since they tend to boost the stock's price, however in some cases they are authorised, namely when the buy-back forms part of an operation to reduce the company's share capital<sup>171</sup>.

Trade-based schemes may also be observed in the after-market of an Initial Public Offer (IPO). In this scheme, parties which have been allocated stock in a primary offering col-  
lude to purchase further blocks of stock introduced in the secondary market, in order to generate interest from other investors, at which point they begin offloading their holdings<sup>172</sup>. However, this case must be distinguished from legitimate operations of stabilisation which aim at preventing speculative attacks by short sellers and which are authorised in most modern securities markets.

### **3.2.3.2 Contract-based manipulations**

Contract-based manipulations are schemes in which the manipulator's profit results from his ability to trigger a contractual right or benefit by trading<sup>173</sup>. IOSCO has acknowledged the increased risk of such manipulations due to the growth of derivative markets<sup>174</sup>. In fact,

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<sup>168</sup> *Ibid.*

<sup>169</sup> Swiss Federal Banking Commission, 2003.

<sup>170</sup> The Committee of European Securities Regulators, 2004, p. 12.

<sup>171</sup> *Ibid.*

<sup>172</sup> *Ibid.*

<sup>173</sup> Fischel & Ross, 1991, p. 23.

<sup>174</sup> "Furthermore, with the growth of derivative products, there may be an increased incentive to manipulate the asset underlying the contract. For example, the price of securities can be manipulated to affect the price of a derivative contract or other products (e.g., convertible preferred shares) that are tied in some form to those securities. When such distortions occur, innocent counterparties and market participants who engage in transactions at those manipulated prices can be harmed, including public companies, pension funds, col-

contract-based manipulations are the most effective and the least self-detering trade-based manipulations<sup>175</sup>. The expectation of financial gain from the activation of a contract clause, or from a cross-market position grants these schemes an element of *trade subsidisation* which serves to cover any costs incurred by the manipulator in the trading leg of the scheme<sup>176</sup>.

Derivatives and futures contracts are obvious targets for these kinds of manipulations<sup>177</sup>. Manipulations of prices in the cash market (in the case of futures) and in the underlying assets (in the case of derivatives) may affect the price level of these contracts and result in significant financial gains – or loss avoidance – for the manipulator. Contract-based manipulations may also take place in the context of employee compensation packages<sup>178</sup>. Management compensation packages that are activated when the share price reaches a certain level create obvious incentives for the management to use various methods to force the price to an artificial level in order to receive their compensation.

Contracts containing redemption, conversion or repurchase clauses, which are often introduced in agreements between an issuer and its shareholders, may also create incentives for manipulation<sup>179</sup>. *US v. Milken*<sup>180</sup> is the most famous affair of a manipulation connected to a redemption clause. Wickes Corporation had approximately eight million shares of convertible exchangeable preferred stock outstanding which it had issued in 1985. A redemption feature of this stock gave Wickes the option to redeem it prior to May 1988 provided that the closing price equalled or exceeded \$6<sup>1/8</sup> per share. The notorious Michael Milken, who acted as a representative of Wickes' investment banker, asked Ivan Boesky, a legendary Wall Street arbitrageur who acted as Milken's agent, to purchase enough of Wickes' shares for them to reach \$ 6<sup>1/8</sup> and guaranteed Boesky against loss<sup>181</sup>. The manipulation was successful and Wickes was able to call the preferred stock for redemption. Equivalently, a famous example of a manipulative scheme based on a stock repurchase agreement

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*lective investment vehicles, banks, and governmental bodies.*" (Technical Committee of the International Organization of Securities Commissions, 2000, p. 2).

<sup>175</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 143.

<sup>176</sup> *Ibid.*, p. 144.

<sup>177</sup> *Ibid.*

<sup>178</sup> *Ibid.*, p. 147.

<sup>179</sup> *Ibid.*, p. 144.

<sup>180</sup> 759 F. Supp. 109 (S.D.N. Y. 1990). See also Fischel & Ross, 1991, pp. 530-532.

<sup>181</sup> Milken and Boesky are legendary Wall Street figures and symbols of the "greed decade", as the 1980s is often referred to. Together they created the greatest insider-trading ring in financial history. For a detailed account of the long list of financial crimes they were involved in, see Stewart, 1992.

can be found in *US v. Mulheren*<sup>182</sup>. Ivan Boesky owned stock in Gulf & Western Industries Inc. which he wanted to sell back to the issuer for \$45 per share. G&W's chairman agreed to buy back the shares but only at the price at which G&W stock last traded on the NYSE at the time of the transaction. The following day Boesky called Mulheren and told him that "it would be great if it [the G&W stock] traded at \$45", at which point Mulheren started buying G&W shares until the price reached \$45 and Boesky was able to sell his holdings back to the company.

Contract-based manipulations are also observed in the market for corporate control, which offers ample manipulation incentives and opportunities<sup>183</sup>. Controlling shareholders of a potential target company may attempt to keep the share price at an artificially high level in order to extract a better offer from bidders or in order to discourage aspiring bidders. Bidders, on their part, may engage in sales of the target company's stock in order to depress its price and make their offer more appealing. In case the offer involves stock in the bidding company, the bidders may also try to manipulate the stock of their own company, in order to increase the face value of the offer<sup>184</sup>. This is what happened in the *Guinness* scandal which is the best known manipulation case in Britain's recent financial history. Guinness which was engaged in a brutal takeover battle with Argyll for the control of Distillers Inc. attempted to make its offer more attractive to the shareholders of Distillers by engaging in massive purchases of its own stock through its colluding partners. The total Guinness shares purchased during this manipulative operation represented 25 per cent of the company's entire issued share capital<sup>185</sup>.

### **3.2.3.3 Market power manipulations**

Market power manipulations "*involve a party or parties, with a significant influence over the supply, demand or delivery mechanisms for a financial instrument and/or the underlying product of a derivative contract, exploiting a dominant position in order to materially distort the price at which others have to deliver, take delivery or defer delivery of the instrument/product in order to satisfy their obligations*"<sup>186</sup>.

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<sup>182</sup> 938 F.2d 364 United States v. A. Mulheren. See also Fischel & Ross, 1991, pp. 532-534.

<sup>183</sup> See Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 146.

<sup>184</sup> *Ibid.*

<sup>185</sup> Barnes, 2009, p. 150.

<sup>186</sup> See The Committee of European Securities Regulators, 2004, p. 12, where market power manipulations are termed as an "abusive squeeze".

Market power manipulations are more common in (commodity) futures markets, due to the particularities that these markets present in terms of their function and trading rules<sup>187</sup>. Futures are standardised contracts as to the quality and quantity of the underlying commodity, which are often liquidated through offsetting contracts or cash<sup>188</sup>. Nevertheless, each party is required to tender or receive actual delivery if the other party demands it. Near the time when a futures contract expires, the deliverable supply of the underlying commodity is fixed<sup>189</sup>. At the same time, the demand of short traders for the commodity becomes inelastic because they need to fulfil their obligations to the long traders<sup>190</sup>. The inelastic demand is due to the fact that there are no substitutes for the underlying commodity. Short traders must either satisfy their contractual obligations by purchasing the commodity in the spot market and delivering it to the long traders or convince the long traders to agree to a cash settlement (in effect purchasing the commodity from the long traders)<sup>191</sup>. This situation creates opportunities for non-competitive pricing.

The most famous forms of market power manipulation are *squeezes* and *corners*. The two terms are often used interchangeably; however they do not have the same meaning<sup>192</sup>. A *squeeze* usually involves the acquisition of futures contracts in excess of the deliverable supplies<sup>193</sup>. By building up a large futures position, an aspiring manipulator creates artificial demand and can exploit the delivery mechanism of the contracts to dictate settlement prices.<sup>194</sup> The immediate supply shortage of the underlying commodity in the market puts the manipulator in a position to bargain up the price of the offsetting futures contracts which he holds and which the short traders need to cover their positions.

A *corner* has more devastating consequences and more severe and long-lasting price effects than a *squeeze*<sup>195</sup>. In a corner, like in a *squeeze*, the manipulator usually builds up a large position in the futures market thereby creating artificial demand for an asset. However, unlike in the case of a *squeeze*, the manipulator also acquires a large position in the

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<sup>187</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 149.

<sup>188</sup> *Ibid.*

<sup>189</sup> Fischel & Ross, 1991, p. 543.

<sup>190</sup> *Ibid.*

<sup>191</sup> *Ibid.* Alternatively, short traders may cover their position with offsetting long contracts

<sup>192</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 150.

<sup>193</sup> Fischel & Ross, 1991, p. 543.

<sup>194</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 150.

<sup>195</sup> *Ibid.*

cash market for the same asset and *creates* (rather than just take advantage of) an artificial supply shortage by withholding deliverable supply of that asset from the market<sup>196</sup>. Corners have more amplified effects than squeezes because they involve simultaneous manipulations of the futures and the spot markets and they target both the supply and the demand side of an asset. Famous corners include the Sumitomo case (corner of the copper market), the corner of the silver market by the Hunt Brothers and the corner of the US government auctions for two-year treasury bills by Salomon Brothers. The last case is very particular in the sense that it took place in a highly liquid financial securities market and not in a commodity market<sup>197</sup>.

It has to be noted that market power manipulations such as corners and squeezes are difficult to perpetrate because they are very costly, require large capital resources and also bear significant risks for their perpetrators<sup>198</sup>. As in the case of Sumitomo and the Hunt Brothers, they commonly result in the detection and financial devastation of their perpetrators. The main reason for that is the so-called “burying the corpse” effect: in the aftermath of the scheme, the perpetrators need to offload their excess holdings in large blocks, which is not easy in the depressing market that follows the conclusion of the manipulation<sup>199</sup>. Moreover, the size of the positions held by the perpetrators is very difficult to conceal for a long period of time.

A particular form of market power manipulation mentioned in the CESR’s guidance on the EC Market Abuse Directive refers to excessive bid-ask spreads<sup>200</sup>. In a quote-driven market, market makers are the liquidity providers and effectively the sole suppliers of securities. In the absence of competition, there are incentives for them to collude and maintain spreads at artificial levels that do not reflect the actual liquidity in the market or the risks incurred by them as liquidity providers.

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<sup>196</sup> Fischel & Ross, 1991, p. 543.

<sup>197</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 152.

<sup>198</sup> *Ibid.*, p. 153.

<sup>199</sup> *Ibid.*, pp. 153-154.

<sup>200</sup> The Committee of European Securities Regulators, 2004, p. 12. *Contra* Fischel & Ross, 1991, p. 540, who reject the classification of excessive mark-ups as manipulations.

### 3.3 The regulation of market manipulation

#### 3.3.1 The need to prohibit market manipulation

Unlike in the case of insider trading, there are very few who would argue against the prohibition of market manipulation<sup>201</sup>. This is primarily due to the negative effects that market manipulation has, by definition, on the informational efficiency of the market<sup>202</sup>. The very objective of these schemes is to supply the market with misleading information and to create alterations in its price and trade decoding mechanisms. They result in inefficient market prices which do not reflect the real value of the assets concerned. Investors, who use price movements as indicators of future profitability of the assets in the market, may invest in non-profitable assets because of the price distortions resulting from market manipulation<sup>203</sup>.

Consequently, it is not only the informational efficiency of the market that is affected but also its allocative efficiency. The efficient allocation of scarce resources is one of the principal functions of capital markets, which are therefore prevented from fulfilling that function. The impact on the economy of such a situation is grave as it leads to a waste of resources on “bad” issuers whose instruments are overvalued, while at the same time more deserving businesses cannot raise adequate funds to support their operations<sup>204</sup>. When investors perceive this problem of price inefficiency in the market, an adverse selection problem arises, as they are unable to distinguish between “good” and “bad” issuers. This leads to a reduction in liquidity as some investors prefer to exit the market. At the same time, market makers increase bid-ask spreads, in order not to lose out to manipulators, thereby imposing a further strain on liquidity through increased transaction costs<sup>205</sup>.

Moreover, market power manipulations in the futures markets disrupt the two principal functions of these markets, namely investment and hedging activities<sup>206</sup>. Commonly observed side effects of corners and squeezes include dead weight losses due to distortions in the patterns of consumption, transportation and storage of physical commodities<sup>207</sup>. Studies

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<sup>201</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 210.

<sup>202</sup> *Ibid.*, p. 212.

<sup>203</sup> *Ibid.*

<sup>204</sup> *Ibid.*

<sup>205</sup> *Ibid.*, pp. 212-213.

<sup>206</sup> *Ibid.*, p.213.

