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# When Insider Trading and Market Manipulation Cross Jurisdictions: What Are the Challenges For Securities Regulators and How Can They Best Preserve the Integrity of Markets?

Janet Elizabeth Austin

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WHEN INSIDER TRADING AND MARKET MANIPULATION CROSS  
JURISDICTIONS. WHAT ARE THE CHALLENGES FOR SECURITIES  
REGULATORS AND HOW CAN THEY BEST PRESERVE THE INTEGRITY  
OF THE MARKETS?

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A DISSERTATION SUBMITTED TO  
THE FACULTY OF GRADUATE STUDIES  
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FOR THE DEGREE OF  
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## **Abstract**

Over the last few decades world securities markets have become significantly more sophisticated in terms of how securities are traded as well as the variety of securities traded. My hypothesis is that the ability of securities regulators to take enforcement action against market abuse has not kept pace with the level of sophistication of the markets and, in particular, the way in which trading can take place across borders and the manner in which market related information can spread rapidly across the world. I argue that that regulators need to do more to protect the integrity of the markets by improving their efforts to initiate action against market abuse. Furthermore, given the global nature of the problem I argue that the International Organization of Securities Commissions (IOSCO) should be more proactive in coordinating the activities of securities regulators in this regard.

I commence with an analysis of why the integrity of securities markets is critical to the economy of a country and why it is necessary for regulators to enforce laws prohibiting market abuse in order to protect market integrity. I then move on to identify the changes to securities markets, the regulatory responses to these changes, trends in the types of market abuse which is taking place across borders and how those responsible for taking enforcement action against such market abuse have responded. Finally I consider IOSCO, its history, how its role has evolved, its impact to date and how IOSCO could build upon its success in terms of improving the enforcement outcomes of securities regulators in relation to market abuse. I conclude that the transformation of the markets have presented opportunities to engage in market abuse across borders and that, while some positive steps have been taken to address this issue, more could be achieved. Finally I discuss and make recommendations about what might be done to improve the ability of securities regulators to take successful enforcement action.

## **Dedication**

To my husband, Mark, and my sons Hamish and Samuel.

## **Acknowledgments**

I would like to thank my supervisor Professor Mary Condon for her patience and many helpful comments and suggestions. Thank you also to my committee members Professor Douglas Cumming and Professor Poonam Puri for their assistance with this dissertation.

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## Glossary and List of Abbreviations

AMF	The Securities Commission of Quebec (Autorité des marchés financiers)
ATS	Alternative Trading System
ASIC	Australian Securities and Investments Commission
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht. The Federal Financial Supervisory Authority of Germany.
BCSC	British Columbia Securities Commission
Contract for difference	A contract between a buyer and seller stipulating that the seller will pay to the buyer the difference between the current value of an asset and its value at specified time.
CSA	Canadian Securities Administrators
ECN	Electronic Communication Network
ESMA	European Securities and Markets Authority (formally the Committee of European Securities Regulators)
ESMA MoU	The Committee of European Securities Regulators Multilateral Memorandum of Understanding on the Exchange of Information and Surveillance of Securities Activities.
FCA	Financial Conduct Authority of the United Kingdom. This organisation took over the responsibilities of the Financial Services Authority (FSA).
FINRA	United States Financial Industry Regulatory Authority
FSA	Financial Services Authority of the United Kingdom. This organisation

has now been replaced by the Financial Conduct Authority.

IIROC	Investment Industry Regulatory Organization of Canada
IOSCO	International Organization of Securities Commissions
IOSCO MMoU	International Organization of Securities Commissions Multilateral Memorandum of Understanding Concerning Consultation and the Exchange of Information
ISG	Intermarket Surveillance Group
Layering	A form of market manipulation where there are a series of orders entered to match existing orders with the intention of inflating or reducing the price of the security.
MAD	European Union Commission Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation (market abuse)
MAD II	European Union Commission Directive 2014/57/EU of 16 April 2014 on Criminal Sanctions for market abuse
MAR	European Union Commission Regulation no 596/2014 of 16 April 2014 on market abuse
Marking the close	Manipulative practice of placing orders late in the day with the intention of raising the reported closing price of the security.
Matched order	Manipulative practice of a market participant prearranging the purchase of a security from another market participant with the intention of giving the appearance of active trading in the security.
MTF	Multilateral Trading Facility
Offshore Financial	A country which has laws, or is commonly thought to have laws,



Centre	which protect financial secrecy thereby preventing the disclosure of the beneficial ownership of corporate entities and bank accounts.
OSC	Ontario Securities Commission
OTC	Over the Counter. A system for trading securities in which market participants trade with each other directly and without a centralized exchange.
OTCBB	Over the Counter Bulletin Board. An OTC quotation system available to FINRA members to list interest in OTCBB eligible securities, as defined by FINRA.
Pink Sheets	An OTC quotation system made available by a corporation called OTC Markets Group. Also called Pink OTC.
Pump and dump	A common form of market manipulation scheme. Usually in such a scheme the perpetrator acquires a large number of securities in a particular entity. False or misleading information is then published and/or wash sales and matched orders utilised to artificially inflate the price of the securities. When the price of the securities has become artificially inflated the perpetrator sells the securities.
Quote stuffing	Also called 'Spoofing'. A manipulative practice where a series of orders are placed by a trader to give the impression of activity or price movement in a security but the orders are withdrawn before they are executed.
SEC	United States Securities and Exchange Commission
Spoofing	Also called 'Quote Stuffing'. A manipulative practice when a series of orders are placed by a trader to give the impression of activity or price movement in a security but the orders are withdrawn before

they are executed.

Wash sale

A manipulative practice whereby the same beneficial owner of the security is both the buyer and the seller of the securities. The purpose of a wash sale is to give the appearance of active trading in the security.

## INTRODUCTION

Two related factors that have recently been changing the nature of insider trading enforcement are technology and globalization. The old assumptions about the logical places to look for connections — neighbors, family, co-workers — may not always bear fruit in a world where you can whisper to someone a half a world away and equally easily trade in a market just as far away.

L C Thomsen, Former Director of Enforcement at the SEC<sup>1</sup>

The trading of securities in world markets has changed dramatically over the last few decades. Innovations in securitization have led to a vast array of new forms of securities that can be traded and the volume of securities traded has grown five fold since 1990.<sup>2</sup> There has also been a significant increase in market capitalizations and the variety of markets for trading securities has multiplied as new trading platforms have appeared. At the same time the larger and more established stock exchanges have expanded into new regions and markets and some have become global conglomerates. New players in the markets, such as hedge funds and ‘high frequency’ (or algorithmic) traders have also emerged to have significant influence.<sup>3</sup> As a result of these changes markets are becoming truly global thereby allowing traders to trade almost instantly across a wide variety of products and in markets around the world.

Such innovations have been driven by the benefits global markets provide investors and enterprises. Investors now have access to a diverse array of investment opportunities and at

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<sup>1</sup> LC Thomsen, Former Director of Enforcement at the SEC “US experience of Insider Trading Enforcement actions” Speech by SEC Staff: Remarks before the Australian Securities and Investments Commission 2008 Summer School, Melbourne, February 19, 2008, online: <http://www.sec.gov/news/speech/2008/spch021908lct.htm>.

<sup>2</sup> From US\$11 trillion in 1990 to US\$54 trillion in 2010, see McKinsey Global Institute “Mapping global capital markets 2011”, August 2011, online: [http://www.mckinsey.com/mgi/publications/Mapping\\_global\\_capital\\_markets/index.asp](http://www.mckinsey.com/mgi/publications/Mapping_global_capital_markets/index.asp) at 13.

<sup>3</sup> Further details on these changes are set out in Chapter 2.

the same time enterprises can issue a variety of securities in different markets which may have the effect of lowering their cost of capital to expand.<sup>4</sup>

However there can be negative ramifications on markets as they become more international in scope. For example, the Global Financial Crisis clearly demonstrated that problems in markets cannot now be easily quarantined and troubles in one market can now rapidly spread to other markets around the world.

