

**FINANCIAL SERVICES ACTION PLAN  
FORUM GROUP ON MARKET MANIPULATION**

**ISSUES PAPER  
FOR THE  
FIRST MEETING OF THE GROUP**

# FINANCIAL SERVICES ACTION PLAN FORUM GROUP ON MARKET MANIPULATION

## INDEX

- I. MISSION STATEMENT
- II. SPECIFIC ISSUES
  - Malpractice, limits and innovation
  - Instruments
  
  - Markets
  
  - Manipulators
  
  - Best practices
  
  - Penalties

## I. MISSION STATEMENT

On 11 May 1999 the Commission adopted its Communication *“Financial Services : Implementing the Framework for Financial Markets : Action Plan”* (Document COM(1999) 232). The Action Plan builds on the Commission’s Communication on a Framework for Action for Financial Services of October 1998, setting out what our policy responses should be to the pressures that arise from the introduction of the EURO, globalisation, and technological advance in financial services. One of the measures in the Action Plan, intended to ensure the development of a single EU wholesale market, is the adoption of a directive to address market manipulation.

With more and more capital managed by institutional investors and intermediaries the possibility of market abuse (namely market manipulation or insider dealing) has increased. Many of these actors are not any longer price takers: they have enough capital base to move the market to their advantage. Curbing such practices needs to be integrated within a general approach towards tackling market abuses.

Maintaining confidence in the integrity of the market will be crucial to ensuring the capacity of our securities markets and future pan-European trading platforms to attract investors from all over the world. While the existence of potential threats to the integrity of EU markets has been widely recognised no legislative action, apart from the Insider Dealing Directive 85/592/EEC, has been taken to date. However, Commission recommendation 77/534/EEC *“Concerning a European Code of Conduct relating to Transactions in Transferable Securities”* already recognises the potential dangers arising from market manipulation and provides a definition of it (see “malpractice, limits and innovation” below). The Code also contains a number of principles concerning not only specific activities which would qualify as market manipulation but also “persons” who because of their position are the most likely candidates for market manipulation.

The objective of the new directive would be then to enhance market integrity and investors confidence by reducing the possibility of market participants to rig EU securities markets. There is a widely shared perception that there is plenty of room for improvement in this area, specially in the case of cross-border transactions.

The Commission proposal for a directive to tackle market manipulation will be built on the experience accumulated by the Member States (specially from those which have already legislation to fight against these practices) and the industry and on the work of FESCO (the Forum of European Securities Commissions). The input to be provided by the European industry will be done through the Forum Group.

The objective of technical discussions in the Forum Group is neither to “negotiate”, nor to present “positions” of EU representative bodies or markets on specific issues : these aspects will come into play at a later stage when the Commission comes forward with more formal draft proposals for measures. Individuals on the Group will be expected to provide forward-looking, specific, unbiased, concrete and detailed technical input from a market perspective. In particular the Commission will very much welcome written contributions (papers ; brochures, technical descriptions ; etc.) before or after the meetings. These documents could be intended only for the Commission or for all participants. The documents could be the product of an expert, several experts, or the whole group.

Although the Commission will chair the meetings of the Group, in practice its role will be that of a “facilitator” of discussions. The Commission’s services will provide the secretariat (preparation and distribution of papers and other documentation etc.) and act as a general point of contact. The Commission will also produce issues papers setting-out the main themes and possible areas of attention, but only to provide broad guidance.

Market experts are invited to determine the technical issues at stake and the way forward. The list of issues presented in this paper is not exhaustive. Market experts may consider that some of the open questions in the area of market manipulation are more appropriate for supervisors/regulators than for the industry.

The Forum Group is invited to concentrate their discussions, at the first meeting, around a number of themes including :

- **Malpractice, limits and innovation.** What are the most common market practices of a manipulative nature which should be made illegal at EU level (e.g. artificial transactions ; dissemination of misleading information ; price manipulation). Where should the dividing-line be drawn between market manipulation and restricting the freedom to trade ? Is there a large grey area ? Could excessive rigidity in combating market manipulation inhibit the development of new useful market practices ?
- **Instruments.** Which type of financial or non-financial instruments should be affected ?
- **Markets.** Which types of markets should be covered (e.g. stock markets ; derivatives markets ; over-the-counter markets).
- **Manipulators.** Who should be subject to the provisions in the new directive (e.g. all market participants ; only professional/sophisticated investors ; only broker/dealers who are members of the EU regulated markets ; what about employees or agents of the broker/dealers ?)
- **Best practices.** What are the most effective means at the level of the firm of a non-disciplinary nature (e.g. Chinese walls) to combat market manipulation ?
- **Penalties.** What should be the penalties for misbehaviour ?

To facilitate the discussion these themes are developed in detail at the next section (“specific issues”).