<sup>207</sup> *Ibid.*

confirm the extensive price distortions that market power manipulations can provoke in the commodity markets and the economic hardship that may follow as a result<sup>208</sup>.

Civil law remedies are not sufficient for deterring market manipulations<sup>209</sup>. The prohibition must be effected through formal regulation and public enforcement measures in order to protect retail investors. The threat of multiple small investors' lawsuits in today's anonymous and globalised financial markets is not a powerful deterrent<sup>210</sup>. The elevated cost associated with such lawsuits, the cross-border nature of some manipulative schemes and the associated jurisdictional constraints, the fragmentation of the financial markets which facilitates the concealment of such schemes, as well as the severe difficulties in proving price artificiality, causation and intent in a civil trial, expose manipulators to a rather limited risk of liability<sup>211</sup>. State regulation and enforcement are preferable for two additional reasons<sup>212</sup>. First, regulators and public enforcers have more means and resources at their disposal in order to detect, investigate, pursue and punish market manipulation<sup>213</sup>. Secondly, public authorities have the ability to coordinate by building international supervisory and enforcement networks to facilitate information exchange, joint investigations and enforcement<sup>214</sup>.

### 3.3.2 The issue of deregulation of trade-based manipulations

As we saw in section 3.2.3.1.1, trade-based manipulations can be distinguished from other forms of manipulations, which are often assimilated to a form of fraud, because they are based on *actual trades*, unsupported by additional elements such as the dissemination of false rumours, artificial transactions or trade subsidisation. Moreover, trade-based manipulations are, in principle, largely self-defeating because they have a negative expected re-

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<sup>208</sup> See Pirrong, 1995, where the author discusses the massive manipulations that took place at the Chicago Board of Trade during the last quarter of the 19<sup>th</sup> century, their severe effects on the prices and the volatility of the commodities concerned, as well as their economic impact. "*Unsurprisingly, these extreme price distortions caused a variety of acute economic dislocations. The documented effects included exceptionally large flows of stocks of grain into Chicago, artificial shortages of rail cars and congestion in Chicago freight yards, flows of grain and provisions from markets that Chicago typically shipped to, the failure of banks that had extended credit to futures traders who were bankrupted in a corner, the idling of grain-carrying lake vessels (because stocks were hoarded in Chicago in anticipation of a squeeze), excessive basis volatility and poor hedging performance, and the temporary idling of processing facilities caused by the high prices. These dislocations engendered considerable public criticism of the Board. This discontent led to the passage of an Illinois statute against manipulation in 1874 and spurred efforts to pass federal laws taxing or outlawing futures trading*" (Pirrong, 1995, pp. 165-169).

<sup>209</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 214.

<sup>210</sup> *Ibid.*

<sup>211</sup> *Ibid.*

<sup>212</sup> *Ibid.*, p.215.

<sup>213</sup> *Ibid.*

<sup>214</sup> *Ibid.*

turn, as they boil down to a “buy high”-“sell low” operation which is the inverse of what is required to make a profit. These observations have led some authors to advocate for the deregulation of trade-based manipulations, regardless of the trader’s intent<sup>215</sup>.

Fischel and Ross argue convincingly that it is very hard to distinguish between manipulative and non-manipulative trades without reference to the trader’s intent, since the two forms have no other observable distinctive features<sup>216</sup>. As a result, the detection, the investigation and the prosecution of trade-based manipulations involve excessive enforcement costs which, given the self-detering nature of trade-based schemes, are not counterbalanced by any concrete benefits<sup>217</sup>. The prohibition of such manipulations also leads to opportunity costs in the form of foregone beneficial trading activity: investors may refrain from trades that could potentially increase the informational efficiency of the market, for fear that they might be characterised as manipulative<sup>218</sup>. Moreover, and as a result of such a restrictive regime, a loss of liquidity in the markets is another likely side effect<sup>219</sup>.

But even when we set economic arguments aside, fairness or morality arguments do not fare any better in defending a prohibition of pure trade-based schemes<sup>220</sup>. These schemes hardly differ in any way from classic forms of speculation<sup>221</sup>, which is an integral element of modern competitive financial markets<sup>222</sup>. In conclusion, the deregulation of such forms of manipulation would likely increase social welfare, rather than harm it, and at the same time would not raise any serious morality or fairness concerns.

However, there are circumstances under which trade-based manipulations stop being harmless and become objectionable both from an economic and from a moral standpoint. Avgouleas<sup>223</sup> identifies three additional elements that warrant a prohibition and severe sanctioning of trade-based manipulations. If any of these three elements are present, the said manipulations are not self-detering and should be contained. The presence of these ele-

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<sup>215</sup>See Fischel & Ross, 1991, where the authors are in favour of deregulating not only trade-based manipulations but also any form of manipulation based on actual trades, including contract-based manipulations and market power manipulations. For a fervid response to their arguments see Thel, 1994.

<sup>216</sup> Fischel & Ross, 1991, p. 533.

<sup>217</sup> *Ibid.*, p. 522.

<sup>218</sup> *Ibid.*, pp. 522-523.

<sup>219</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 225.

<sup>220</sup> *Ibid.*

<sup>221</sup> *Ibid.*, p. 224.

<sup>222</sup> *Ibid.*, p. 226.

<sup>223</sup> *Ibid.*, pp. 136-137, 220-224.

ments also creates the potential of serious price distortions and negative welfare effects and raises grave moral concerns.

The first element refers to the case where an insider is the perpetrator of the trade-based manipulation<sup>224</sup> and/or the manipulation is combined with misinformation and deception of the market. As we have seen, insiders have incentives to create price distortions, possibly by making false or misleading announcements, in order to extract the full value of the information in their possession. If the insider either feeds false information to the market or intentionally alerts the market to the fact that the trades originate from himself as an informed trader, the price level will keep moving in the direction of the false information and the manipulative trades, giving the opportunity to the insider to secretly reverse his position without simultaneously reversing the price trend he created.

The second case where trade-based schemes should be prohibited is when there is an element of trade subsidisation in the scheme, such as the activation of contractual clauses or profits in cross-market positions<sup>225</sup>. If the subsidisation exceeds the costs of the manipulative trades, then these schemes are no longer self-detering. Such subsidisation also facilitates the execution of large trades by the manipulator, the size of which may mislead the market into inferring that these trades originate from an informed trader (possibly an insider). This may result in amplified price distortions as well as herding effects.

Finally, the prohibition of trade-based manipulations is justified in cases where the manipulators have engaged in concealed efforts to control the supply or demand in a particular asset in order to dictate its price<sup>226</sup>. In such cases, where the market is squeezed or cornered, prices will keep rising because the manipulator is the one controlling their level. Additionally, even though we discussed that these schemes are costly and may result in the financial devastation of their perpetrators, they are by no means self-detering, especially since the perpetrators can adopt the right hedging strategies to protect themselves from the price collapse that typically concludes these schemes<sup>227</sup>.

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<sup>224</sup> *Ibid.*, pp. 134, 224.

<sup>225</sup> *Ibid.*, pp. 222-224.

<sup>226</sup> *Ibid.*, pp. 220-222.

<sup>227</sup> *Ibid.*, p. 220.

## 4 The European Union's regulatory framework for market abuse

### 4.1 Background

In view of the European Communities' ambition to create a single market, a common legal and regulatory framework for securities markets was indispensable. Until the mid 1980s the approximation of the national legislation of the member states was only possible through the case law of the European Court of Justice (ECJ)<sup>228</sup>. What is more, the ECJ showed a tendency to uphold restrictive national rules at the expense of the integration of financial markets<sup>229</sup>. In 1985 the Delors Commission published its White Paper on the internal market which was adopted by the Council of Ministers and led to the Single European Act (SEA) of 1986. The White Paper advocated the need for the liberalisation and the integration of the markets through the adoption of a common regulatory framework. Under the framework of the SEA the harmonisation of the prudential regulation of credit and financial institutions was addressed by the Banking Directive, the Investment Services Directive and the Capital Adequacy Directive. The promotion of transparency through disclosure and the prohibition of insider dealing were also addressed by the Insider Dealing Directive, the Public Offer Prospectus Directive and the Major Shareholdings Directive. However, many issues remained unaddressed and as a result the goal of integration remained far from sight.

A Commission Communication on the implementation of the *Financial Services Action Plan* (FSAP) in May 1999 recognised the inefficiency of the existing regime and set the foundations for its reform. In 2000 the Council set up the *Committee of Wise Men* with the mandate to propose a timely and efficient procedure for the implementation of the FSAP. In its report that was delivered in 2001, the Committee proposed a four level approach which became known as the Lamfalussy process, from the name of the chairman of the Committee. At the *first level*, the European Parliament and the Council reach an agreement on the core political principles of each legislation proposal and define the implementing powers in a framework directive or a regulation. At the *second level*, the European Commission may adopt technical implementing measures for the proposed legislation after consulting with the *Committee of European Securities Regulators* (CESR) and obtaining the agreement of the *European Securities Committee* (ESC)<sup>230</sup>. At the *third level*, the CESR

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<sup>228</sup> *Ibid.*, p. 241.

<sup>229</sup> *Ibid.*

<sup>230</sup> Both the CESR (mainly acting in a advisory role) and the ESC (having primarily a regulatory role) are bodies which were conceived by the Lamfalussy report

works on joint interpretation recommendations, consistent guidelines and common standards (in areas not covered by EU legislation), peer review, and compares regulatory practice to ensure consistent implementation and application across the EU. At the *fourth and final level*, the Commission checks Member State compliance with EU legislation and may take legal action against Member States suspected of breach of Community Law. The ECOFIN Council endorsed the final report of the Lamfalussy Committee in March 2001 and the European Parliament adopted a resolution on the 5<sup>th</sup> of February 2002 by which it accepted the new approach.

The EC Market Abuse Directive<sup>231</sup> (MAD) is one of the four *Level 1* Lamfalussy Directives – the other three being the Directive on Markets in Financial Instruments (MiFID), the Prospectus Directive and the Transparency Directive. Therefore, according to the Lamfalussy process, the MAD provides the core principles of the EU's regime against market abuse. It is complemented at the second level by the Directives 2003/124/EC, 2003/125/EC and 2004/72/EC as well as the Regulation 2273/2003 which specify some technical implementation details. At the third level, the CESR has issued three sets of guidance for the Member States. At the fourth level, the Commission supervises compliance by the member states.

The MAD and its implementing measures constitute a set of *rules-based* legislation, meaning that they are very detailed and leave a small margin of interpretation for Member States and the authorities concerned. This is hardly surprising, as the MAD is based on the principle of *maximum harmonisation*<sup>232</sup>. The objective of the Directive is to create harmonised *administrative* regimes across the EU. Article 14 of the Directive provides that “*Without prejudice to the right of Member States to impose criminal sanctions, Member States shall ensure, in conformity with their national law, that the appropriate administrative measures can be taken or administrative sanctions be imposed against the persons responsible (...)*”. Article 11 also provides for the creation of a *single administrative authority* competent to ensure compliance with the Directive in each Member State.

## **4.2 The prohibition of insider dealing**

The prohibition of insider dealing was introduced in EU law in 1989 by the Insider Dealing Directive (Council Directive 89/592/EEC) which was repealed by article 20 of the MAD. The motivation for the prohibition of insider dealing as stated in the recitals of the MAD

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<sup>231</sup> Directive 2003/6/EC of the European Parliament and of the Council

<sup>232</sup> Enriques & Gatti, 2007, p. 17.

has remained essentially unchanged compared to Directive 89/592<sup>233</sup>. Recital 2 indicates that market abuse (meaning insider trading and market manipulation) harms the *integrity* of the financial markets and *public confidence* in those markets, which are prerequisites for economic wealth and growth. Recital 12 mentions that the objective of legislation against insider trading and market manipulation is to ensure the integrity of Community financial markets and to enhance investor confidence in those markets. Recital 15 indicates that both insider trading and market manipulation prevent full and proper market transparency, a prerequisite for trading for all economic actors in integrated financial markets.

The formal prohibition of insider trading is contained in articles 2 to 4 of the MAD. The prohibition covers three types of acts: trading for one's own or a third party's account in financial instruments while in possession of inside information relating to those instruments; disclosing inside information to any other person, unless the disclosure is made in the normal course of professional activities; and recommending or inducing another person to trade in financial instruments on the basis of inside information. We note that neither intent nor the extraction of a financial gain is a necessary element for the prohibition to apply.