This dissertation seeks to investigate another issue which may have emerged in the wake of these dramatic changes to the markets. This is whether these changes have resulted in a weakening of the system of enforcing regulations which protect the integrity or fairness of the markets. This dissertation argues that the changes to the markets have weakened the ability of regulators to take action against unfair trading practices, such as insider trading and market manipulation, and as such this threatens the integrity of the markets as a whole.

Securities regulators protect the integrity of the markets through laws and regulations. Importantly such laws prohibit unfair trading practices, such as insider trading and market manipulation. When such unfair trading practices are detected, securities regulators can take enforcement action against those that violate these laws and thereby hopefully deter others from engaging in such practices. Given the changes to the markets and the increased capacity to trade across borders, the question becomes whether this has given rise to new forms of insider trading and market manipulation? Furthermore, are there now greater opportunities to engage in insider trading and market manipulation spanning jurisdictions in order to avoid detection and/or prosecution? If these questions are answered in the affirmative, how have regulators responded? Is that response sufficient? Has the integrity of the markets been preserved?

In exploring these issues this dissertation seeks to obtain answers to a number of related questions. First and most fundamentally why is preserving market integrity important?

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<sup>4</sup> For example the level of holdings of foreign equities has increased from approximately US\$1 trillion in 1990 to \$14 trillion in 2010. Purchases of foreign equities were \$670 billion in 2010, see McKinsey Global Institute, *supra*, note 2 at 6 and 31-33.

Second what are these changes to the markets and have these changes altered the types of unfair practices which could threaten the integrity of the markets? In other words have new and different types of market manipulation and insider trading conduct appeared in the wake of these changes and do such violations now more frequently straddle jurisdictional boundaries? Third if such changes have occurred, how are securities regulators responding to them and to the new threats they pose? Do they have the capacity in terms of detection, investigation and enforcement tools to robustly tackle securities offences which extend beyond their jurisdiction? Can the effectiveness of such regulators be improved? If so does this require a global approach to the problem and how will such an approach be implemented?

### **Market Integrity**

A key concept in this dissertation is that of market integrity. This is because if it is in fact true that the changes to the markets have increased the threat of insider trading and market manipulation, these forms of misconduct would present a challenge to capital markets if not effectively addressed. This is due to the fact that any increase in unfair trading practices may, over time, cause a reduction in market integrity and thereby decrease investor confidence with the effect that the flow of capital into those markets will be reduced.<sup>5</sup> As such any assault upon market integrity has a direct impact upon investors and listed entities.

However the impact of threats to market integrity is not limited to investors and listed entities. Securities markets are vital mechanisms by which companies can access finance to grow and develop and therefore absolutely critical to the economic and therefore social development of a country or even a region.

Because of the importance of capital markets to the economy and a nation generally, there is a strong public interest in maintaining the integrity of securities markets. As such most

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<sup>5</sup> Previous instances of disclosed market abuse have impacted upon markets, reducing market valuations and shaking investor confidence. For example there was manipulation and insider trading associated with the collapse of Enron in 2001, see generally Paul M Healy and Krishna G Palepu "The Fall of Enron" (2003) 17:2 *Journal of Economic Perspectives* 3 and William W Bratton "Enron and the Dark Side of Shareholder Value" (2002) 76 *Tul L Rev* 1275.

regulators of securities markets around the world have as a key objective a requirement to work towards the protection of market integrity or market fairness.<sup>6</sup> This, coupled with the goal of promoting efficient capital markets, are the two core functions of securities regulators. However these two goals are, to at least some extent, linked. This is because some studies have shown that markets which lack integrity may not be as efficient as those which have a high level of market integrity.<sup>7</sup> It appears that this may be because a deficiency in market integrity in turn reduces investor confidence in the market, investors being wary of investing in a market which is not considered fair for all participants with the result that the liquidity of the market concerned is reduced. Inefficient markets also have the effect of raising the cost of capital of listed entities.

### **Market Abuse and Market Integrity**

One of the main ways in which securities regulators seek to comply with their core function of protecting the integrity of the markets is to eliminate, or at least suppress, market abuse. Market abuse refers to actions which unfairly take advantage of other participants in the market or actions which give a false appearance of the price or trading of securities. It consists first of insider trading, also known as insider dealing. In brief, insider trading can be defined to encompass the actions of a person or entity in taking advantage of their access to non-public information by either trading on the basis of that information, or passing it on to others who in turn trade on that information.<sup>8</sup> Market abuse also encompasses various acts designed to mislead or manipulate the market with the effect that the market no longer properly reflects the genuine forces of supply and demand. Collectively these acts to mislead or manipulate the market are known as market manipulation.<sup>9</sup> Market manipulation occurs

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<sup>6</sup> The concept of market integrity is explored more fully in chapter 2.

<sup>7</sup> These studies are discussed in chapter 2.

<sup>8</sup> The breadth of use of inside information which may be prohibited differs between jurisdictions. See generally E Avgouleas *The Mechanics and Regulation of Market Abuse, A Legal and Economic Analysis* (Oxford: Oxford University Press, 2005).

<sup>9</sup> See Avgouleas, *supra* note 8 at 4 and P Barnes *Stock Market Efficiency, Insider Dealing and Market Abuse* (Farnham, Surrey, GBR: Ashgate Publishing Group, 2009) at 9.

when a person engages in misconduct which leads to false impressions about the price of securities which could lead to distorted valuations or artificially inflated or deflated prices.<sup>10</sup>

Although market abuse incorporates both insider trading and market manipulation, it is not a term of art and could also be more broadly defined to include a wide range of dishonest or fraudulent practices which may in some way have a negative impact upon investors. However, the definition of market abuse which will be used in this dissertation is limited to insider trading and market manipulation because these are the actions which impact directly upon the integrity of the markets.<sup>11</sup> This definition is also consistent with the definition of market abuse as set out in first European Union Directive on Market Abuse.<sup>12</sup>

In their role of protecting markets from market abuse, securities regulators are charged with taking enforcement action against such abuse. Although there is debate about how rigorous and punitive such enforcement has to be to achieve compliance, there appears to be a growing consensus, based upon empirical evidence, that at least some level of enforcement is necessary.<sup>13</sup> As such, the G20 group of countries has listed effective enforcement of rules surrounding the financial markets as one aspect of strengthening global financial stability.<sup>14</sup>

### **Cross Border Market Abuse**

This dissertation will seek to explore the question of whether the changes to the markets that have taken place over the last few decades have created new avenues to engage in market

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<sup>10</sup> Avgouleas, *supra* note 8 at 4.

<sup>11</sup> Other types of dishonest behaviour involving securities are not considered as part of this dissertation because they do not directly mislead or affect the market for securities. For example one dishonest practice associated with securities, but not considered here, is the practice known as ‘churning’. This consists of excessive trading in a client’s account by a broker wishing to maximize commissions regardless of the client’s best interests. While this type of activity is dishonest and impacts upon the broker’s client, this practice does not directly impact upon the integrity of the market. Similarly the dishonest activity when persons are contacted, usually ‘cold called’, and sold securities not listed on any exchange is not included within the definition of market abuse in this dissertation. However, where persons are sold securities on an exchange and the price is manipulated this is included.

<sup>12</sup> EU, *Commission Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse)* [2003] OJ, L96/16. This directive states (at (12)):  
“Market abuse consists of insider dealing and market manipulation. The objective of legislation against insider dealing is the same as that of legislation against market manipulation: to ensure the integrity of Community financial markets and to enhance investor confidence in those markets.”

<sup>13</sup> For further details see discussion contained in Chapter 2.