**Timetable:**

- |                                                                  |                |
|------------------------------------------------------------------|----------------|
| • Selection of the Forum Group                                   | September 1999 |
| • First meeting of the Forum Group                               | October 1999   |
| • Completion of the work of the Forum Group (after 3/4 meetings) | March 2000     |
| • Start consultation with Member States                          | Spring 2000    |
| • Proposal for a directive                                       | by end 2000    |
| • Expected adoption of the directive                             | by end 2003    |

• • • • •

## II. SPECIFIC ISSUES

### MALPRACTICE, LIMITS AND INNOVATION

The financial services industry, as a whole, should have a strong commercial incentive in building a reputation for integrity and fairness, at both national and EU level. In this context a basic feature of the new directive would be the definition of its scope in terms of what type of transactions and what kind of activities of manipulative nature should have to be made illegal at EU level.

The 77/534/EEC Code of Conduct already defines market manipulation :

*“Any attempt or manipulation by persons acting separately or in concert with others, which aims at or results in the rise or fall in the price of securities by fraudulent means, is contrary to the fundamental objective of this code. Fraudulent means are considered in particular to be the publication or diffusion of information which is false, exaggerated or tendentious, and also the use of other devices aimed at disrupting the markets' normal operation”.*

This, in practice, may refer to different types of manipulative conducts such as :

- Artificial transactions (absence of genuine change of interest between the contracting parties) able to mislead other market participants. An example of this may be the widely reported case in which series of fictitious transactions (buying and selling orders in a company about to complete its merger with another company where placed in the stock exchange) introduced by several CSFB traders in the Stockholm Stock Exchange in order to manipulate its OMX index. Fines on the traders were imposed.
- Dissemination of misleading information. The 77/534/EEC Code of Conduct states in this regard that : *“Information should be available to the public which is fair, accurate, clear, adequate and which is given in good time .... If the information ... is deliberately slanted or distorted, the prices quoted may well become completely artificial and the market may cease to fulfil its role (because it will become an artificial market)”.*
- Price manipulation. This kind of behaviour may arise, for instance, at the stock markets at the expiring date of derivative contracts written on underlying instruments (or indexes) traded on those stock markets. It may also happen by abusive squeezes of deliverable products (financial or not) at settlement date. As in the case of insider trading, it seems logical that the illegal activity, to be qualified as such, would have to have a “significant” effect on the price of the security.

On the other hand, an important consideration would be also to establish, if possible, clear limits between curbing market manipulation and unnecessarily restricting freedom to trade. Is there a large grey area ? In the same vein, we have to make sure that excessive rigidity in combating market manipulation does not inhibit innovation (development of new useful practices) in the market place.

***Market experts are invited to comment on how spread is, between market practitioners, the notion that high levels of integrity and fairness may have also high commercial value. With this in mind, which are the transactions/activities which should be clearly classified as market manipulation ? Which transactions/activities fall into a grey area which deserves a careful analysis and perhaps a case-by-case evolution ? Are new technologies and practices (e.g. internationalisation of portfolios) providing more or less opportunities for market manipulation ?***

## **INSTRUMENTS**

The insider trading directive applies to inside information related to “transferable securities” such as :

- ( a ) shares and debt securities, as well as securities equivalent to shares and debt securities ;
- ( b ) contracts or rights to subscribe for, acquire or dispose of securities referred to in (a);
- ( c ) futures contracts, options and financial futures in respect of securities referred to in (a) ;
- ( d ) index contracts in respect of securities referred to in (a),

when admitted to trading on a market which is regulated and supervised by authorities recognised by public bodies, operates regularly and is accessible directly or indirectly to the public.

On the other hand, the financial instruments falling under the “European passport” provided by the ISD (Investment Services Directive – 93/22/EEC) which was adopted several years later than the Insider Trading Directive are :

- Transferable securities
- Units in collective investment undertakings
- Money-market instruments
- Financial-futures contracts, including equivalent cash-settled instruments
- Forward interest-rate agreements (FRAs)
- Interest-rate, currency and equity swaps
- Options to acquire or dispose of any instruments mentioned above, including equivalent cash-settled instruments. This category includes in particular options on currency and on interest rates.

An important difference in the case of market manipulation *vis-à-vis* insider trading may come up when handling deliverables, whether financial or non-financial. Unfair practices involving squeezing of deliverables with the purpose of manipulating their prices should be forbidden. Several cases of squeezes of deliverables have been reported in the recent past. An example of this was reported concerning EUREX (the futures exchange). Apparently a number of participants had created artificial shortages in the popular 10-year German government bond. Another example may happen in the settlement of credit derivatives such as default swaps. They have to be settle physically in the sense that the buyer has to deliver securities or loans if a borrower defaults. Specifying more exactly the security that is deliverable helps to reduce the risk of mismatching his exposure, but increase the risk that the seller can push its price up (manipulation).