According to the MAD, the offence of insider trading can be committed by either primary or secondary insiders, although the Directive does not explicitly use the respective terms. Article 4, perceives as a secondary insider any person who commits the offence of insider trading (by trading, tipping, making an investment recommendation or inducing others to trade in the instruments concerned) while that person knows or ought to have known that he possesses inside information. Therefore, a subjective element becomes important in determining whether secondary insiders are liable for insider trading, unlike in the case of primary insiders. Furthermore, it is interesting that the Directive also considers as an insider anyone who possesses inside information by virtue of his criminal activities. Recitals 14 and 17 make the motivation for this provision very clear. The EU legislator recognised the effect that some criminal activities such as terrorism may potentially have on financial

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<sup>233</sup> The recitals of Council Directive 89/592/EEC stated: “Whereas the smooth operation of that market depends to a large extent on the confidence it inspires in investors; Whereas the factors on which such confidence depends include the assurance afforded to investors that they are placed on an equal footing and that they will be protected against the improper use of inside information; Whereas, by benefiting certain investors as compared with others, insider dealing is likely to undermine that confidence and may therefore prejudice the smooth operation of the market;”

markets and, as expressly stated in recital 14, met the related concerns in the aftermath of the September 11 attacks in the United States<sup>234</sup>.

The definition of *inside information* is central for the application of the prohibition and is provided by article 1. There are four conditions that need to be met for information to qualify as inside information. First, the information needs to be precise. According to the implementing Directive 2003/124/EC, information is precise if it indicates an event (or a set of circumstances) that has already occurred or is reasonably expected to occur and if it is specific enough to enable a conclusion as to the possible effect of that event (or set of circumstances) on the price of a financial instrument. Rumours and speculations are excluded from the definition of inside information<sup>235</sup>. However, a piece of information is not required to be comprehensive to be considered precise. For instance, the expression of interest by a bidding company without mention of a decision on the price, could be considered as precise information<sup>236</sup>. Similarly, information can be considered precise if it refers to matters or events that could be alternatives<sup>237</sup>.

The second condition for the qualification of information as inside information is that it has to be non-public. Information which is made accessible on a commercial basis, for instance through paid subscription, is considered public information<sup>238</sup>. It is also irrelevant whether the information was made public through an incorrect disclosure by the issuer or a third party<sup>239</sup>.

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<sup>234</sup> It should be noted that the SEC and the FBI, aided by other agencies and the securities industry, devoted enormous resources to investigating the issue of insider trading prior to 9/11 and they secured the cooperation of many foreign governments, but found no convincing indications of such trading. According to the SEC press release on 22.07.2004: “On Sept. 12, 2001, the Securities and Exchange Commission began an investigation to determine whether there was evidence that anyone who had advance knowledge of the terrorist attacks on September 11 sought to profit from that knowledge by trading in United States securities markets. In the course of that review, we did not develop any evidence suggesting that anyone who had advance knowledge of the September 11 attacks traded on the basis of that information. In the course of our investigation, we examined more than 9.5 million securities transactions that took place during the weeks preceding September 11. Along with the New York Stock Exchange, NASD, the American Stock Exchange, the Chicago Board Options Exchange, the Pacific Exchange, and the Philadelphia Stock Exchange, we reviewed trading in securities and derivative products of 103 companies in six industry groups with trading in seven markets. We also reviewed trading in 32 exchange traded funds and broad and narrow indices.” (Securities and Exchange Commission Press Release, 2004). See also National Commission on Terrorist Attacks upon the United States, 2004, p. 499.

<sup>235</sup> The Committee of European Securities Regulators, 2007, p. 4.

<sup>236</sup> *Ibid.*, p.5

<sup>237</sup> *Ibid.*

<sup>238</sup> *Ibid.*

<sup>239</sup> *Ibid.*

The third condition is that the information must relate, directly or indirectly, to an issuer or to a financial instrument. The CESR has provided, in its second set of guidance, a “*non-exhaustive and purely indicative*” list of events that may be considered as inside information. However, the CESR cautions that the materiality of the event must be considered for its qualification as inside information. Moreover, recital 16 of the MAD provides a hint of what is viewed as information that *indirectly* relates to an issuer or a financial instrument by pointing to information “*which could have a significant effect on the evolution and forming of the prices of a regulated market*”.

The final condition for information to fall under the definition of article 1 is that the information in question must be price sensitive, namely it must be likely to have a significant effect on the prices of the financial instrument concerned if it were to be made public. According to the implementing Directive 2003/124/EC, this means that the information must be of such a nature that it would be likely to be used by a reasonable investor as part of the basis of his investment decisions. The CESR considers that the decision on the likelihood of a significant price impact should be determined on an *ex ante* basis by those in possession of potential inside information<sup>240</sup>. According to the CESR, it is a question of determining the degree of probability with which at that point in time an effect on prices could reasonably have been anticipated. Although mere possibility is not enough, it is however not necessary that there should be a degree of probability close to certainty<sup>241</sup>. In determining the likelihood of a price impact, the following factors should be taken into account: the relative magnitude of the affair/event in the general context of the issuer’s activities, the relevance of the information with regard to the main determinants of the financial instrument’s price, the reliability of the source and the market variables that affect the price of the said financial instrument<sup>242</sup>.

In relation to commodity derivatives such as futures, inside information means precise, non-public, price sensitive information relating to these instruments which market users would expect to receive in accordance to *accepted market practices* on the markets concerned<sup>243</sup>. Article 4 of the Directive 2003/72/EC specifies that market users are deemed to expect to receive such information either if it is routinely made available to them or if it is required to be disclosed in accordance with legal or regulatory provisions, market rules,

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<sup>240</sup> *Ibid.*, p.6

<sup>241</sup> *Ibid.*

<sup>242</sup> *Ibid.*

<sup>243</sup> Art.1(1)§2 of the MAD.

contracts or customs on the relevant underlying commodity market or commodity derivatives market. As regards persons who execute orders on financial instruments, the Directive extends the meaning of inside information to include precise, non-public, price sensitive information concerning directly or indirectly the said instruments conveyed by a client and related to the client's pending orders<sup>244</sup>. When read in conjecture with recital 19, this provision clearly aims at the prohibition of *front-running*, meaning the practice of executing transactions for one's own or a third party's behalf in advance of large price-sensitive orders received from a client<sup>245</sup>. The CESR has provided detailed guidance on when information relating to a client's pending orders constitutes inside information<sup>246</sup>.

### 4.3 The prohibition of market manipulation

The formal prohibition of market manipulation is contained in article 5 of the MAD and is formulated in one simple sentence: "*Member States shall prohibit any person from engaging in market manipulation*". There is little to be said on that provision except that it is entirely dependent on the definition of market manipulation. That definition is given in Article 1(2) which adopts a three-part approach in outlining the complex notion of market manipulation. The first part offers a core definition, according to which market manipulation means:

*(a) transactions or orders to trade:*

*- which give, or are likely to give, false or misleading signals as to the supply of, demand for or price of financial instruments, or*

*- which secure, by a person, or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level,*

*unless the person who entered into the transactions or issued the orders to trade establishes that his reasons for so doing are legitimate and that these transactions or orders to trade conform to accepted market practices on the regulated market concerned;*

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<sup>244</sup> Art.1(1)§3 of the MAD.

<sup>245</sup> A distinction must be made between the prohibition of front-running as an insider trading offence (art. 1(1)§3 in combination with article 2 of the Market Abuse Directive) and the prohibition of front-running as a violation of client order handling rules (addressed by article 22 of the MiFID).

<sup>246</sup> The Committee of European Securities Regulators, 2007, pp. 11-14.

*(b) transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance;*

*(c) dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading. In respect of journalists when they act in their professional capacity such dissemination of information is to be assessed, without prejudice to Article 11, taking into account the rules governing their profession, unless those persons derive, directly or indirectly, an advantage or profits from the dissemination of the information in question.*

The second part of the definition proposes some instances “*in particular*”, which are “*derived from the core definition*”:

*- conduct by a person, or persons acting in collaboration, to secure a dominant position over the supply of or demand for a financial instrument which has the effect of fixing, directly or indirectly, purchase or sale prices or creating other unfair trading conditions,*

*- the buying or selling of financial instruments at the close of the market with the effect of misleading investors acting on the basis of closing prices,*

*- taking advantage of occasional or regular access to the traditional or electronic media by voicing an opinion about a financial instrument (or indirectly about its issuer) while having previously taken positions on that financial instrument and profiting subsequently from the impact of the opinions voiced on the price of that instrument, without having simultaneously disclosed that conflict of interest to the public in a proper and effective way.*

Finally, the third part of this complex approach serves to “future-proof” the definition of market manipulation. The elusive nature of this crime, as well as the ingenuity and complexity that manipulative schemes tend to present, have led the EU legislator to adopt an open-ended definition by expressly stating that:

*The definitions of market manipulation shall be adapted so as to ensure that new patterns of activity that in practice constitute market manipulation can be included.*

The definition of market manipulation is supplemented by the second level Directive 2003/124/EC which provides non-exhaustive signals that should be taken into account when potential manipulative conduct is examined by the competent authorities. At the third level, the CESR has issued guidance on types of practices that CESR members would consider to constitute market manipulation<sup>247</sup>.

We note that the MAD uses roughly the same classification of types of market manipulation that was used in section 3.2. The first case of article 1(2)(a) refers to artificial transactions or, as the CESR guidance terms them, “*false/misleading transactions*”<sup>248</sup>. The second case of article 1(2)(a) refers to price manipulations or “*price positioning*”<sup>249</sup>. Article 1(2)(b) refers to information-based manipulations or “*transactions involving fictitious devices/deception*”<sup>250</sup>. Finally, article 1(2)(c) refers to a special form of an information-based manipulation which does not require the manipulator to undertake any accompanying transactions. The CESR refers to these manipulations simply as “*dissemination of false and misleading information*”<sup>251</sup>. It should be underlined that the violation of the disclosure obligations set out in article 6 of the MAD may, in some instances, constitute market manipulation in that sense. We examine these disclosure obligations in the section 4.4.

It is hard not to notice that the Directive’s definition of market manipulation, similarly to that of insider trading, is devoid of subjective elements. The intent of the alleged manipulator is neither stated nor implied as a condition for the consummation of the offence. The realisation of a financial gain is also largely immaterial to the Directive’s definition of market manipulation, although it is mentioned – but not necessarily as a *sine qua non* con-

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<sup>247</sup> The Committee of European Securities Regulators, 2004.

<sup>248</sup> *Ibid.*, pp. 9, 11. The CESR guidance classifies the following manipulations as false/misleading transactions: wash trades, painting the tape, improper matched orders and placing orders with no intention of executing them.

<sup>249</sup> *Ibid.* The CESR guidance considers the following manipulations as price positioning: marking the close, colluding in the after-market of an IPO, abusive squeeze, creation of a floor in the price pattern, excessive bid-ask spreads, trading on one market to improperly position the price of a financial instrument on a related market.

<sup>250</sup> *Ibid.*, pp. 9, 12. According to the CESR guidance the following manipulations fall under the class of transactions involving fictitious devices/deception: concealing beneficial ownership in a financial instrument through the violation of disclosure requirements, dissemination of false or misleading information through media/scalping, pump and dump, trash and cash and opening a position and closing it immediately after its disclosure.

<sup>251</sup> *Ibid.*, pp. 9, 13 The following manipulations are considered by the CESR as dissemination of false and misleading information: spreading false/misleading information through the media and other behaviour designed to spread false/misleading information.

dition – in the last of the three instances derived from the core definition. On the other hand, the effect on prices and the (likely or actual) false or misleading signals are the main determinants in the Directive’s definition of market manipulation. Therefore, we can safely conclude that the EU legislator opted for the effects-based approach by establishing an objective effect-based offence, leaving subjective mental elements out of the definition and the prohibition of market manipulation<sup>252</sup>.

However, even though subjective elements such as intent are absent from the definition of market manipulation – with the obvious intention of facilitating prosecution and punishment<sup>253</sup> – the defendants in such cases are not left without protection. Specifically, there are defences against the prosecution of the first two forms of manipulation, namely artificial transactions and price-based manipulations. According to article 2(a), if the person who entered into the transactions or issued the orders establishes that his reasons for doing so are legitimate and that these transactions or orders conform to *accepted market practices* on the regulated market concerned, then the conditions for market manipulation are not fulfilled<sup>254</sup>. This defence is not available for the other two types of market manipulation, for which the EU legislator rules out the existence of legitimate reasons because of the likeness they bear to outright fraud. *Accepted market practices* (AMPs) are defined by article 1(5) of the Directive as practices “*that are reasonably expected in one or more financial markets and are accepted by the competent authority in accordance with guidelines adopted by the Commission (...)*”<sup>255</sup>. The CESR points out that the decision as to whether a process constitutes an AMP is a matter of national discretion<sup>256</sup> and that it is possible for a practice to constitute an AMP according to one competent authority but not viewed as such by another. Each CESR member is required to consult, both nationally and

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<sup>252</sup> See The Committee of European Securities Regulators, 2004, p. 4, where the CESR expressly acknowledges the use of an effects-based definition of market manipulation by the MAD. See also Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 276.