<sup>14</sup> See G20 Working Group 1 “Enhancing Sound Regulation and Strengthening Transparency Final Report”, 25 March 2009, online: < <http://cdm16064.contentdm.oclc.org/cdm/ref/collection/p266901coll4/id/2932> > at 45.

abuse that straddles international boundaries and whether this can result in opportunities to avoid detection, investigation or prosecution.

Insider trading and market manipulation straddling such international boundaries will be referred to in this dissertation as 'cross border market abuse'. This comprises instances of market abuse where all of the acts, events or activity that constitute the market abuse do not take place within just one jurisdiction but rather spans two or more jurisdictions. This could involve, for example, a person with material insider information in one jurisdiction placing an order on an exchange in another jurisdiction. It could also involve improperly exploiting markets located in different jurisdictions. For example market manipulation of cross listed securities in the form of wash sales taking place across different markets.<sup>15</sup>

### **National Securities Regulators but International Markets**

Despite the changes to the markets and the trading of securities, the regulation of securities markets is still discharged at the national or even provincial level. The enforcement of serious market abuse offences is also still undertaken by national securities regulators, sometimes with the assistance of self-regulatory bodies.<sup>16</sup> This status quo is likely to continue because the establishment of a global body to regulate and supervise the markets would require nations to surrender regulatory and/or enforcement powers to some form of supranational body. It is highly improbable that most countries would agree to such change because of political and constitutional considerations.

Yet the supervision of the markets by the regulators of individual countries gives rise to potential difficulties if those regulators detect an increasing frequency of cross border market abuse but in circumstances where their detection, investigation and enforcement powers are limited to their home jurisdiction. In some cases there may not be a sufficient jurisdictional connection to allow the regulator to take action or the regulator may not be able to obtain the

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<sup>15</sup> See D Cumming and S Johan "Global Market Surveillance" (2008) *American Law and Economics Review* 454 at 464 for some examples of cross-market manipulation.

<sup>16</sup> In Canada securities are regulated at the provincial or territorial level, although many market regulatory functions are delegated to a national self-regulatory body, the Investment Industry Regulatory Organization of Canada (IIROC).



required evidence and testimony to complete the investigation from outside of the jurisdiction.<sup>17</sup> Furthermore cross border market abuse may prove more difficult for a country's securities regulator to detect than market abuse that takes place solely within the confines of its own jurisdiction. This is because constraints in the scope of regulator's powers may result in the investigation not making the necessary links between, for example, an insider and the person who eventually trades on the basis of that insider information.

Some of these difficulties may be able to be addressed by enacting legislation to extend the extraterritorial reach of the securities regulator's jurisdiction and powers. But this, by itself, is unlikely to be enough. The involvement and cooperation of other agencies in foreign countries will almost certainly be required to effectively tackle many cases of cross border market abuse. In addition, despite the fact that countries are unlikely to surrender powers to a supranational body, an international organization, such as the International Organization of Securities Commissions (IOSCO) may be able to play an important role in coordinating the international enforcement activities of securities regulators.

### **Methodology – researching cross border market abuse**

As referred to above this dissertation seeks to examine how the markets have become more sophisticated and whether, because of these changes, there has been a transformation in the types and instances of market abuse and, in particular, cross border market abuse. This dissertation also considers whether or not regulators enforcement efforts are keeping pace with these changes.

In relation to the changes to the markets and the regulatory response to such changes, documentary and archival research was undertaken to identify the main developments that have occurred to securities markets over the last few decades. Similarly documentary research was undertaken to detail the principle changes that have been made in relation to

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<sup>17</sup>See for example *R v Libman* [1985] 2 S.C.R. 178 which delineates limits of the jurisdiction of Canadian Courts in relation to criminal offences where part of the activity took place outside of Canada.

laws, regulations and policy which may impact upon the securities regulators ability to stop market abuse and cross border market abuse.

Determining what is occurring in relation to cross border market abuse in the face of the changes to the markets presented the most challenging aspect of this research. Obviously no one who has successfully engaged in market abuse without detection is likely to disclose this to anyone, including those conducting research in this area. As such currently information in relation to what is occurring in relation to cross border market abuse can only be gleaned from two sources. First instances of cross border market abuse that have been detected and reported by securities regulators and second, unusual activity that is detected in markets which is not explained by the ordinary forces of supply and demand. Both methods have their limitations.

Attaching significance to the number of matters detected by securities regulators is problematic because the cases detected may not be a true reflection of the actual extent of market abuse. One concern is that current detection methods may not be sophisticated enough to detect such abuse. In addition, for those conducting research into this area, information on matters detected may not be available for analysis due to privacy constraints and also because regulators generally do not report on cases detected but ultimately not pursued. Information on the number of reported cases may also be misleading as such cases may just reflect cases that are selected for investigation rather than all those that are detected. Case selection may in turn be affected by considerations such as the priorities of the regulator, the likelihood of success and/or the investigative and prosecutorial resources available. Furthermore it could be hypothesised that a regulators' response could also be manipulated if, for example, there is a temptation for it to artificially inflate the problem to increase its resources and power. Alternatively a regulator may decide to downplay the problem in order to avoid criticism that it is not effectively addressing the issue.

The second source of information on cross border market abuse, that is unusual activity detected in markets, also has a number of shortcomings. These include the fact that the

detected unusual activity may not be an indication of illegal activity. For example unusual price increases before a takeover announcement may indicate insider trading but may equally indicate that market participants merely accurately identified this company as a takeover target. This data may also not indicate the source of the market abuse or whether it is limited to one jurisdiction.

Despite its limitations, the focus of this dissertation is the first source of information, that is, market abuse reported by regulators. However some reference is made to current research in relation to the second source, that is, measured unusual activity. Mindful of the limitations of drawing conclusions from this first source of information, this dissertation seeks to only ascertain if regulators are detecting more cross border market abuse, *not* if there is an increase in the overall level of cross border market abuse. In addition to ascertaining whether regulators are detecting more cross border market abuse this dissertation attempts to identify what barriers may still obstruct the detection of cross border market abuse.

In considering the information reported by regulators, this dissertation draws upon a combination of methodologies. In this way it is hoped that a more accurate picture of what is occurring in relation to cross border market abuse and its detection and enforcement has emerged, first by an examination of the different legislative frameworks and second by way of interviews conducted with enforcement staff from securities regulators in each of these five jurisdictions namely Canada, UK, USA, Australia and Germany. These countries are home to 50% of the world's capital markets in terms of market capitalization.<sup>18</sup> The principal securities regulators interviewed in these countries are Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) in Germany, the Financial Conduct Authority (the FCA, formally the Financial Services Authority (FSA)) in the UK, the Australian Securities and Investments Commission (ASIC) in Australia and the US Securities and Exchange Commission (the SEC). In Canada securities regulation is undertaken by provincial

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<sup>18</sup> All of these jurisdictions are in the top eight in the world in terms of market capitalization. Specifically the US makes up 36% of the world capital markets, the UK 6 %, Canada 4 %, Germany 3% and Australia 2%, see The World Bank, "The World Data Bank - Market Capitalization of listed companies", online: <<http://data.worldbank.org/indicator/CM.MKT.LCAP.CD> >.

securities regulators. However the largest of these is the Ontario Securities Commission (the OSC). It was this regulator which was interviewed. In addition because of the importance of self-regulatory organizations in Canada and the USA, staff from the two primary self-regulatory bodies in these jurisdictions were also interviewed. These organisations are the Investment Industry Regulatory Organization of Canada (IIROC) and the Financial Industry Regulatory Authority (FINRA). The results of these interviews were subjected to a comparative analysis with a view to identifying common themes

To reinforce this analysis documentary and archival material published by the securities regulators from Canada, UK, USA, Australia and Germany was reviewed. The material analysed in relation to these securities regulators consisted of annual reports for the 10 years from 2004 to 2013 together with, where available, individual case reports on enforcement action taken in relation to cross border market abuse. In Canada the reports reviewed were from the OSC, the British Columbia Securities Commission (BCSC) and the Canadian Securities Administrators (CSA)<sup>19</sup> In addition to collating and analysing this information this material was also subjected to a comparative analysis with a view to identifying common themes.