***Market experts are invited to comment on the type of instruments, whether financial or not financial, which should fall under the new directive. Of particular interest would be the approach to be taken in case deliverables. In the case of commodities is important to remember that commodity derivatives are out of the ISD.***

## **MARKETS**

The insider trading directive focuses on “secondary markets”. As indicated in the previous section the directive refers to transferable securities which are “*admitted to trading on a market which is regulated and supervised by authorities recognised by public bodies, operates regularly and is accessible directly or indirectly to the public*”. By not referring specifically to listing this definition of an organised market goes beyond that of “official” markets and also includes derivatives markets, etc. This means that in practice it refers to the same type of “regulated market” defined years later in Article 1.13 of the ISD (the Investment Services Directive).

Primary markets are in principle excluded from the insider trading directive at least for the stabilisation period. As indicated in its recital Nr 12 : “*the fact of carrying out transactions with the aim of stabilising the price of new issues or secondary offers of transferable securities should not in itself be deemed to constitute use of inside information*”. In this regard it is important to note that FESCO has a working group on “market conduct standards for participants in an offering” which is about to complete its work. This may have some bearing on the future directive on market manipulation. During the meeting Commission representatives will brief orally the Forum Group on this matter.

It is interesting to note that as indicated in Article 2.3 first paragraph the insider trading directive applies to “*any acquisition or disposal of transferable securities effected through a professional intermediary*”. This means that it applies also to off-market transactions on the instruments admitted to trading on the organised markets mentioned above provided it is done through a professional intermediary.

Of particular importance would be the analysis from the market manipulation point of view of the case of Alternative Trading Systems (ATs). These systems are sometimes referred also as Proprietary trading systems (PTs), Electronic Communication Networks (ECNs), Market Service Providers (MSPs), Automated Trading Systems (ATs) or simply electronic trading platforms. They are systems generally considered to play a more sophisticated role than the traditional broker/dealer but less than the traditional securities exchanges. These quasi-exchanges are screen-based automated systems, run by broker/dealers as for-profit businesses, which produce in-house matching of buying and selling orders in either exchange-listed or OTC (over-the-counter) securities (e.g. equity, government and corporate bonds, options). Participation is usually limited to institutional investors, brokers/dealers, and other market professionals. By combining technology with other attractive features such as anonymity and reduction of market impact of large trades, these systems are capturing an increasing share of trading volume, specially in the USA.

Another importance case would be the treatment of pan-European trading platforms. In the stock trading area a pan-European network/platform may be built around the London-Frankfurt axis. In the derivatives area we have already EUREX and EURO-GLOBEX which go even beyond the EU.

***Market experts are invited to comment on the type of markets (“regulated” according to the ISD ; OTC – over-the-counter transactions ; off-market transactions ; etc) to be considered. Of special interest would be the treatment of Alternative Trading Systems (ATs) and pan-European trading platforms for stock or derivatives.***

## **MANIPULATORS**

The Insider Trading Directive applies to persons. They may be “internal” insiders (having direct access to information) such as directors, shareholders, employees, civil servants, etc. or “indirect” insiders (having indirect access to information) e.g. the tippees. On the other hand, the State, the Central bank or other State related bodies, and any person acting on their behalf, are out of the directive when pursuing monetary, exchange-rate or public debt-management policies. The 77/534/EEC Code of Conduct also refers continuously to “persons” who should be subject to the Code. More specifically the Code mentions categories of persons who should be particularly concerned : companies’ supervisory boards ; company directors and managers ; financial intermediaries ; persons concerned professionally or regularly dealing on the securities markets ; holders or acquirers of major shareholdings ; and those who are in a position to influence public opinion (e.g. financial analysts and journalists).

In the press has also been widely reported the activities of actual or potential manipulators:

- **Lawyers, accountants, deal makers.** The SEC is cracking down the so-called “pump and dump” schemes. The action is directed against a range of participants including lawyers and accountants who files company documents, as well as deal makers who were said to have manipulated small company shares. Many schemes are promoted through bulletin boards on the internet or investor newsletters, as companies seek to inflate their share prices before selling their holdings to the public.
- **Company managers and brokers.** In Greece an investigation has been launched to verify whether company managers, of companies with small market capitalisation and poor earnings records, have colluded with brokers to influence share prices.
- **Fund managers and broker/dealers.** It has been reported that the London Stock Exchange has fined recently broker/dealers which have accepted orders that included the instructions to move a share price. In other instance, a broker/dealer (acting in the name of an American fund manger) has tried to influence the FTSE-100 index with last minute trading in a handful of shares.
- **Researchers and investment banks.** The SEC has issued an “early warning signal” for the potential conflict of interest among research analysts, the investment-banking arms of their firms and the companies they follow. Apparently analysts are under increasing pressure to put positive recommendations on companies stocks if their firm’s investment-banking arm has a relationship with the companies.
- **Websites.** The SEC is also investigating an internet website which offers fast-action trading tips and stock recommendation to day trading. Direct or indirect compensation may have been received from companies receiving good recommendations.