<sup>253</sup> Avgouleas, *The Mechanics and Regulation of Market Abuse: A Legal and Economic Analysis*, 2005, p. 276.

<sup>254</sup> Recital 20 of the Market Abuse Directive qualifies this provision by specifying that “*A sanction could still be imposed if the competent authority established that there was another, illegitimate, reason behind these transactions or orders to trade*”.

<sup>255</sup> Technical issues regarding Accepted Market Practices are contained in the second-level Directive 2004/72/EC as well as in the first set of CESR guidance. See The Committee of European Securities Regulators, 2004.

<sup>256</sup> The Committee of European Securities Regulators, 2004, p. 4.

with other competent authorities and to disclose any market practices that they have accepted. These AMPs are then published on the CESR's website<sup>257</sup>.

Besides the defences provided by accepted market practices, there are other circumstances under which conduct, that could potentially be viewed as market manipulation, is authorised. These circumstances are outlined in recitals 32 and 33 of the MAD and the respective *safe harbours* are provided in articles 7 and 8 of the Directive. According to article 7 “*This Directive shall not apply to transactions carried out in pursuit of monetary, exchange-rate or public debt-management policy by a Member State, by the European System of Central Banks, by a national central bank or by any other officially designated body, or by any person acting on their behalf. Member States may extend this exemption to their federated States or similar local authorities in respect of the management of their public debt*”. Article 8 provides that “*The prohibitions provided for in this Directive shall not apply to trading in own shares in ‘buy-back’ programmes or to the stabilisation of a financial instrument provided such trading is carried out in accordance with implementing measures adopted in accordance with the procedure laid down in Article 17(2)*”<sup>258</sup>. Buy-back activities may be authorised in order to give the issuers the possibility to reduce their capital, to meet obligations arising from debt instruments convertible into equity and to meet obligations arising from the allocation of shares to employees<sup>259</sup>. Stabilisation transactions may be authorised in order to provide support for the price of an offering of securities during a limited time period if they come under selling pressure, thus alleviating sales pressure generated by short term investors and maintaining an orderly market in the relevant securities<sup>260</sup>.

A distinction must be made between accepted market practices and safe harbours. According to the CESR, the intention of the AMP concept is to avoid the penalising of behaviours which would constitute market manipulation under the effects-based definition of article 1(2)(a) of the MAD, as, under certain conditions, such behaviours might be justified<sup>261</sup>. However, it must be emphasised that in the case of AMPs, the conformity of the transaction/order to an AMP and the ability of the person who effected such a transaction or is-

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<sup>257</sup> AMPs have not been published as a static annex so that they can remain contemporaneous. See The Committee of European Securities Regulators, 2004, p. 5.

<sup>258</sup> The technical aspects of buy-back programmes and the stabilisation of financial instruments are addressed by the implementing Commission Regulation (EC) No 2273/2003 as well as the third set of CESR guidance.

<sup>259</sup> See recital 5, Commission Regulation (EC) No 2273/2003, 2003.

<sup>260</sup> See recital 11, Commission Regulation (EC) No 2273/2003, 2003.

<sup>261</sup> The Committee of European Securities Regulators, 2004, p. 4.

sued such an order to establish that he had legitimate motives, are *cumulative conditions* for this defence to be available<sup>262</sup>. On the other hand, in the case of buy-backs and stabilisations, conformity with the formal procedural obligations in the MAD and its implementing measures is a sufficient condition for the permissibility of such transactions and the ability to establish a legitimate motive is not a requirement.

## 4.4 Mandatory disclosure and other obligations

### 4.4.1 Issuers' disclosure obligations

The MAD uses the notion of inside information to serve two separate purposes: the prohibition of insider trading and the imposition of *ad hoc* disclosure obligations on the issuers of financial instruments. These obligations are imposed by article 6 of the Directive. Member States are invited to ensure that issuers inform the public “*as soon as possible*” of inside information that *directly* relates to them<sup>263</sup> and post such information on their Internet sites. The disclosures made under the MAD must also respect the requirements of the Transparency Directive since they fall within its ambit<sup>264</sup>.

A delay in disclosure is admissible, under the issuer's responsibility, only in order to serve its legitimate interests and provided that there is no risk of the public being misled or the information being leaked as a result of the delay<sup>265</sup>. According to the Implementing Directive 2003/124/EC, legitimate interests of the issuer may relate to negotiations in course – the outcome of which could be affected due to the disclosure – or decisions taken and contracts made by the management which need the approval of another body of the issuer in order to be effective<sup>266</sup>.

Selective disclosure (for instance exclusive disclosure to investment analysts) is prohibited<sup>267</sup> and, once the issuer discloses inside information to a third party who does not owe a duty of confidentiality, the issuer must make a simultaneous public disclosure (unless the disclosure to the third party was accidental, in which case public disclosure must be made “promptly” after). Naturally, such a disclosure is legitimate in the first place only if it is made in the course of the third party's professional duties.

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<sup>262</sup> *Ibid.*

<sup>263</sup> The disclosure of information that relates to an issuer *indirectly* (such as a central bank's decision on the interest rates or the coming publication of rating agencies' reports) is not its responsibility. See The Committee of European Securities Regulators, 2007, p. 8.

<sup>264</sup> Article 2(1) (k) of Directive 2004/109/EC of the European Parliament and of the Council, 2004.

<sup>265</sup> Art. 6(2) of the MAD.

<sup>266</sup> Art. 3, Commission Directive 2003/124/EC, 2003.

<sup>267</sup> Art. 6(3)§1 of the MAD.

Issuers are also required to draw up and regularly update an *insider list* of all the persons having access to inside information relating to them and must transmit that list to the competent authority of their home country. Article 5 of the implementing Directive 2004/72/EC provides the minimum content of the insider list, the way it should be updated and maintained and the information duties of the persons on the list.

#### **4.4.2 Other market actors: disclosure and further obligations**

The obligations imposed by the MAD extend beyond the issuers of financial instruments. The management of the issuer and the persons closely associated with the management must disclose to the competent authority their transactions in the issuer's instruments or in derivatives linked to them<sup>268</sup>. Member States must, on their side, ensure that the public has access to information relating to such transactions. The goal of these provisions is to enhance both the transparency and the informational efficiency of the market<sup>269</sup>.

Furthermore, a crucial issue addressed by the MAD is that of the production and dissemination of tainted investment research. Article 6(5) of the Directive invites Member States to put in place appropriate regulation to ensure that persons, who produce or disseminate investment research or investment-related information through distribution channels or directly to the public, present such information in a fair manner and disclose any conflicts of interest. Implementing Directive 2003/125/EC contains detailed measures that the Member States are expected to adopt. These include: measures for the disclosure of the identity of the person who produces the investment recommendation; general standards for the fair presentation of recommendations (separation of facts from non-factual information, reliability of sources, clear designation of forecasts and projections as such and ability to corroborate the recommendation in question); general standards for disclosure of interests and conflicts of interest; additional obligations related to fair presentation and the disclosure of interests and conflicts of interest for persons whose main business activity is the production of recommendations; and measures concerning the dissemination of recommendations produced by third parties.

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<sup>268</sup> Art. 6(4) of the MAD.

<sup>269</sup>This double objective is stated in the recitals of the Market Abuse Directive: "*Greater transparency of transactions conducted by persons discharging managerial responsibilities within issuers and, where applicable, persons closely associated with them, constitutes a preventive measure against market abuse. The publication of those transactions on at least an individual basis can also be a highly valuable source of information to investors*". Recital 26, Directive 2003/6/EC of the European Parliament and of the Council, 2003

We should note that, according to the definition given to the terms “*research or other information recommending or suggesting investment strategy*” by article 1(4) of Directive 2003/125/EC, macro-economic analysis, general market commentary and research concerning broad markets fall outside the scope of the MAD<sup>270</sup>. The same is true of credit rating agencies’ reports<sup>271</sup> and of personal recommendations and individual investment advice<sup>272</sup>. It is also interesting that the Commission adopted a very cautious approach regarding journalists that disseminate investment recommendations and investment-related information. Specifically, the Commission excluded journalists, who are subject to “equivalent appropriate regulation” or self-regulation in the Member States, from the scope of article 6 (5), provided that that regulation achieves similar results. This approach derives from the Commission’s desire to avoid any conflicts with the European Convention on Human Rights and to appear respectful of the Member States’ constitutional rules regarding the freedom of the press<sup>273</sup>.

Finally, the MAD calls on Member States to impose prevention and detection duties on certain market actors. Article 6(6) provides that market operators must adopt structural provisions aimed at preventing and detecting market manipulation practices<sup>274</sup>. Paragraph 9 of the same article introduces the establishment of suspicious transaction reporting (STR) procedures for market abuse. Member States are required to institute an obligation, for any person professionally arranging transactions in financial instruments<sup>275</sup>, to report to the competent authority any reasonable suspicions of market abuse. The technical implementation details of this provision are included in the implementing Directive 2004/72/EC and

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<sup>270</sup> Avgouleas, A Critical Evaluation of the New EC Financial-Market Regulation: Peaks, Troughs, and the Road Ahead, 2005, p. 215.

<sup>271</sup> See recital 10 of Directive 2003/125/EC. It should be noted that on April 23, 2009 the European Parliament and the Council approved the proposed Regulation concerning credit ratings submitted to them by the Commission. See Press Release: Approval of new Regulation will raise standards for the issuance of credit ratings used in the Community, 2009. The proposed regulation is available at: [http://ec.europa.eu/internal\\_market/securities/docs/agencies/proposal\\_en.pdf](http://ec.europa.eu/internal_market/securities/docs/agencies/proposal_en.pdf)

<sup>272</sup> Recital 3 of Directive 2003/125/EC

<sup>273</sup> Recital 11 of Directive 2003/125/EC

<sup>274</sup> Recital 27 of the Market Abuse Directive provides some examples of such structural measures: requirements concerning transparency of transactions concluded; total disclosure of price-regularisation agreements; a fair system of order pairing; introduction of an effective atypical-order detection scheme; sufficiently robust financial instrument reference price-fixing schemes and clarity of rules on the suspension of transactions.

<sup>275</sup> According to the definition of article 1 paragraph 3 of implementing Directive 2004/72/EC, such persons are investment firms or credit institutions, in the sense of the Investment Services Directive (Directive 93/22/EEC).

sufficient guidelines are provided to the Member States by the CESR in its first and third sets of guidance<sup>276</sup>.

#### **4.5 Evaluation of the EU approach**

It is widely acknowledged that there is strong support across the EU markets for the Market Abuse regime, as well as for the larger context of the Financial Services Action Plan and the Lamfalussy process<sup>277</sup>. There is also widespread consensus that the new regime has achieved many of its objectives and represents an important achievement on the road to a further integration of the EU financial markets<sup>278</sup>. However, the cross-national transposition of the Directive and its implementing measures has put the new regime to the test and has revealed certain flaws and inconsistencies. These are outlined in a report issued by the *European Securities Markets Expert Group (ESME)* in 2007. Several of the flaws relate to harmonisation issues created by the wording of the MAD or the inadequate treatment in the level 2 and 3 technical implementation and guidance.

Such issues include:

- The preponderant use of second level directives instead of regulations, which lead to a less harmonised regulatory framework across the EU, notwithstanding the increased level of detail of the Directives;
- The legal uncertainty and the divergent implementation across the EU regarding scope of the insider trading prohibition. Specifically, some countries like Spain have interpreted article 2(1) to prohibit trading *while in possession* of inside information whereas others have interpreted the same article as prohibiting trading *on the basis of* inside information;
- The lack of legal certainty regarding the disclosure obligations of issuers when they are faced with market rumours and whether they have an obligation to respond to such rumours in order not to mislead the public;
- The administrative burden and high compliance costs of keeping lists of insiders, (especially for large companies) in view of their limited benefit for the authorities and other issues such as the tendency of companies to over-comply by drawing up

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<sup>276</sup>See The Committee of European Securities Regulators, 2004, pp. 14-18 and The Committee of European Securities Regulators, 2009, pp. 7-10.

<sup>277</sup> Inter-institutional Monitoring Group, 2006, p. 5; European Commission, 2009, p. 3.