Finally an examination was undertaken of the main international organization involved in assisting securities regulators coordinate their activities to take action against cross border market abuse, namely IOSCO. IOSCO has developed a framework for securities regulation and is also involved in developing policy which can be adopted by securities regulators to address emerging issues in securities regulation. In addition IOSCO has developed a Multilateral Memorandum of Understanding (MMoU) which is proving to be a key tool which can be utilized by securities regulators to exchange the information required for their enforcement activities. Documentary and archival research was undertaken on this organization and the MMoU and supplemented by an interview with staff from the IOSCO General Secretariat.

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<sup>19</sup> See Chapter 4 as to the exact material that was examined from Canadian Securities Regulators.

## **Structure and Organization of Chapters**

This dissertation is divided into the following six chapters:

### Chapter 1

This chapter consists of a review of the existing literature pertaining to key issues discussed in this dissertation. As such this chapter explores what is meant by market integrity or market fairness, the importance of these concepts to capital markets as well as the elimination of market abuse. In addition, as this dissertation is premised upon the basis that securities regulators should take enforcement action against market abuse, the literature in relation to the importance of public enforcement for the enhancement of market integrity is also examined in detail.

### Chapter 2

This chapter surveys the changes to securities markets that have taken place over approximately the last two decades. It considers why these changes occurred and how these changes may have impacted upon market abuse and its frequency. It also considers the difficulties these changes may have caused for securities regulators in terms of the detection, investigation and prosecution of market abuse and cross border market abuse. Finally this chapter considers the regulatory responses of certain governments to the changes and how these new laws may prevent market abuse as well as assist regulators in their efforts to detect, investigate and prosecute market abuse.

### Chapter 3

This chapter is an analysis of the issues in this dissertation from interviews conducted by the author with senior personnel employed by securities regulators involved in the conduct of investigations into possible market abuse. The impact of these changes to detection, investigation and enforcement of cross border market abuse is considered further along with the challenges faced by securities regulators in terms of their investigative methods and how they have adapted to these challenges. This chapter also endeavours to analyse these

responses in relation to whether it appears that such regulators detection and enforcement methods are satisfactory in light of the complexity of the markets.

#### Chapter 4

This chapter builds on the analysis in chapter 3 from a review of publically available material published by the principal securities regulators of Canada, UK, USA, Australia and Germany. This chapter examines trends in the types of cross border market abuse cases that have emerged over the ten years from 2004 until 2013. The chapter concludes by making some recommendations about strategies which might possibly be adopted to improve the prospects of regulators successfully meeting these challenges.

#### Chapter 5

Because of the key role the IOSCO now plays in the investigation and enforcement of cross border market abuse, this chapter examines IOSCO in depth. It sets out how IOSCO rose in prominence as a global network of securities regulators and how the IOSCO MMoU was formed. The terms and conditions of the MMoU are considered together with how this MMoU is being utilized by securities regulators in their investigations. This chapter also considers how the MMoU is being utilized by IOSCO in its efforts to move towards global convergence of securities regulation.

#### Chapter 6

Given the success of IOSCO, particularly with respect to the MMoU, this chapter considers how IOSCO might build upon that success as well as possible challenges that may arise with respect to the MMoU going forward. In addition this chapter suggests other ways in which IOSCO could further assist in coordinating the activities of securities regulators in terms of tackling cross border market abuse by way of specific policies that might be developed.

In the absence of supranational global securities regulator, this chapter also reflects upon how IOSCO might work to fill this gap and, in particular, what other roles it could play beyond

the expansion of the MMoU and policy development. In particular, given its success with respect to the MMoU, this chapter suggests other systems and tools which IOSCO could possibly develop which could be used by securities regulators in their efforts to detect, investigate and prosecute market abuse. Finally, this chapter also considers whether, if such systems could be developed, they could be used by IOSCO as a lever to work towards the convergence of securities regulation around the world.

In the conclusion I reflect upon the findings that flow from the previous chapters. This analysis reveals that the changes in the markets over the last decade do appear to have given rise to new avenues to engage in cross border market abuse. Securities regulators are detecting more complex instances of cross border market abuse and have taken some steps to address this issue. It will be argued that there is more that can be done to confront this issue. As such I conclude this dissertation by making suggestions about how this might best be achieved.

## CHAPTER 1

### THE IMPORTANCE OF TAKING ENFORCEMENT ACTION AGAINST MARKET ABUSE

Economic theory suggests that financial markets play a prominent role in the efficient allocation of capital resources and constitute the steam-engine of economic growth in the modern world. They are also, more than ever before, a very significant mechanism in the distribution of wealth between different social classes and countries. In this capacity, financial markets have acquired, for some commentators, the (often undesired by its actors) status of a social institution. The orderly operation of any social institution entails not only that it functions legally and all those involved with it uphold the law and engage in lawful practices, but also that it is vested with a certain degree of legitimacy. The occurrence of market abuse make financial markets look like a 'crooked crap game', diminishing their legitimacy and harming, in the process, the way investment is channelled to productive uses on an international scale.

E Avgouleas *The Mechanics and Regulation of Market Abuse, A Legal and Economic Analysis*<sup>20</sup>

The following chapters consider how securities markets have changed over the last few decades and what has been the impact of these changes on the nature of market abuse that is now occurring in these markets. The response of securities regulators, in terms of how it is now detecting, investigating and prosecuting market abuse, is also considered. However the importance of such an examination is premised upon the basis that it is necessary for regulators to eliminate, or at the very least, reduce market abuse by deterring market participants from engaging in market abuse, ensuring that the markets are monitored for market abuse and taking enforcement action against market abuse that is detected. This chapter examines this underlying foundation, namely, why protecting markets from market abuse is important and why taking enforcement action against detected instances of market abuse is necessary.

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<sup>20</sup> Avgouleas, *supra* note 8 at 4-5.



As will be explored in this chapter, the main rationale for eliminating market abuse is that it is necessary to preserve the integrity of the markets. However this in turn raises the issue of what is exactly is market integrity and why is it important. This issue, namely what is market integrity, will also be considered in this chapter. Market integrity lies at the very foundation of securities regulation. Securities regulations have been enacted in most countries with a view to promoting and protecting the integrity of the securities markets. Securities regulators are in turn charged with the responsibility for administering and enforcing these regulations. Whilst securities regulations restrain the activities of individuals and enterprises such regulations are believed to be in the public interest to protect the overall integrity of the markets.

In examining these issues Part 1 of the chapter outlines the goals of securities regulators in relation to promoting market integrity or market fairness. These goals are described together with an examination of the literature that seeks to define what is market integrity or market fairness. This part then moves on to establish the link between market integrity and the elimination of market abuse. Part 2 considers the rationale behind the prohibition of market abuse practices such as insider trading and market manipulation. Part 3 analyses whether merely outlawing market abuse is sufficient, or whether it is necessary that such laws be enforced and, if so, whether public enforcement is more important than private enforcement. Part 4 then looks at the difficulties of enforcement of market abuse for regulators, and starts to consider how enforcing prohibitions against market abuse across borders may pose particular challenges for securities regulators.

## **Part 1 Market Integrity and Market Abuse**

### **What is Market Integrity?**

Most securities regulators of developed capital markets assert that protecting the integrity of the markets (or 'market Integrity') is a key component of an effective capital market. Yet a review of the literature shows that although this term is often used as an important component of a capital market, its actual meaning appears to be somewhat fluid. The Oxford

dictionary defines “integrity” as “honesty” or “soundness”. In terms of capital markets and what is required to protect the soundness of those markets, the concept of ‘market integrity’ seems to have acquired a meaning that ranges along a spectrum. This extends from the mere elimination of identified dishonest practices in the market at one end to ensuring the market is fair for all participants at the other. Furthermore, arriving at a fixed definition is made more complex by the fact that another key goal of securities regulators, that is, the goal of ‘investor protection’, may be a stand-alone objective, or may form part of what is required to protect market integrity.