***Market experts are invited to comment on who should be subject to the provisions of the new directive. All market participants ? Only profession/sophisticated investors ? Only broker/dealers who are members of the EU regulated markets ? What about employees/agents of broker/dealer and of news vendors ? What about lawyers and accountants filing company documents ? Company directors and managers ?***

## **BEST PRACTICES**

Apparently most of the cases related to market manipulation have their origin in inadequate internal controls at the firm level. The existence of internal procedures to ensure ongoing compliance with established rules (including those related to clients' and exchanges' conduct of business rules) seems to be the key for success. This fact is recognised by Community legislation as indicated below.

Article 10 of the ISD (Investment Services Directive 93/22/EEC) which affects to investment firms and to banks involved in securities business states that (indents 1 and 4):

*"Each home Member State shall draw up prudential rules which investment firms shall observe at all times. In particular, such rules shall require that each investment firm:*

- Have sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing, and adequate internal control mechanisms including, in particular, rules for personal transactions by its employees,*
- Arrange for records to be kept of transactions executed which shall at least be sufficient to enable the home Member State's authorities to monitor compliance with the prudential rules which they are responsible for applying; such records shall be retained for periods to be laid down by the competent authorities."*

Article 11 of the ISD (clients' related conduct of business rules) repeats several times that investment firms (including banks) should promote the integrity of the market and Article 15.2 requires compliance with the rules relating to transactions on the market.

Article 8.3 of Directive 92/96/EEC on life assurance states that: *"The competent authorities of the home Member State shall require every assurance undertaking to have sound administrative and accounting procedures and adequate internal control mechanisms."*

Commission proposal COM(1998)451 of 17.7.98 ("second" UCITS proposal), modifying Directive 85/611/EEC, which is currently under negotiation, states in its Article 5f.1: *"Each home Member State shall draw up prudential rules which management companies, the authorisation of which covers only the activity of management of unit trusts/common funds and investment companies, shall observe all times. In particular, the competent authorities of the home Member State having regard also to the nature of the UCITS managed by a management company, shall require that each such company has sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms ensuring –inter alia- that the assets of the unit trusts/common funds or of the investment companies managed by the management company are invested according to the fund rules or the instruments of incorporation and the legal provisions in force."*

***Market experts are invited to comment on the best arrangements, procedures, controls, etc. at the firm level or otherwise which may inhibit, at a minimum cost, manipulative practices. The comments would take into account the incoming scenario with easy means for news dissemination (e.g. internet) and for electronic trading.***

## **PENALTIES**

During the negotiations on the Insider Trading Directive it was not possible to agree on the type of sanctions (criminal vs civil) nor in the level of sanctions. As a result this was left to the Member States to decide (Article 13). The following are the penalties (national legislations) foreseen in case of insider trading which could be used as a reference in case of market manipulation:

### **MAXIMUM CRIMINAL SANCTIONS**

<b>Member State</b>	<b>Fine in local currency</b>	<b>Imprisonment</b>
Austria	Sch. 1,080,000	2 years
Belgium	BF 2 million + 3x profits	1 year
Denmark	Unlimited	4 years
Finland	Unlimited	2 years
France	FF10 million or 10x profits	2 years
Germany	DM3.6 million	5 years
Greece	None	5 years
Ireland	IR£200,000	10 years
Italy	L 300 million	6 years
Luxembourg	LF 50 million	5 years
Netherlands	Fl. 100,000	2 years
Portugal	Esc. 18 million	2 years
Spain	Pts. 36 million	6 years
Sweden	Unlimited	4 years
United Kingdom	Unlimited	7 years

### **MAXIMUM ADMINISTRATIVE SANCTIONS**

<b>Member State</b>	<b>Fine in local currency</b>
France	FF10 million or 10x profits
Germany *	DM 3 million
Greece	Drs. 1,000 million or 5x profits
Italy	L250 million
Luxembourg *	LF 5 million
Spain	Pts. 5 million or 5x profits

\* Germany and Luxembourg do not provide for administrative sanctions for insider dealing itself, but for regulatory offences (for example failure to co-operate with an investigation or, in the case of Germany, failure to publish information as required).

***Market experts are invited to comment on the type and level of the penalties which should be sufficient and appropriate to tackle practices leading to market manipulation.***