<sup>278</sup>See European Securities Markets Expert Group (ESME), 2007, p. 3.

excessively long and ultimately useless lists. The ESME has called for more precise level 2 and level 3 measures;

- The low reporting threshold for managerial transactions (EUR 5'000), which, due to its trivialness, does not seem to serve the market signalling function it was intended to serve;
- The narrow set of legitimate purposes recognised for buy-back programs and the lack of common technical standards for stabilisations and accepted market practices;
- The definition of *inside information* with respect to commodity derivatives which does not appear to be aligned with the underlying market reality and which the ESME recommends to make more precise and similar to the general definition used for the other financial instruments;
- The restrictive conditions for legally delaying the disclosure of inside information, namely the prerequisite that the “*omission would not be likely to mislead the public*” (article 6(2) of the MAD). According to the ESME, the definition of inside information *per se* implies that a reasonable investor would use it as a basis for his decisions: thus any delay in the dissemination is almost by definition misleading<sup>279</sup>.

Most of these issues are beyond the scope of this paper and some will likely be addressed in the forthcoming revision of the MAD, as indicated in the Commission’s relevant call for evidence<sup>280</sup>.

Nevertheless, it is worth examining a structural flaw of the MAD that seems to have created severe difficulties in its implementation. This relates to the issue of the *two-fold notion* of inside information, namely of its application on both the prohibition of insider trading and the duty of disclosure by the issuer. Although it is recognised that the definition works well as a test concerning when a person in possession of such information should refrain from trading, it is also acknowledged that it fares rather poorly when used to determine when an issuer has an obligation to make information public<sup>281</sup>. Specifically, in order for information to be considered as “inside information” and to fall under the obligation to

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<sup>279</sup> *Ibid.*, p. 8.

<sup>280</sup> European Commission, 2009.

<sup>281</sup> European Securities Markets Expert Group (ESME), 2007, p. 5.

disclose, it would be reasonable to require a higher level of “*precision*” – in the sense of article 1(1) of the MAD – than when considering whether a piece of information is “inside information” for insider trading purposes. In certain jurisdictions this is the actual practice and there is an implicit distinction between what is precise for an insider and what is precise for the market as a whole.

The ESME cautions that if the single definition of inside information were strictly applied – and given the restrictive conditions for delaying disclosure – “*no listed company may keep any information confidential; no company would choose to be listed any more*”<sup>282</sup>. Moreover, it identifies an active risk of market manipulation and insider trading emanating directly from the adoption of a single definition. It warns that, “*whenever an issuer discloses inside information at an early stage in order to comply with the MAD, it bears the risk of creating false market expectations and even manipulation in case the inside information does not develop in a real event*”<sup>283</sup>.

The confusion is aggravated by the fact that article 2 of the implementing Directive 2003/124/EC seems to recognise a distinction between the two definitions of inside information, as it provides that “*Member States shall ensure that issuers are deemed to have complied with the first subparagraph of Article 6(1) of Directive 2003/6/EC where, upon the coming into existence of a set of circumstances or the occurrence of an event, albeit not yet formalised, the issuers have promptly informed the public thereof*”. According to the ESME, this rule has been used by some Member States to limit the duty of disclosure only to events that have reached a high level of precision<sup>284</sup>.

Oddly enough and contrary to the CESR’s predictions that this issue would be addressed by the European Commission as part of its review of the operation of the Market Abuse provisions<sup>285</sup>, the Commission discounted the issue in its recent “call for evidence”<sup>286</sup>, disregarding the concerns of a large number of market participants. And although this document “*does not officially represent or pre-judge any future formal proposals of the Commission*”, it is surprising that the Commission adopted such an inflexible approach. According to its argumentation: “*At this stage, changes in the definition of inside information for disclosure purposes would not seem to be justified. The general obligation for issuers*

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<sup>282</sup> *Ibid.*, p.6.

<sup>283</sup> *Ibid.*, p.5.

<sup>284</sup> *Ibid.*, p. 7.

<sup>285</sup> The Committee of European Securities Regulators, 2009, p.14.

<sup>286</sup> European Commission, 2009.

*to disclose inside information, even if based on a somewhat broad definition of inside information, has some important advantages. Firstly, it offers a strong incentive for improving public availability of information regarding the issuers and their financial instruments. It thus supports investors' confidence and is beneficial to the liquidity and efficiency of financial markets. Secondly, it is also an effective means to reduce the possibilities of insider dealing*". This conscious decision by the Commission to support the preservation of legal uncertainty is regrettable. However, the Commission does seem to consider the "second best solution" to the single definition problem proposed by ESME, namely to relax the conditions for the authorised delay of disclosure. This would significantly reduce compliance costs for issuers, without however removing uncertainty regarding the definition of inside information for disclosure purposes.

## **5 The Swiss regime on market abuse**

Unlike the EU regime which is essentially an administrative framework that must be implemented by each Member State, the Swiss regime on market abuse is a national system and is composed of both criminal and administrative provisions. We examine each set of rules separately.

### **5.1 Criminal provisions**

#### **5.1.1 The prohibition of insider dealing**

On the front of criminal enforcement against insider dealing, the Swiss regime has a rather poor record. The prohibition of insider dealing was introduced in the Swiss Penal Code on the 1<sup>st</sup> of July 1988 after considerable pressure from the US authorities, which sought to obtain Switzerland's cooperation in pursuing the offence offshore<sup>287</sup>. Since then the number of criminal prosecutions of insider trading in Switzerland has been embarrassingly low and a consensus was formed over the years concerning the necessity of a legislative reform.

The prohibition contained in article 161 of the Swiss Penal Code refers to both primary and secondary insiders. Primary insiders are exhaustively enumerated in the first paragraph of the said article and include the Board of Directors of the issuer, the management, the auditors, the agents of the issuer itself, its parent company or its subsidiaries, as well as mem-

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<sup>287</sup> According to the principle of "double incrimination", before the introduction of the insider trading offence in the Swiss penal system, the Swiss authorities could not grant mutual assistance to foreign authorities for such offences.

bers of public authorities, public servants and the auxiliary persons thereof. It is prohibited for primary insiders to obtain, for themselves or third parties, a financial advantage by exploiting confidential information, the dissemination of which would predictably have a significant impact on the prices of the stock or other securities of the issuer, or derivatives thereon, which are listed or pre-listed on a Swiss exchange. It is also prohibited for them to divulge such information to third parties, although – according to the prevailing view – the act of providing investment recommendations based on confidential information when the recipient of the recommendation cannot distinguish that the recommendation is based on such information, is not prohibited<sup>288</sup>. The penalty provided for primary insiders is imprisonment or a fine.

Parties which have received confidential information by primary insiders, directly or indirectly, qualify as secondary insiders and, according to the second paragraph of article 161, the prohibition of obtaining a financial advantage for themselves or for others by exploiting such information extends to them. However, the penalty for secondary insiders is limited to imprisonment of a maximum of one year or a fine. The fourth paragraph of article 161 specifies that, in the case of grouping of two corporations, the prohibition of insider trading applies to insiders and tippees from both companies. The fifth paragraph serves to extend the scope of the article – its formulation being primarily adapted to the legal form of corporations – to cooperatives and foreign companies.

The third paragraph of article 161 of the Penal Code was repealed in October 2008. Until its repeal this paragraph had been held accountable for much of the failure of the Swiss legal framework to repress insider trading. It provided that the confidential information which fell under the prohibition of article 161 pertained only to certain facts, namely the imminent issue of new equity rights, the grouping of companies “*or any other similar event of comparable significance*”. This provision restricted unjustifiably the scope of the price-sensitive events falling under the definition of confidential information. According to the Swiss Federal Court the formulation “*or any other event of comparable significance*” refers to both qualitative and quantitative criteria<sup>289</sup>. In that sense, for the application of article 161 to confidential information relating to “other events”, a potential price impact comparable to that of an announcement of an issue of new shares or the grouping of com-

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<sup>288</sup> Thévenoz & Bovet, L'approche de la CFB dans son 2e projet "Règles de conduite sur le marché", 2008, p. 120.

<sup>289</sup> ATF 2A.567-2001; ATF 1A.325/2000; ATF 118 Ib 547.

panies was not a sufficient condition. For article 161 to apply, it was also required that the “other event” in question was also of the same *nature* as the two other types of operations. Effectively, this restricted the scope of article 161 to operations in capital markets as well as merger and acquisitions<sup>290</sup>. Accordingly, until the repeal of the third paragraph of article 161 in 2008, the exploitation of information related to the financial results (such as imminent profit warnings) or the business operations (such as an R&D breakthrough or failure) of an issuer of financial instruments was not a prosecutable offence<sup>291</sup>. The only exception reserved by the Federal Court to this rule concerned information related to massive losses which could require the financial reconstruction of the issuer<sup>292</sup>. The Federal Court did in fact express the view that the restrictive scope of article 161 did not allow for the satisfactory protection of the lawful interests defended by the prohibition (mainly the interests of investors) but, bound by the letter of the law, refused to provide a jurisprudential solution where the legislator failed to provide a legislative one<sup>293</sup>.

The repeal of the third paragraph of article 161 has significantly broadened the definition of the term “fact”. According to the related Message of the Federal Council<sup>294</sup>, the revised regime allows the inclusion of events such as profit warnings as well as any other event the publication of which would likely have a significant price impact on the securities concerned. Regarding the definition of events which would likely have a significant price impact, the Federal Council refers to the practice of the SIX Swiss Exchange (formerly SWX Swiss Exchange) on the interpretation of the rule on *ad hoc* disclosure (article 72 of the Listing Regulation). The SIX interpretation of price sensitive information is quite large as it includes changes in the composition of the Board of Directors or the management, as well as important modifications related to the company’s operations<sup>295</sup>. The transfusion of the notion of price sensitive information from the context of *ad hoc* disclosure to the context of insider trading seems familiar. The creeping influence of the MAD and its dual-fold notion of inside information is evident. However, as long as the legislator does not attempt to force a unique definition of price sensitive information on both *ad hoc* disclosures and insider trading, the related dysfunctions of the EU regime should not arise.

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<sup>290</sup> Iffland J. , *Abus de Marché*, 2005, p. 52.

<sup>291</sup> *Ibid.*, pp. 52-53.

<sup>292</sup> ATF 1A.325/2000; ATF 118 Ib 547.

<sup>293</sup> ATF 1A.325/2000. See also (Iffland J. , 2004, p. 313).

<sup>294</sup> FF 2007 418-419.

<sup>295</sup> Bovet & Gomez Richa, 2009, p. 217.

Even after the reform of article 161, Swiss criminal law appears relatively restrictive in its prohibition of insider trading and it stops short of the current global trend of criminalising abuse of confidential price sensitive information, irrespective of the capacity of the perpetrators. In that sense, *accidental insiders*, meaning persons who received inside information by chance or who infer such information from innocent communications or simple allusions, are not subject to the prohibition of article 161<sup>296</sup>. It is also unclear to what extent the criminal liability of secondary insiders should be regarded as derivative to that of primary insiders and whether the liability of the primary insider who communicated the confidential information to the secondary insider is a necessary condition for the liability of the latter. The case law on this matter is contradictory, with two conflicting decisions from the Federal Court rendered in less than a year apart. According to the Court's decision in the *Société Générale* case in 1992, the incrimination of the tippee does not require that of the primary insider who informed him<sup>297</sup>. In the case of *Credit Suisse* the Federal Court alluded to a diametrically opposed conclusion<sup>298</sup>.

These contradictory interpretations have been attributed by certain authors to the unclear objectives pursued by article 161 in terms of the legal assets that it is meant to protect<sup>299</sup>. The Message of the Federal Council concerning the introduction of article 161 proclaims that the said article serves the double objective of protecting the issuers against the misappropriation of their information as well as ensuring the integrity of the market and the equality amongst investors<sup>300</sup>. However, this double objective has created interpretation problems. Such is the case of article 161 par. 2 where questions regarding extent of the criminal liability of secondary insiders and the dependence of such liability on the liability of primary insiders would be answered differently depending on which objective is granted priority. If the protection of the issuer is deemed as the predominant objective, then the criminal liability of tippees can only be derivative to that of the primary insiders and it would be absurd to punish a tippee irrespective of liability of the primary insider. If however we acknowledge that the legal asset protected by article 161 is primarily market integ-

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<sup>296</sup> ATF 119 38.

<sup>297</sup> *“Les biens juridiquement protégés par l'art. 161 CP sont non seulement les obligations de fidélité et de loyauté des initiés envers la société, mais aussi l'intégrité du marché boursier, et partant l'égalité des chances entre tous les investisseurs (FF 1985 II p. 86). Dès lors, les "tippees" sont punissables, quand bien même l'initié ne le serait pas, pour n'avoir pas, en divulguant l'information, violé un devoir de discrétion à l'égard de la société.”* ATF 118 Ib 448.