Despite the fluidity of this term, most securities regulators, either expressly or implicitly, have the protection of the integrity of the capital markets as one of their key objectives. However not all refer specifically to ‘market integrity’ as the goal. Instead their objectives are often framed as maintaining market fairness or maintaining market confidence, or these objectives are somehow combined.

For example, in the United States the emphasis is on the protection of market ‘fairness’. The Securities and Exchange Commission’s (SEC) stated mission is “to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.”<sup>21</sup> The *Securities Act*<sup>22</sup> and the *Securities Exchange Act*<sup>23</sup> (*Exchange Act*) form the framework for regulation of markets in that country. The *Securities Act* provides that the SEC, in exercising its powers under that Act, should consider “in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”<sup>24</sup> The *Exchange Act* sets out the reasons for the legislation, including that:

transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto,

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<sup>21</sup> Securities and Exchange Commission, “The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation”, online: Securities and Exchange Commission <<http://www.sec.gov/about/whatwedo.shtml>>.

<sup>22</sup> *Securities Act*, 15 USC § 77 (1933).

<sup>23</sup> *Securities Exchange Act*, 15 USC § 78 (1934).

<sup>24</sup> *Securities Act*, 15 USC § 77b at (b) (1933).

including transactions by officers, directors, and principal security holders, to require appropriate reports, to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for the clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of *fair and honest* markets in such transactions.<sup>25</sup> [Emphasis added]

The *Securities Act* and the *Exchange Act* were first introduced as a response to the stock market crash of 1929 and the Great Depression that followed. Congress had two key concerns necessitating the need for this legislation. First, investors had been cheated because of market abuse, namely, widespread manipulation of stocks in the markets.<sup>26</sup> Second, the Great Depression had been exacerbated by a lack of investor confidence in returning to the markets after the stock market crash, hindering the capacity of corporations to raise capital.<sup>27</sup>

Similarly, regulators in Canada do not specifically have the preservation of market integrity as a required objective. Rather, the emphasis in Canada is on fostering market ‘fairness’. For example, in Ontario, the purposes of the *Ontario Securities Act*<sup>28</sup> are:

- (a) to provide protection to investors from unfair, improper or fraudulent practices; and
- (b) to foster fair and efficient capital markets and confidence in capital markets.<sup>29</sup>

The Ontario Securities Commission, which administers and enforces this Act, is directed in the Act as to how to achieve the purposes of the Act. It is directed to set requirements for

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<sup>25</sup> *Securities Exchange Act*, 15 USC§ 78b.

<sup>26</sup> The House Report accompanying the Securities Act of 1933 examined the decade after World War I and concluded: “Fully half or \$25,000,000 worth of securities floated during this period have been proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities.” H.R. Rep. No. 85, 73d Cong., 1<sup>st</sup> Sess. 2 (1933) as quoted in John C Coffee Jr & Hilary A. Sale, *Securities Regulation Cases and Materials*, 11<sup>th</sup> ed. (New York: Thomson Reuters/Foundation Press 2011) at 2.

<sup>27</sup> *Ibid.*

<sup>28</sup> *Ontario Securities Act*, RSO 1990, c S.5.

<sup>29</sup> *Ibid* at s 1.

timely, accurate and efficient disclosure of information, to restrict fraudulent and unfair market practices and procedures and to set requirements for the maintenance of high standards of fitness and business conduct in order to ensure honest and responsible conduct by market participants.<sup>30</sup>

The objectives of the securities regulator for the United Kingdom, the Financial Conduct Authority (FCA), also do not specifically include the protection of market integrity. Rather, the Act that it administers and enforces requires it to work towards maintaining confidence in the UK financial system, protecting consumers and reducing financial crime.<sup>31</sup> However, the United Kingdom has incorporated the Market Abuse Directives (MAD) of the European Parliament and Council<sup>32</sup> within in its legislation. The first MAD set out a framework whereby each country in the European Union was required to legislate to prohibit market abuse, encompassing insider trading, market manipulation and front running. It also made specific reference to market integrity, and linked this to the elimination of market abuse and market confidence. The preamble of the MAD provided that:

An integrated and efficient financial market requires market integrity. The smooth functioning of securities markets and public confidence in markets are prerequisites for economic growth and wealth. Market abuse harms the integrity of financial markets and public confidence in securities and derivatives.<sup>33</sup>

Further on in the preamble, however, the MAD indicated that market integrity and enhancing investor confidence are separate goals, although the elimination of market abuse is relevant to both:

Market abuse consists of insider dealing and market manipulation. The objective of legislation against insider dealing is the same as that of legislation against market manipulation: to ensure

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<sup>30</sup> *Ibid* at s 2.1.

<sup>31</sup> *Financial Services and Markets Act* (UK), 2000, c 8, ss 3-6.

<sup>32</sup> MAD, *supra* note 12.

<sup>33</sup> *Ibid* at (2).

the integrity of Community financial markets and to enhance investor confidence in those markets.<sup>34</sup>

The stated objectives of Germany's securities regulator, BaFin, more closely follow this directive. BaFin frames its objective as "to ensure the transparency and integrity of the financial market and the protection of investors."<sup>35</sup> Specifically, the Act that BaFin administers and enforces gives BaFin wide powers. This includes the power to issue orders that are appropriate and necessary to eliminate or prevent undesirable developments that may be detrimental to the stability of financial markets or undermine confidence in the proper functioning of financial markets.<sup>36</sup>

The principles promulgated by IOSCO in its key policy statement, the *Objectives and Principles of Securities Regulation*, also only mentions market fairness. The principles are:

- The protection of investors;
- Ensuring that markets are fair, efficient and transparent;
- The reduction of systemic risk.<sup>37</sup>

IOSCO sees fairness and investor protection as separate goals, although fairness is linked to investor protection by the elimination of market abuse. In 2011, the IOSCO Technical Committee defined "market integrity" as "the extent to which a market operates in a manner that is, and is perceived to be, fair and orderly and where effective rules are in place and enforced by regulators so that confidence and participation in the market is fostered".<sup>38</sup>

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<sup>34</sup> *Ibid* at (12).

<sup>35</sup> BaFin, "Securities Supervision", online: BaFin <[http://www.bafin.de/EN/BaFin/FunctionsHistory/SecuritiesSupervisionAssetManagement/securitiessupervisionassetmanagement\\_node.html](http://www.bafin.de/EN/BaFin/FunctionsHistory/SecuritiesSupervisionAssetManagement/securitiessupervisionassetmanagement_node.html)>.

<sup>36</sup> *Wertpapierhandelsgesetz [WpHG, Securities Trading Act]*, 9 September 1998 (Federal Law Gazette I, p 2708), as amended by Article 3 of the Act of 22 June 2011 (Federal Law Gazette I, p 1126) at s 4, online: <[http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg\\_101119\\_en.html](http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg_101119_en.html)>.

<sup>37</sup> See IOSCO, *Objectives and Principles of Securities Regulation* (June 2010), online: IOSCO <<http://iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>> at 3. These goals may conflict, which may cause difficulties in deciding on a regulatory solution; see Chester S Spatt, "Regulatory Conflict: Market Integrity vs. Financial Stability" (2009-2010) 71 U Pitt L Rev 625.

<sup>38</sup> IOSCO Technical Committee, "Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency", Final Report, (October 2011), online: IOSCO <<http://iosco.org/library/pubdocs/pdf/IOSCOPD361.pdf>> at 9.

IOSCO seems to view fairness as a broad concept, incorporating not only the elimination of dishonest practices but also encompassing a need to promote equal access to markets:

The regulator's approval of exchange and trading system operators and of trading rules helps to ensure fair markets.

The fairness of the markets is closely linked to investor protection and, in particular, to the prevention of improper trading practices. Market structures should not unduly favor some market users over others. Regulation should detect, deter and penalize market manipulation and other unfair trading practices.

Regulation should aim to ensure that investors are given fair access to market facilities and market or price information. Regulation should also promote market practices that ensure fair treatment of orders and a price formation process that is reliable.<sup>39</sup>

### **Market Integrity, Market Confidence and Market Fairness**

As the above review demonstrates, there is little in the objectives of securities regulators which consistently delineates the meaning of market integrity, market confidence and market fairness, or how and if they are linked. This is probably deliberate to enable regulators the flexibility to tackle new problems that may arise. This flexibility enables them to justify that these problems fall within their domain, allowing them to take action.

It may also be that these three concepts, protecting market integrity, market confidence and ensuring that the market is fair, are just normative goals of securities regulators and there is no real distinction between them. Certainly it seems that in practice that these concepts would be closely linked and there may be no need to delineate them when a regulator or a legislature considers how these concepts should be reflected in the laws and practices applicable to a particular market. All three concepts would seem to require the elimination of market abuse, such as market manipulation and insider trading. Market fairness is, perhaps,

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<sup>39</sup> IOSCO "Objectives and Principles of Securities Regulation" (May 2003), online: IOSCO < <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf> > at 6.

the broadest concept and may require, in addition to the elimination of these practices, the promotion of disclosure, transparency and equal access to markets.

There also appears to be no precision in the literature as to what is encompassed within the concept of 'market integrity'. Finance academics tend to refer primarily to the concept of market integrity, rather than fairness, although market integrity is rarely defined or given a precise definition.<sup>40</sup> However conceptually it is linked with efficiency, in that a market of high integrity should also be efficient because prices will reflect their fundamental value. To finance scholars, the influence of the Capital Asset Pricing Model (CAPM) and the Efficient Capital Market Hypothesis (ECMH) leads to "a prediction that, in a[n] 'informationally efficient' market, prices will reflect as closely as possible the asset's 'fundamental value'."<sup>41</sup> If prices reflect an asset's fundamental value, this will result in the most efficient allocation of capital, as investors will pay no more for securities than their inherent value. As such, market integrity seems to mean eliminating practices that may interfere with the ability of prices to reflect the asset's fundamental value. If all material information in relation to a security has been publically disclosed, prices should reflect the asset's fundamental value incorporating all this information.

Using CAPM and ECMH, finance academics construct 'event' studies, the difference between the price of a security that has been the subject of an abnormal occurrence and what it would have been without such an event.<sup>42</sup> For example, as insider dealing is illegal, in theory prices before significant announcements should reflect their fundamental value incorporating all publically available information. After the announcement, the prices should almost immediately reflect their fundamental value incorporating this new information. If price

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<sup>40</sup> One exception is Utpal Bhattacharya, Hazem Daouk, Brian Jorgenson and Carl-Heinrich Kehr, who, writing in the *Journal of Financial Economics* in 2000, gave the definition of market integrity as "the disadvantages outsiders face vis-a-vis insiders when trading in the market. We expect that market integrity changes over time." This definition was given in the context of an event study measuring of the incorporation of information into prices in a capital market where insider trading laws were not enforced. See Utpal Bhattacharya et al, "When an event is not an event: the curious case of an emerging market" (2000) 55(1) *J Fin Econ* 69 at 72, n 4.

<sup>41</sup> Avgouleas, *supra* note 8 at 53.

<sup>42</sup> Avgouleas, *supra* note 8 at 53.

movements are 'abnormal' before significant announcements, this may be an indication of insider trading.

However, there is another body of literature, developed primarily in the legal discipline, which appears more concerned with the normative concept of 'fairness', independent of any issues of economic efficiency. The argument is that fairness is a necessary component of the capital market, either morally, or based on the concept that fairness is necessary for an effective market:

[M]arkets contain an internal morality, which both supplies the normative justification for market transactions and suggests that a successful market will be characterized by fair ground rules.<sup>43</sup>

As such, perhaps there is a distinction between market integrity and market fairness, if 'market integrity' means the elimination of practices which interfere with the accuracy of the prices of securities and market fairness is the set of rules of a market which reflect what is culturally acceptable. The practical impact of the difference is that it may dictate whether or not certain practices should be prohibited. If our only concern is whether the markets are 'fair' for participants and that the laws and procedures reflect this as a norm, it does not matter whether or not these laws and procedures make the market more efficient. However, if we are concerned with market integrity, in the sense that prices in the market fully reflect information and thereby contribute to efficient capital markets, then the whole issue of the impact of certain laws and procedures on market efficiency does become a concern.

## **Part 2 The Rationale behind Prohibiting Insider Trading and Market Manipulation**

Notwithstanding whether a narrow definition of market integrity suggested by the finance literature is adopted, or a broader definition suggested by the legal literature is adopted, there is a strong case to eliminate market manipulation in the interests of maintaining the normative concept of fairness in the markets, as well as ensuring prices reflect their fundamental value. In relation to insider trading, the case is less clear, however, it would

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<sup>43</sup> See e.g. Ian B Lee, "Fairness and Insider Trading" (2002) 2002:1 Colum Bus L Rev 119 at 142.



seem now that the preponderance of the literature supports the proposition that insider trading damages the fairness of the markets as well as its efficiency.

### **Market Manipulation**

The regulation of market manipulation and the rationale for why it is prohibited is not controversial. Clearly manipulation, such as making false statements or engaging in fictitious trades, are normatively 'unfair' as they mislead market participants as to the genuine forces of supply and demand. Nor does market manipulation contribute to efficient capital markets as these practices interfere with proper price formation of securities, which can result in inefficient allocation of resources.<sup>44</sup> Losses incurred by investors from market manipulation are also relatively easy to determine.<sup>45</sup> Furthermore from a cost/benefit standpoint, public regulation of market manipulation can be supported because, absent perhaps serious violations, it is usually not feasible for the victims of market manipulation to take private action due to the difficulties and costs involved in the detection and enforcement of such securities violations.<sup>46</sup>

The main area of controversy seems to be in relation to how market manipulation should be defined and, accordingly, the breath of the prohibition.<sup>47</sup> Should it, for example, extend beyond fictitious trades to actual trades where the trade was made with manipulative intent?

### **Insider Trading**

However, the debate is less clear in relation to insider trading and whether it should be prohibited. Some argue that insider trading operates against market efficiency and should not be prohibited. This debate has been captured succinctly by Lawrence Ausubel:

The classic law-and-economics view on insider trading can be briefly summarized as follows.

Insider trading is banned today out of considerations of fairness. In an unregulated environment,

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<sup>44</sup> Avoguleas, *supra* note 8 at 211.

<sup>45</sup> *Ibid.*

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

<sup>47</sup> See e.g. D R Fischel & D J Ross, "Should the Law Prohibit "Manipulation" in Financial Markets" (1991) 105 Harv L Rev 503.

insiders might be able to earn trading profits by utilizing information that outsiders cannot legally obtain. Out of some sentimental attachment to fairness, we enact insider trading regulations in order to level the securities market playing field, so that all traders have relatively equal access to information. Unfortunately, considerations of economic efficiency work in the opposite direction as those of fairness. First, if insiders are permitted to trade freely on their private information, then information becomes more rapidly reflected in securities prices. Insider trading thus contributes to efficient markets and so to allocational efficiency, as proper capital-asset pricing leads to the optimal allocation of capital resources.<sup>48</sup>

Most of the arguments in favour of allowing insider trading can be traced back to Henry Manne's seminal writings in 1966.<sup>49</sup> Since that time, these theories, sometimes referred to as 'Coasian theories',<sup>50</sup> have developed such that those law and economics scholars who argue against regulating insider trading can be divided into two categories:

Law and economics theories about insider trading fall into two main categories: agency theories and market theories of insider trading. Agency theories of insider trading analyse its effect on the classic corporate agency problem, the manager-shareholder conflict of interest. These theories consider whether insider trading ameliorates or worsens this conflict, and therefore whether it increases or reduces firm-level efficiency. In contrast, market theories of insider trading address its broader ramifications for market efficiency.<sup>51</sup>

The basic premise of the agency theories is that insider trading could act as an efficient compensation mechanism for managers.