<sup>298</sup> See Iffland J. , 2004, p. 316; Iffland J. , *Abus de Marché*, 2005, p. 53.

<sup>299</sup> Iffland J. , 2004, p. 315; Iffland J. , *Abus de Marché*, 2005, p. 53.

<sup>300</sup> FF 185 II pp. 75-76, 86.

rity and the equality of investors, then the criminal liability of the tippees can be separate and independent to that of the insider<sup>301</sup>.

The origin of this confusion is the fact the Swiss legislator attempted to import the theoretical foundations of the US insider dealing regulation<sup>302</sup>. However, the particularity of the US system is that it was not built on a specific rule that prohibits insider dealing but it has evolved through the practice and the case law that developed around section 10(b) of the SEA 1934, which contains nothing more than a general provision against securities fraud. The Swiss legislator attempted to transpose certain elements of this – far from ideal – system into Swiss law, depriving some of them of their theoretical foundation and justification in the process. For instance, in US practice the criminal liability of insiders is subject to the existence of a *fiduciary duty* of the insider towards his *counterparty*. In the Message of the Federal Council concerning the introduction of article 161, this fiduciary duty towards other investors was transformed to a *duty of loyalty* towards the *issuer*, losing all of its meaning and further clouding its already questionable theoretical foundation<sup>303</sup>.

### 5.1.2 The prohibition of market manipulation

The prohibition of market manipulation was introduced in Swiss criminal law in 1997 by article 161bis of the Penal Code. The said article prohibits schemes to significantly influence the price of securities traded in a Swiss exchange and thereby obtain for oneself or for third parties an unlawful enrichment, either by disseminating misleading information in bad faith or by effecting purchases or sales of securities which are directly or indirectly attributed to the same persons or colluding persons. The penalty provided for such acts is imprisonment or a fine, as in the case of insider trading by primary insiders.

The restrictive formulation of article 161bis makes it clear that only certain artificial transactions – in the form of wash trades and matched orders, but not in the form of “spoofing” which involves the simple registration of orders – and information-based manipulations fall within the prohibition. Price manipulations based on actual transactions, where the manipulator is not present on both sides of the transaction and therefore assumes a certain risk are not covered by article 161bis<sup>304</sup>. That includes contract-based manipulations and market power manipulations like corners and squeezes<sup>305</sup> which, as we saw earlier, are not

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<sup>301</sup> Iffland J. , 2004, pp. 315-316; Iffland J. , Abus de Marché, 2005, p. 53.

<sup>302</sup> Iffland J. , 2004, pp. 317-319.

<sup>303</sup> *Ibid.*, p. 319.

<sup>304</sup> Iffland J. , Abus de Marché, 2005, p. 54.

<sup>305</sup> *Ibid.*

self-deterring and can have devastating consequences on the market. The original draft of article 161bis prohibited manipulative transactions in general and did not make a distinction between actual and artificial transactions. However, the Swiss legislator ultimately opted to exclude transactions effected with third parties acting in good faith from the scope of the prohibition, for fear of inhibiting the execution of legitimate transactions<sup>306</sup>. On an international level this situation is quite unique and deprives article 161bis of a large part of its practical significance<sup>307</sup>.

It must be noted that before the introduction of article 161bis, the Federal Court had already adopted a wider definition of market manipulation. In the case of “Fondation F.” of the 27<sup>th</sup> of September 1996<sup>308</sup> – and while article 161bis had been approved by the Federal Assembly and its introduction was pending – the Court seemed to adopt the view that transactions executed with the purpose of influencing the price of a security are manipulative and constitute fraud, irrespective to whether they are artificial or not<sup>309</sup>. According to its reasoning, the public may in good faith believe that the price of a security represents real demand and supply and that the transactions on that security are real and founded on a reasonable economic justification. Such a rationale inevitably leads to the admission of the fraudulent character of transactions – even real transactions with third parties acting in good faith – which are effected with a view to influence the price of the security concerned<sup>310</sup>. It also implies that a person, who concludes a transaction at a price different to the one that he would have been willing to accept had he not intended to influence the market price, gives a misleading indication of the real value which he attributes to the security concerned<sup>311</sup>. By acknowledging that the fraud relates to the *motive* of the person concluding the manipulative transaction and not to the *existence* of the transaction, the Federal Court removed the significance of the distinction between artificial and real transactions<sup>312</sup>.

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<sup>306</sup> Iffland J. , Note concernant l'arrêt Fondation F. rendu le 27 septembre 1996 par la Ière Cour de droit public du Tribunal fédéral, 1997, pp. 121-122.

<sup>307</sup> Iffland J. , Abus de Marché, 2005, p. 54.

<sup>308</sup> ATF 122 II 422.

<sup>309</sup> Iffland J. , La notion de manipulation de cours illicite après l'arrêt Fondation F. et l'entrée en vigueur de l'art. 161 bis CP, 1997, p. 75.

<sup>310</sup> Iffland J. , Note concernant l'arrêt Fondation F. rendu le 27 septembre 1996 par la Ière Cour de droit public du Tribunal fédéral, 1997, p. 122.

<sup>311</sup> *Ibid.*

<sup>312</sup> *Ibid.*

Moreover, the Court has expressly rejected the view conveyed by the Federal Council in its Message concerning article 161bis<sup>313</sup>, that article 146 of the Penal Code on fraud does not apply in the case of market manipulation<sup>314</sup>. Accordingly, the Court decided that the acts of market manipulation persecuted by the French authorities in the case of “Fondation F.” constituted either fraud (article 146 of the Swiss Penal Code) or at least a malicious attack on the financial interests of another party (article 151 of the Swiss Penal Code), were punishable under Swiss criminal law and therefore justified the mutual assistance to the French authorities in compliance with the double incrimination principle. As a result, and taking into account the Federal Court’s wide definition of market manipulation, the Court appears to acknowledge that market manipulations based on “real” transactions, which are excluded from the scope of article 161bis, may nonetheless be punishable as fraud (article 146) or at least as a malicious attack on the financial interests of another party (article 151). The resulting situation seems paradoxical, since it appears that general provisions such as articles 146 and 151 of the Swiss Penal Code prohibit forms of market manipulation that the special provision on market manipulation deliberately excludes from its scope<sup>315</sup>. However, a plausible explanation could be that article 161bis and articles 146 and 151 pursue different objectives<sup>316</sup>. Article 161bis is concerned with the protection of market integrity, whereas articles 146 and 151 protect the private interests of investors<sup>317</sup>. Therefore, for market manipulations that fall within the scope of article 161bis, articles 146 and 151 of the Penal Code apply in perfect concurrence with article 161bis, whereas manipulations beyond the scope of article 161bis may still be punished under articles 146 and 151<sup>318</sup>. However, it has to be borne in mind that the case law established by “Fondation F.” is anterior to the introduction of article 161bis and the principles adopted therein have yet to be confirmed by the Federal Court in a subsequent decision<sup>319</sup>.

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<sup>313</sup> FF 1993 I 1327-1328.

<sup>314</sup> According to the Federal Council article 146 does not apply to market manipulations because there is neither a direct link between the manipulator and its victims nor clear correspondence between the manipulator’s enrichment and the damage suffered by his victims.

<sup>315</sup> Iffland J. , *Abus de Marché*, 2005, p. 54.

<sup>316</sup> *Ibid.*, pp. 54-55.

<sup>317</sup> *Ibid.*

<sup>318</sup> Iffland J. , Note concernant l’arrêt Fondation F. rendu le 27 septembre 1996 par la Ière Cour de droit public du Tribunal fédéral, 1997, p. 123.

<sup>319</sup> Iffland J. , *Abus de Marché*, 2005, p. 55.

## 5.2 Administrative provisions

### 5.2.1 Background

In principle, criminal law by itself does not allow for the efficient repression of financial crimes<sup>320</sup>. It is for that reason that the MAD provides in article 14 that Member States must introduce administrative measures and sanctions in addition to the criminal sanctions they have in place against market abuse. In Switzerland the administrative framework against market abuse has evolved primarily through the law and practice of banking supervision and the efforts of the Swiss Federal Banking Commission (SFBC), which was replaced by the FINMA as of the 1<sup>st</sup> of January 2009.

The landmark in this evolution was the *Biber* case<sup>321</sup> where the Federal Court endorsed the administrative practice of the SFBC. In 1994 Biber Holding AG had encountered liquidity problems and a consortium of banks had come to the rescue, among which was Credit Suisse. Credit Suisse acquired 1.7 million Biber shares from this operation, which it initially attributed to its “Multinational Division Schweiz”, and was represented in the Board of Directors of the said company. In 1995 Biber run into financial difficulties once more and the consortium launched a new restructuring plan called Omega. Biber’s Board was informed of the situation during its meeting on the 4<sup>th</sup> of December 1995. The next day, a management commission of Credit Suisse transferred the bank’s holdings in the company to its Trading division. The representative of Credit Suisse on the Board of Biber informed the head of the Trading division of the meeting of the Board of December the 4th. The head of Trading was instructed not to liquidate the Bank’s holdings in Biber before the publication of the consolidated accounts of the group, which took place on the 20<sup>th</sup> of February 1996 and revealed a total loss of CHF 320 million. After the related press conference, Credit Suisse started liquidating its position. The price of the Biber share did not drop dramatically because the public believed that the consortium would take further restructuring measures, something that Credit Suisse knew was not going to happen. In fact the Omega plan never materialised and Biber was declared bankrupt on the 21<sup>st</sup> of January 1997. The SFBC ruled against Credit Suisse declaring that the sale of the Biber shares which it knew were overvalued violated the requirement of the *assurance of irreproachable conduct*, a central concept of supervisory banking law embodied in articles 3 paragraph 2 lit. c of the Banking Act and 10 paragraph 2 lit. d of the *Stock Exchanges and Se-*

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<sup>320</sup> *Ibid.*, p. 70.

<sup>321</sup> ATF 2A.230/1999. See also Iffland J. , *Abus de Marché*, 2005, pp. 55-56 and Thévenoz & Bovet, *L’approche de la Commission fédérale des banques dans sa pratique* , 2008, pp. 95-98.

*curities Trading Act (SESTA)*. In its decision of the 2<sup>nd</sup> of February 2000, the Federal Court rejected the appeal filed by Credit Suisse and confirmed the ruling of the SFBC, acknowledging that the assurance of irreproachable conduct extends beyond the prohibition of exploiting price sensitive confidential information in the sense of article 161 of the Penal Code.

Certainly the significance of the Biber decision lies in the possibility that it provided to the SFBC to forbid conduct that fell outside the scope of the criminal provisions of 161 and 161bis of the Penal Code. However, it also lies in the fact that, with regard to market abuse, this decision broadened the obligations of banks and securities dealers to include the protection of the interests of their *counterparties* not just those of their *clients*<sup>322</sup>. Normally, in the system of the SESTA the only obligations of securities dealers are towards their clients. Therefore, the Biber case marked the transition from a rationale of protection of the client to the rationale of protection of the market<sup>323</sup>. The reference that the decision made to the interests of third parties opened a new dimension in the supervisory activities of the SFBC and served as a foundation for the regulation against market abuse<sup>324</sup>. The practice that the SFBC developed based on the Biber decision has been relatively rich<sup>325</sup>. The SFBC's approach consisted of generating rules and prohibitions for the protection of the market, as well as establishing minimum organisational obligations for its supervisees, based on the requirement of the assurance of irreproachable conduct. The SFBC also used article 11 of the SESTA<sup>326</sup> to generate rules and prohibitions for the protection of the supervisees' clients<sup>327</sup>.

However, the supervisory authority of the FINMA is limited, as in the case of its predecessor the SFBC, to the market actors under its supervision. In the SESTA system such actors

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<sup>322</sup> Iffland J. , *Abus de Marché*, 2005, p. 56.

<sup>323</sup> *Ibid.*

<sup>324</sup> *Ibid.*

<sup>325</sup> *Ibid.*

<sup>326</sup> Article 11 of the SESTA provides:

1. *A securities dealer has vis à vis his clients :*

a. *a duty of disclosure; he shall in particular inform them of the risks associated with certain types of transactions;*

b. *a duty of diligence; he shall in particular ensure the best possible execution of his clients' orders and that they are able to retrace the steps taken in the execution of their orders;*

c. *a duty of loyalty; he shall ensure that in the event of any potential conflict of interests his clients interests are not adversely affected.*

2. *In discharging these duties the clients' business expertise and professional knowledge shall be taken into account.*

<sup>327</sup> Thévenoz & Bovet, *L'approche de la Commission fédérale des banques dans sa pratique* , 2008, p. 95. For a detailed account of the SFBC's practice see *Ibid.*, pp. 95-117

are the exchanges as well as their participants, who need to have a securities dealer licence and are by that fact subject to the FINMA's supervision. On the other hand, in principle, investors only have a legal relationship with their broker and are not affiliated to the exchange through which they transact<sup>328</sup>. Unless they are entities already supervised by the FINMA in their capacity as banks or securities dealers for instance, they are not subject to the FINMA's supervision. The same is true for listed companies, which have a legal relationship with the exchange where their instruments are traded and which may have disciplinary powers on them according to the listing regulations, but they are not necessarily supervised by the FINMA<sup>329</sup>. According to article 6 of the SESTA "*The stock exchange shall supervise price formation, execution and settlement of transactions in such a manner so as to ensure that insider trading, price manipulation and other breaches of law may be detected. Whenever there is a suspicion of any breach of law or exchange regulations or any other irregularities, the stock exchange shall inform FINMA. FINMA shall order the necessary investigations.*" Therefore, the FINMA has no real direct means of intervention against persons who are not subject to its supervision. This situation created inequality of treatment between supervised and unsupervised entities with regard to the suppression of market abuse acts<sup>330</sup>. What is more, before the introduction of the FINMA Act, the means at the SFBC's disposal were very limited (and remain relatively limited even after the introduction of the FINMA Act). In case of violations, the SFBC could either reprimand its supervisees and give them instructions to adopt proper business conduct in the future or withdraw their licence, which was only an *ultima ratio*<sup>331</sup> and therefore an "empty threat" in any case other than a severe violation.

Frustrated by its inadequate means the SFBC pushed for regulations and reforms to extend its powers. This was materialised in the SFBC's report concerning sanctions, delivered to the Zimmerli Commission in April 2003, which in 2001 was given the mandate to prepare proposals for the reform of the supervision of the financial markets, namely the establishment of the FINMA. In the said report the SFBC adopted a wide and unconvincing interpretation of the existing legal framework regarding its role in the supervision of financial markets and proposed to broaden its powers in the domain of market abuse by extending its jurisdiction over the entirety of market actors including investors and listed compa-

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<sup>328</sup> Iffland J. , Abus de Marché, 2005, p. 60.

<sup>329</sup> *Ibid.*

<sup>330</sup> Thévenoz & Bovet, L'approche de la Commission fédérale des banques dans sa pratique , 2008, p. 98.

<sup>331</sup> Weber & Darbellay, 2008, p. 301.

nies<sup>332</sup>. The SFBC also sought to be granted new enforcement means, namely the ability to impose financial sanctions, to prohibit perpetrators from working in supervised entities and to confiscate the illegal gains. The SFBC was effectively proposing its own transformation from a supervisory authority of financial intermediaries to a supervisory authority of the financial markets<sup>333</sup>. In 2004 the Zimmerli Commission published its report concerning sanctions in the supervision of financial markets in which it did not retain the SFBC's proposals regarding financial sanctions. Instead it proposed a generalisation of declarative decisions in case of violations and other measures such as confiscation, exclusion of the perpetrators from being engaged in a supervised entity, as well as the publication of the new authority's (the FINMA) decisions. These measures have been incorporated in the FINMA Act.

In December 2003 the SFBC released a draft circular on market abuse. The aim of the Circular was to provide guidance on the SFBC's practice on this matter. The text endorsed the principles of the Biber case and outlined the circumstances under which a violation of the assurance of irreproachable conduct would be retained. It also prescribed a set of organisational measures that the supervised entities were expected to have in place. This Circular received fervent opposition during the consultation process and was ultimately withdrawn. The main criticism lay in the fact that the Circular was deemed as an attempt to over-regulate, which went beyond the regulatory requirements adopted abroad, bore unsettling similarities to criminal law instead of respecting the Swiss tradition of self-regulation and, if adopted, would compromise the competitiveness of the Swiss markets<sup>334</sup>. Moreover, the circular contained a catch-all category of market abuse under the label "*other market misconduct*" which some market participants viewed as likely to create legal uncertainty<sup>335</sup>. Finally, some points in the draft circular suffered from a vague formulation that had no place in a circular that was supposed to be *specifying* administrative practice<sup>336</sup>. Some authors consider that, behind the criticism lay scepticism against the SFBC which had exhibited a propensity to interpret the existing legal framework in favour of its own powers and possibly at the expense of the principle of legality<sup>337</sup>. Its perceived attempt to pass detailed

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<sup>332</sup> Iffland J. , *Abus de Marché*, 2005, pp. 61-62.

<sup>333</sup> *Ibid.*, p.62.

<sup>334</sup> *Ibid.*, p.65 ; Weber & Darbellay, 2008, p. 303; Commission Fédérale des Banques, 2004, p. 79.

<sup>335</sup> Weber & Darbellay, 2008, p. 303.

<sup>336</sup> Iffland J. , *Abus de Marché*, 2005, p. 68.

<sup>337</sup> *Ibid.*, p.69.

regulation by means of a Circular and without coordinating with the ongoing legislative works was not viewed favourably by market participants<sup>338</sup>.

### **5.2.2 The FINMA Circular 08/38**

In 2005, after an exchange with the concerned financial circles, the SFBC resumed the project of the circular on market abuse. In November 2007 it launched a consultation process on its new draft circular, which resulted in widespread acceptance among market participants<sup>339</sup> who appreciated the shortened length of the new draft, the establishment of material criteria for the identification of practices constitutive of market abuse and the introduction of accepted market practices. The SFBC Circular 08/1 of the 19<sup>th</sup> of March 2008 came into force on the 1<sup>st</sup> of May 2008. On the 1<sup>st</sup> of January 2009, the FINMA Circular 08/38 replaced the SFBC Circular 08/1, by introducing only slight modifications to the form of the revised circular.

The new Circular is a softened version of the 2003 draft Circular. It was renamed from “*Rules on Market Abuse*” to “*Rules on Market Conduct*” to indicate its new orientation, from a restrictive and detailed text with prohibitions to *principles-based* guidelines on market conduct<sup>340</sup>. It is structured in the following seven chapters: (i) Objective, (ii) scope, (iii) exploitation of price sensitive confidential information, (iv) the uninhibited operation of supply and demand (namely rules against market manipulation), (v) dissemination of information likely to influence prices, (vi) the principle of good faith (namely rules of conduct towards clients) and (vii) organisational obligations of securities dealers.

#### **5.2.2.1 Objective and scope of the FINMA Circular 08/38**

The Circular seems to refer to articles 1 and 6 of the SESTA as its legal foundation. However, this reference is confusing because, as we saw, article 6 of the SESTA assigns the supervision of the market to the stock exchange and not to the FINMA<sup>341</sup>. The Circular then specifies at section 3 that the requirements contained in it originate from articles 10 par. 2 lit. d (assurance of irreproachable conduct) and 11 (rules of conduct towards clients) of the SESTA and that the organisational obligations derive from article 10 par. 2 lit. a (adequacy of organisation for compliance with the SESTA) of the same Act. Finally, the Circular makes an explicit reference to the Biber case to establish that these requirements go beyond the scope of articles 161 and 161bis of the Penal Code.

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<sup>338</sup> *Ibid.*, p.67.

<sup>339</sup> Weber & Darbellay, 2008, p. 303.

<sup>340</sup> *Ibid.*, p. 304.

<sup>341</sup> Thévenoz & Bovet, L'approche de la CFB dans son 2e projet "Règles de conduite sur le marché", 2008.

Regarding the scope of application of the Circular, chapter II provides that it applies to securities dealers who are subject to the SESTA. Section 5 of the Circular indicates that securities dealers do not only have the obligation to respect the guidelines of the Circular for transactions made for their own account, but they also have to clarify and, if necessary, abstain from executing clients' transactions for which there are strong indications that they fail to respect the requirements of chapters III to V of the Circular. However, according to a sentence which did not exist in the SFBC 08/1 Circular, securities dealers are not required to adopt measures for the systematic monitoring and supervision of clients' orders. Banks which do not have a securities dealer licence as well as fund managers who hold a licence under article 13 par. 2 lit. a, b, c, d and f, as well as article 13 par. 4 of the *Collective Investment Schemes Act* are also subject to chapters III to VI of the Circular regarding their own transactions as well as those of their clients, but are not subject to the organisational requirements of chapter VII.

#### **5.2.2.2 Exploitation of confidential information**

According to section 10 of the Circular, the exploitation of confidential price sensitive information for the purpose of effecting transactions on securities is considered as abuse of information and is "not authorised". We notice the careful wording of the Circular which, as in the following chapters, avoids using strong terms. According to the Circular, trades on securities must only be effected on the basis of publicly accessible information, meaning information that has been disclosed through the media or the usual means of financial information. Any other information relating to securities or the issuers thereof is considered "*confidential*". The element of "*price sensitivity*" that, in combination with confidentiality, makes a trade unauthorised, refers to information that is relevant for the evaluation of a company, including organisational, corporate governance related and financial information. As an indication, the Circular draws an analogy with information that may be the object of ad hoc disclosure obligations, without however suggesting that the two types of information perfectly coincide, as in the case of the MAD.

We notice that the Circular does not distinguish between primary and secondary insiders and is not concerned with the source of the confidential information. In that sense, any supervised entity can fall within the scope of the prohibition, whether primary, secondary or accidental insider. Furthermore, the Circular prohibits the unjustified (meaning outside the scope of accepted market practices) dissemination of confidential price sensitive information, as well as the provision of investment recommendations based on such informa-

tion, which, as we mentioned in section 5.1.1, is not covered by article 161 of the Penal Code. Like in the MAD, rumours and not well defined indications are not considered as price sensitive confidential information. However, the intentional spread of rumours in order to justify trading based on confidential information is not authorised. The Circular also refers to *scalping* as a form of abusive use of information. As we have seen, scalping is ordinarily considered as an information-based market manipulation<sup>342</sup>. However, if scalping refers to the passive exploitation of knowledge concerning a forthcoming investment recommendation, rather than the active publication of a recommendation in order to induce investors to trade, then it can be viewed as a form of insider trading<sup>343</sup>.

### **5.2.2.3 The uninhibited operation of supply and demand**

The Circular addresses the issue of market manipulation in its fourth chapter. It may seem surprising that information-based manipulations are not included in the chapter. However, the Circular seems to adopt a narrow definition of market manipulation which only includes schemes that involve the distortion of the price mechanisms through transactions, whether artificial or real. Information-based manipulations are considered by the Circular as a separate form of market abuse and are addressed in chapter V<sup>344</sup>.

The Circular provides at section 22 that securities transactions must present an economic justification and correspond to the real interplay of supply and demand. It prohibits artificial orders, securities transactions and simple order registrations, if the purpose of these operations is to create the appearance of trading activity or to manipulate the liquidity, the price or the listing of securities. The Circular provides as guidance a list of manipulation “*indicators*”, which is effectively a non-exhaustive list of unauthorised market manipulations. The list includes wash trades, nostro-nostro inhouse crosses, improper matched orders, daisy chains, ramping, capping and pegging, squeezes and corners as well as spoofing. Therefore, the prohibition is much larger than the criminal provision of article 161bis, since operations like spoofing and price manipulations involving real transactions are included in its scope.

Unlike the MAD, we notice that the Circular, by placing the focus on the economic justification of transactions, essentially adopts an intent-based definition of market manipulation.

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<sup>342</sup> See section 3.2.1. See also The Committee of European Securities Regulators, 2004, p. 12.

<sup>343</sup> The reader may draw analogies with front-running, which may be viewed as a simple violation of the duty of loyalty toward a client, but it may also, in cases of large-volume client orders, qualify as insider trading. See article 1(1) of Directive 2003/6/EC of the European Parliament and of the Council, 2003.

<sup>344</sup> Weber & Darbellay, 2008, p. 306.

The test it uses for the identification of manipulative transactions focuses on the subjective elements of the said transactions and not on their effects on investors' beliefs or on securities' prices.

#### **5.2.2.4 Dissemination of information likely to influence prices**

As we saw above, the Circular has adopted a narrow definition of market manipulation by excluding information-based manipulations and qualifying them as a separate form of market abuse. The Circular provides that the dissemination of information through financial information channels and through the media, including the Internet and the research and analysis services of securities dealers, is authorised only if the person who disseminates such information legitimately believes that the said information corresponds to existing true circumstances. Inversely, the dissemination of false, incomplete or misleading information with the intention of deceiving other market participants is prohibited.