In their view, relying on capital and product markets to properly incentivize managers is insufficient because these managers work imperfectly, making it relatively difficult to remove poor performing managers. Ex ante compensation contracts are inadequate because they would require costly

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<sup>48</sup> Lawrence M Ausubel, "Insider Trading in a Rational Expectations Economy" (1990) 80(5) Am Econ Rev 1022 at 1024.

<sup>49</sup> Henry G Manne, "In Defence of Insider Trading" (1966) 44 HBR 114. Henry G Manne most recently expressed his view in an article in the National Post, see Henry G Manne "The New Prohibition; Prohibiting insider trading makes even less sense than prohibiting alcohol – and it is futile", National Post, 1 May 2014 at 9.

<sup>50</sup> So called because of their relationship to the theories of the Nobel Prize winning economist Ronald Coase of the Chicago School of Economics.

<sup>51</sup> LN Beny, "Insider Trading Laws and Stock Markets Around the World: An Empirical Contribution to the Theoretical law and Economics Debate" (2007) 32(2) J Corp L 237 at 241.

“periodic renegotiations ex post based on (imperfectly) observed effort and output....” In contrast, insider trading enables managers continually to update their compensation in light of new information without incurring renegotiation costs. Insider trading thus increases manager’s incentives by linking their “fortunes more closely to those of the firm”.<sup>52</sup>

Yet, critics of the agency theories disagree. Such critics point out that current compensation mechanisms, whilst by no means perfect, are superior to compensation based upon insider trading which would distort the motivations of managers to the detriment of shareholders and the market. Allowing insider trading by managers could motivate managers to manipulate the firm’s disclosure practices to accommodate their own self-interest.<sup>53</sup> In addition it would allow managers to profit from good or bad news, so allowing insider trading would not solve the agency problem, as the interests of the managers and the outside owners would not be aligned.<sup>54</sup> It is also doubtful that mutually advantageous contractual arrangements allowing for insider trading could be made between managers and owners. This is because of the difficulty of quantifying the costs and benefits of insider trading, the benefits of insider trading to a manager being limited perhaps only by the personal wealth of the manager who could use leverage and derivatives to amplify their profits. Furthermore, there are inherent problems with requiring large numbers of (often passive) owners to constrain their managers’ insider trading successfully by way of contract alone.<sup>55</sup>

For those who argue that insider trading may be economically efficient (market theories), the hypothesis is that if insider trading is allowed, prices will be more accurate, in the sense that they will more quickly reflect information about a particular stock. This, in turn, improves economic efficiency:

More accurate prices can increase the amount of value added by firms as they use society’s scarce resources for the production of goods and services. In a competitive economy, the increase

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<sup>52</sup> Beny, *Ibid* at 242-243, summarising the work of Dennis W Carlton & Daniel R Fischel, “The Regulation of Insider Trading” (1983) 35 *Stan L Rev* 857.

<sup>53</sup> James D Cox, “Insider Trading and Contracting: A Critical Response to the “Chicago School” (1986) *Duke LJ* 628 at 643.

<sup>54</sup> *Ibid*.

<sup>55</sup> *Ibid* at 653-656.

in the value added will generally increase both the level of firm cash flow ... and returns to other factors of production ... by improving the quality of [capital allocation across] investment projects in the economy and by improving the operation of existing real assets.<sup>56</sup>

Nevertheless some empirical evidence seems to show that, even when systematic insider trading does occur prior to announcements, there is often still a significant change in the stock's price after the announcement. This suggests that insider trading is an imperfect price adjustment mechanism.<sup>57</sup>

However the main criticism levelled at market theories is that insider trading is not conducive to efficient markets as, if outsiders expect that insiders will take advantage of them, outsiders may choose to invest less or not at all.<sup>58</sup> As articulated by John Shad, a former Chairman of the SEC, "if people get the impression that they're playing against a marked deck, they're simply not going to be willing to invest".<sup>59</sup> An extension of this argument is that insider trading increases transaction costs and reduces liquidity as investors demand compensation for the risk of possibly trading with an insider.<sup>60</sup>

Up until recently those who argued that insider trading should not be prohibited could also point to the fact that there was no empirical evidence which showed that insider trading was actually harmful to efficient markets. Certainly individual instances of insider trading are difficult to detect within a market and, at a theoretical level, Manne argued that persons trading with insider traders do not suffer any harm.<sup>61</sup> However recent empirical work suggests that more stringent insider trading laws are economically efficient.<sup>62</sup> For example, a study undertaken by Laura Beny found that countries with such laws were associated with

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<sup>56</sup> Beny, *supra* note 51 at 246.

<sup>57</sup> Cox, *supra* note 53 at note 67.

<sup>58</sup> Ausubel, *supra* note 48 at 1038.

<sup>59</sup> SEC Chairman John Shad quoted in Paul Blustein, "Widening Scandal on Wall Street: Disputes Arise over Value of Laws on Insider Trading", *Wall Street Journal* (17 Nov 1986) 28, as quoted in Lee, *supra* note 43 at 138.

<sup>60</sup> Lee, *supra* note 43 at 138. Also see generally Robert A Prentice & Dain C Donelson, "Insider Trading as a Signaling Device" (2010) 47.1 Am Bus LJ 1.

<sup>61</sup> Manne, *supra* note 49.

<sup>62</sup> See also a number of studies listed in Prentice, *supra* note 60 at 68.

greater stock price accuracy, suggesting a more efficient market.<sup>63</sup> Beny also found that such countries also demonstrated greater stock market liquidity.<sup>64</sup> Like stock price accuracy, a more liquid market points to a more efficient market. A more liquid market has relatively low trading costs and this can reduce the cost of capital, resulting in more efficient capital allocation in the economy.<sup>65</sup> Beny postulated that her study cast doubt on the premise that insider trading prohibitions harmed market efficiency.<sup>66</sup>

Regardless of economic efficiency arguments others argue that insider trading should be banned because it is unfair. This argument is cast on a number of different premises. One is linked to economic efficiency, being that insider trading harms contemporaneous traders and thereby undermines investor confidence. This then results in a reduction in trading. Another comes from the law of fraud and rejects the need to ground the argument in economic theory.<sup>67</sup> This 'fraud' argument states that insider trading is a form of deception undermining the ability of investors to make an informed choice as to their investments. Linked to this is that insider trading usually results in a gain for the trader from improperly obtained information. Studler and Orrs argue that:

economic analysis is not the best approach to understanding insider trading because the core controversies in this area of law are really about ethics not economics. The hard problems in insider trading law are paradigmatically moral, such as whether nondisclosure of material non-public information deprives a participant in a public securities market of the ability to make an autonomous choice, or whether an insider securities trader uses information that is stolen, converted to an improper use, or otherwise morally tainted.

We do not say that economics is unimportant. On the contrary, ethics and economics seem strongly linked in securities regulation. Before arguing about economic costs and benefits, however, we maintain that a threshold issue should be addressed: whether the acts proscribed as insider trading are morally wrong. Even if economic arguments conclusively favored unfettered

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<sup>63</sup> Beny, *supra* note 51 at 279.

<sup>64</sup> *Ibid.*

<sup>65</sup> Beny, *supra* note 51 at 249.

<sup>66</sup> Beny, *supra* note 51 at 281.