#### **5.2.2.5 The principle of good faith**

The Circular's concept of market abuse is wider than the definition adopted by European legislation. The MAD and its implementing Directives only contain rules against acts that harm the *market* and prescribe certain organisational requirements for the prevention and detection of such acts. The Circular on the other hand includes rules against practices that harm *individual investors* as well as against practices that are detrimental to the *market* in general<sup>345</sup>. Accordingly, in the chapter entitled "*The principle of good faith*", the Circular contains rules for the protection of individual investors, in their capacity as clients of the supervised entities. The main body of the corresponding rules in European Law are contained in the MiFID and its implementing Directives.

The Circular requires that securities operations are executed in compliance with the principle of good faith. It states that the conduct rules vis-à-vis the clients of the supervised entities are based on article 11 of the SESTA and it refers to the Code of Conduct for securities dealers issued by the Swiss Banking Association as the concretisation of the said rules. The Circular – in what appears like an awkward attempt to justify its large perception of market abuse and the fact that it blends *client* conduct rules with *market* conduct rules – declares that the principle of good faith requires, *in addition* to the respect of *client* rules, the adoption of an honest conduct towards *the market as a whole* and outlines the practices that are

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<sup>345</sup> Thévenoz & Bovet, *Les abus de marché dans le paysage réglementaire suisse: abus de marché, abus de quelles règles?*, 2008, pp. 93-94.

incompatible with the said principle. Such practices are the ones that the SFBC had already denounced in its administrative practice, namely price fraud, front/parallel running and snake trading. The FINMA effectively affirms that these conducts can have an impact on the market by undermining investors' confidence and by allowing the conclusion of transactions at a different price from that which would be obtained in a normal market<sup>346</sup>.

#### **5.2.2.6 Accepted Market Practices**

Similar to EU law, the Circular recognises the existence of defences against the presumption of market abuse, for practices which may present indications of market abuse but are in fact justified and legitimate market practices. Such defences are only available for three types of market abuse categories: the exploitation of confidential price sensitive information, market manipulation and violations of the good faith principle. As in the case of the MAD, there are no defences for market abuses based on the dissemination of misleading information, because evidently no conceivable legitimate practice may justify such acts.

The Circular considers that there is no exploitation of confidential price sensitive information in the following cases: transactions that take place outside an isolated confidentiality perimeter; transactions which were planned beforehand and regardless of the knowledge of the confidential information or which take place in the context of a long-term strategy; purchases before the launch of a takeover bid (in accordance to the well-established principle in Swiss doctrine that "nobody can be his own insider"); transmission to third parties in the context of their professional duties; transactions based on information on the securities dealer's positions or his order book; and authorised share buy-backs.

Moreover the Circular provides that the following operations are not considered as market manipulation: legitimate stabilisations, market making, authorised share buy-backs, in-house crosses of independent orders and economically justified and authorised matched orders. Finally, the Circular holds that the internalisation of client orders does not violate the principle of good faith as long as the principle of best execution is respected.

#### **5.2.2.7 Organisational rules**

Securities dealers are expected to have organisational measures in place to prevent market abuse. The flow of confidential price sensitive information must be organised and supervised in order to detect abusive practices and to prevent harm to the clients. If there is a

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<sup>346</sup> Thévenoz & Bovet, L'approche de la CFB dans son 2e projet "Règles de conduite sur le marché", 2008, p. 122.

danger of abusive conduct, or if the isolation of information in a confidentiality perimeter is impossible, the existing conflicts of interest must be announced or the securities dealer must abstain from effecting transactions on the securities concerned until the confidential information is published. To that effect, securities dealers must take measures of organisation, training and internal controls proportional to their activities. Vertical and horizontal information barriers (“*Chinese walls*”) must be installed, *ad hoc* if necessary. These include organisational measures related to the premises, the associates, the functions, the internal organisation and the information systems of the securities dealer. Such measures are meant to define perimeters within which confidential information remains isolated. An internal service must be charged with the monitoring of these measures and with directing the horizontal and vertical flow of information. The management is ultimately responsible for the handling of confidential information and of conflicts of interests. If it is assured that confidential information remains within the confidentiality perimeter, transactions in other sectors of activity are authorised. If however conflicts of interests persist, the securities dealer must abstain from effecting transactions on the securities concerned for a certain time period.

The Circular includes further organisational measures such as the establishment of *watch lists* (of confidential price sensitive information in the possession of the securities dealer) and *restricted lists* (of prohibited operations/transactions), the monitoring of employees’ transactions, the assurance of equitable and transparent attribution of securities in an IPO, the independent organisation of the financial analysis, credit and credit rating divisions and recording obligations. The organisational measures of securities dealers can be the object of risk-oriented audits by audit firms in the context of their duties. Audit firms must report any violations to the FINMA according to article 27 of the FINMA Act and include them in the audit report. We examine this dimension of the Circular from an audit perspective in section 6.

### **5.3 The way forward: the report of the Commission of Experts**

On the basis of a decision by the Federal Council, the Federal Department of Finance appointed on the 3<sup>rd</sup> of October 2007 a Commission of Experts with the mandate to examine possible reforms of articles 161 and 161bis, as well as the reform of supervisory financial law, to determine to what extent stock exchange crimes can constitute predicate offences of money laundering, to analyse the question of the personal scope of the market conduct rules and to address questions of procedure and competence on market offences, notably

the competence of the SFBC (respectively its successor, the FINMA). The Federal Council has not yet decided on the action to be taken on the base of the Commission's report. Below we provide an overview of the main recommendations of the Commission.

The Commission recommends the transfer of articles 161 and 161bis of the Penal Code to the SESTA. It also prescribes the qualification of insider dealing and market manipulation as a crime, when these offences result in a substantial financial profit. This would resolve the long overdue question of the adoption of the GAFI recommendations to classify insider dealing and market manipulations among the predicate offences of money laundering. It would also allow the ratification of the relevant convention of the Council of Europe<sup>347</sup>.

Regarding insider dealing, the Commission proposes that the definition of insider should be broadened<sup>348</sup>, in line with the MAD. Persons with direct access to confidential information, including employees below the management and shareholders should fall under the definition of primary insider. Also, the origin of the inside information should be irrelevant. According to the Commission, the notion of secondary insiders should also be extended to persons who receive inside information through their criminal activities or by accident. The Commission also proposes the introduction of a safe harbour clause to concretise the principle that "nobody can be his own insider" in order to increase legal certainty.

Regarding market manipulation, the Commission considers that the scope of the criminal provisions should not be enlarged by including the dissemination of simple rumours – which according to the Commission are not specific enough to be criminally punishable – or manipulations based on real transactions<sup>349</sup>, adopting the argument discussed in section 3.3.2 that it is very hard to distinguish between legitimate and manipulative transactions simply based on good or bad intent. The Commission acknowledges however that these practices should remain within the scope of the relevant administrative provisions.

The Commission also proposes the introduction of a *Limited Market Supervision* in favour of the FINMA, which would be given the authority to investigate and sanction certain

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<sup>347</sup> *Convention on laundering, search, seizure and confiscation of the proceeds from crime and on the financing of terrorism of the 16<sup>th</sup> of May 2005.*

<sup>348</sup> Weber & Ginter, Commission's Report on New Stock Exchange Offences and Market Abuse Regulation, 2009.

<sup>349</sup> *Ibid.*

forms of misconduct, even if the perpetrator is not a supervised entity<sup>350</sup>. To that end, the Commission proposes the introduction of the prohibition of volume manipulation, scalping and front-running in the SESTA with limited enforcement measures in the form of declaratory decisions and disgorgement of gains<sup>351</sup>. The Commission also proposed the centralisation of procedures against market abuse by appointing the Office of the Attorney General of Switzerland as the central criminal authority, to which FINMA would forward the results of its initial administrative investigations.

#### **5.4 Evaluation of the Swiss approach**

The Swiss framework against market abuse still seems very far from where it should be, taking into account Switzerland's role as a financial centre. Steps need to be taken both on the criminal and the administrative front in order to ensure the effective prevention of market abuse. We have seen that the criminal provisions have dramatically improved just by the repeal of the third paragraph of article 161 of the Penal Code. However, the criminal provisions suffer from large gaps, which are unjustified. With regard to insider dealing, to name a few of the deficiencies, the enumeration of primary insiders is restrictive, accidental insiders fall outside the scope of the prohibition, recommendations based on inside information are not prohibited and there is a lack of clarity regarding the criminal liability of secondary insiders when primary insiders are not liable. With regard to market manipulation, the exclusion of a large part of market manipulations by article 161bis of the Penal Code, cannot find sufficient economic or legal justification. We do not believe that considerations relating to the difficulty of proving manipulations based on "real" transactions – such as corners or contract-based manipulations – which may involve potentially devastating consequences for the market and for other investors, justify their exemption from criminal enforcement.

In any event, the inadequacies of the criminal provisions should be addressed by the corresponding administrative provisions. The FINMA Circular, although it seems to be a positive step given the means at the supervisory authority's disposal and the reactions of the market participants to the 2003 SFBC draft Circular, cannot be deemed adequate. First, rules on market abuse are blended with rules of conduct towards clients, which from a systematic standpoint is questionable and creates confusion as to the theoretical foundation

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<sup>350</sup> *Ibid.*

<sup>351</sup> *Ibid.*

and the objective of the Circular<sup>352</sup>. Furthermore, the Circular is a principles-based text which only applies to supervised entities. Even though it covers a wide range of market abuse practices, it becomes clear that there might be cases, such as manipulations based on “real” transactions and performed by non-supervised entities, which fall outside the scope of both the Circular and the Penal Code, resulting in a situation which is unacceptable for a modern financial centre.

We would be inclined to suggest that Switzerland should follow the international trend which is to adopt, in today’s exceedingly complex and globalised markets, a tough stance against market abuse. The establishment of a single independent market supervisory authority with jurisdiction and direct enforcement capabilities over all market actors on matters of market abuse – similar to the US or the EU model – would be desirable<sup>353</sup>. This authority should also be granted the ability to impose financial sanctions, with proper consideration to the procedural guaranties provided by the ECHR<sup>354</sup>.

## **6 The auditor’s role in the new Swiss regulatory framework**

Following a request by PricewaterhouseCoopers SA, this section has been excluded from publication for reasons of confidentiality.

## **7 Conclusion**

This paper has attempted an interdisciplinary analysis of insider dealing and market manipulation. We examined these two practices from an economics perspective and analysed their definition, their manifestations, their economic implications and the arguments for their regulation. We concluded that these are indeed behaviours that need to be regulated and punished due to their severe effects on the markets and the economy as a whole. With respect to the impact of insider dealing on market efficiency, although the debate remains open in academic circles, most legislators seem to have made up their minds that any alleged efficiency advantages of insider dealing are outweighed by other more serious and real implications. Our analysis points to the same direction.

The paper then examined two separate legislative and regulatory frameworks, namely the one established in the EU by the EC Market Abuse Directive and the one established in

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<sup>352</sup> Iffland J. , *Abus de Marché*, 2005, p. 68.

<sup>353</sup> Thévenoz & Bovet, *Abus de marché : Point de la situation et perspectives - Perspectives*, 2008, p. 126.

<sup>354</sup> *Ibid.*

Switzerland, mainly by articles 161 and 161bis of the Swiss Penal Code and the FINMA 08/38 Circular. Although it was acknowledged that the EU regime is not without faults, it can certainly be viewed as a comprehensive solution to the need to regulate market abuse. The reaction of financial market actors to it has been positive and its application has been fairly successful. The Swiss framework is less fortunate by comparison. The penal provisions were notoriously inadequate until as late as October 2008 but some positive steps have been made since then. With respect to the administrative provisions, a lot of the progress marked in the area of market abuse results from the single-handed efforts of an administrative authority, the SFBC and its successor the FINMA, which was never granted sufficient powers to address the problem. However, the issue of market abuse is still in the spotlight in Switzerland and all the current developments seem to be in the right direction. The report of the Commission of Experts examined in section 5.3 suggests several positive measures, including the integration of the criminal provisions in the SESTA and some extended powers of the FINMA. Moreover, a generalised sensitisation against market abuse seems to be gradually expanding in the Swiss marketplace, beyond the narrow confines of banks and securities dealers. In that sense it is worth mentioning that provisions against market abuse have already been integrated in the revised codes of conduct of self-regulatory bodies of asset managers and recognised as minimum standards by the FINMA<sup>355</sup>.

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<sup>355</sup> See “FINMA recognises self-regulatory provisions in the asset management industry” available at <http://www.finma.ch/e/aktuell/Pages/aktuell-selbstregulierungen-20090427.aspx>

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