<sup>67</sup> Avgouleas, *supra* note 8 at 202.

insider trading, moral arguments would potentially give an independent reason for prohibiting insider trading to "satisfy such noneconomic goals as fairness, just rewards, and integrity."<sup>68</sup>

Studler and Orrs believe insider trading should be prohibited because, like fraud or misleading conduct, it interferes with a person's autonomous decision-making and is unfair unless the person who has the information is protecting their legitimate property rights.<sup>69</sup>

More recently Ian Lee took this a step further by arguing that a successful market, to be Pareto efficient, must be governed by rules that are fair, and that such rules must preserve the voluntariness of the market respecting individual preferences and individual choice. As such, he draws from the work of Studler and Orrs that the autonomy of the parties must be respected and that exploiting "a party's informational disadvantage is inconsistent with respect for his or her autonomy".<sup>70</sup>

Critics of unfairness as a justification for insider trading laws believe that it is too vague a concept to ground market rules because of the variety of practices in financial markets:

[J]ustifying the prohibition of insider dealing on grounds of mortality and fairness has given rise to a perpetual struggle to formulate a comprehensive and workable approach to insider dealing regulation that will withstand the scrutiny of economic analysis and not ignore the reality of modern day financial markets.<sup>71</sup>

In addition, in the most jurisdictions, such as the US and Canada, the laws are structured so that only certain persons, not everyone, is prohibited from trading whilst in possession of insider information. For example in Ontario only persons who are in some form of special relationship with the issuer of the securities, or the source of the information is from someone who is in a special relationship and the person knew of the special relationship, are prohibited from trading.<sup>72</sup> In the US only persons who have information sourced from

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<sup>68</sup> A Studler & EW Orrs, "Moral Principle in the Law of Insider Trading" (1999) 78 Tex L Rev 375 at 376.

<sup>69</sup> *Ibid.*

<sup>70</sup> Lee, *supra* note 43 at 150.

<sup>71</sup> Avgouleas, *supra* note 8 at 195.

<sup>72</sup> In Ontario for a person to be guilty of insider trading, the person must be an insider (defined in s.1.1 *Ontario Securities Act*, RSO 1990, c S.5, s 7) of the corporation who issued the securities or is in a special relationship (defined in s.76(5) *Ontario Securities Act*, RSO 1990, c S.5, s 7) with the corporation who issued the securities.

someone who breached a fiduciary duty or misappropriated information are prohibited from trading.<sup>73</sup> If insider trading is unfair because it harms market participants, reduces investor confidence or reduces investor choice, surely all those with insider information should be prohibited from trading, regardless of whether or not they are under some type of duty or occupy a special position that allowed them access to the information? Furthermore, critics of the unfairness justification point to the fact that there will always be informational imbalances depending upon factors such as the wealth, education or knowledge of the market participant leading them to divergent investment choices.<sup>74</sup> However, in answer to this latter proposition, advocates of insider trading regulation state that this confuses inequality with differences in investment preferences based on the extent of examination by the participant of available public information.<sup>75</sup>

Notwithstanding the debate in the literature as to whether the prohibition against insider trading can be justified on efficiency grounds, public opinion appears to be firmly behind the fairness justification grounding its prohibition. Furthermore, the prohibition against insider

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This includes a person who learns of the inside information from anyone who is in a special relationship with the corporation who issued the securities and knows or ought reasonably to have known that the other person was in a special relationship with the corporation who issued the securities.

<sup>73</sup> In the US, insider trading is predominantly prohibited under section 10(b) of the *Securities Exchange Act* 1934 which prohibits a person from using “in connection with the purchase or sale of any security... Any manipulative or deceptive device or contrivance in contravention of such rules and regulations” as the SEC may prescribe, and Rule 10b-5, adopted by the SEC pursuant to this section which states that it is unlawful for “any person to ... employ any device, scheme, or artifice to defraud, ... or to engage in any, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security”. Although US courts have held that Rule 10b-5 prohibits insider trading, they have also held that for there to be a contravention the information must have been sourced from someone who has breached a fiduciary or similar duty (See *United States v Chiarella*, 445 US 222 (1980) and *United States v O’Hagan*, 521 US 642 (1997)). In the United Kingdom, the Code of Market Conduct and s 118 of the *Financial Services and Markets Act 2000* prescribes that a person is prohibited from trading if they are an insider being any person who has inside information:

- as a result of their membership of the administrative, management or supervisory body of an issuer of qualifying investments;
- as a result of holding capital of an issuer of prescribed investments;
- as a result of having access to the information through their employment, profession or duties;
- as a result of criminal activities; or
- which they have obtained by other means, eg a tip-off from a friend, and which they know, or could be reasonably expected to know, is inside information

By way of contrast, in Australia, insider trading is prohibited under section 1043A the *Corporations Act 2001* which provides that any person in possession of inside information, if they know, or ought reasonably to know, it is inside information, cannot trade on that information.

<sup>74</sup> Avgouleas, *supra* note 8 at 203.

<sup>75</sup> Avgouleas, *supra* note 8 at 203.

trading, which started in the US in 1934, has now spread to most countries.<sup>76</sup> Utpal Bhattacharya and Hazem Daouk, who conducted a study of, inter alia, the spread of insider trading regulation, state that “it seems that a consensus has been achieved among governments: insider trading laws are good for society”<sup>77</sup> and note:

Though the debate about the pros and cons of allowing insider trading in stock markets has been quite contentious in the law, economics and finance literature, it seems that from the point of view of actual practice, the debate seems to have been settled. In a comprehensive survey of insider trading regulations in every country that had a stock market at the end of 1998, this paper finds that all of the 22 developed countries and four out of five of the 81 emerging markets had insider trading laws in their books.<sup>78</sup>

The data Bhattacharya and Daouk used was collected in 1998. Given the work of bodies such as the IMF and IOSCO in converging world securities regulation, and the adoption in 2003 of the Market Abuse Directives by the European Community, requiring all countries in the EU to prohibit insider trading, insider trading regulation is even more widespread today.<sup>79</sup>

### **Part 3 Market Abuse – Is Enforcement Important?**

The debate, it seems, has largely moved from whether market abuse should be prohibited to the importance of enforcement of securities laws for the development of stock markets and, if enforcement is important, whether public enforcement is more or less important than private enforcement. Public enforcement:

is the disciplinary function of the regulatory system. Enforcement is an ex post tool used to punish breaches of laws and regulations as well as to deter future wrongdoings. This means that there are tangible consequences to noncompliance with regulation and violations of securities law. Enforcement requires a regulator to investigate both regulated and unregulated entities, bring an

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<sup>76</sup> See Studler, *supra* note 68 at note 276, referring to the fact that the EU issued the Insider Trading Directive in 1989, which led to Germany making insider trading illegal in 1994, it previously having been allowed.

<sup>77</sup> Utpal Bhattacharya & Hazem Daouk, “The World Price of Insider Trading” (2002) 57 J Fin 75 at 90.

<sup>78</sup> *Ibid* at 104.

<sup>79</sup> For a discussion of these developments, see Chapters 5 and 6.



enforcement action against a person who has violated the rules, and apply a penalty if the action succeeds.<sup>80</sup>

Public enforcement encompasses enforcement by securities regulators of securities laws and stock market rules. This differs from private enforcement, which involves individuals or corporations engaging in private litigation in relation to violations of securities laws.

The issue arose primarily because of the debate, referred to above, as to whether insider trading laws detracted or contributed to efficient capital markets and the need for empirical evidence. The debate as to the importance of public enforcement versus private enforcement was energized because of empirical work undertaken by four finance academics from Harvard University, namely, Rafael La Porta, Florencio Lopez-de-Silanes, Andre Shleifer and Robert Vishny (La Porta et al). This research led them to conclude that private, not public, enforcement of securities laws is the key to the development of stock markets. These conclusions caused the World Bank to make policy recommendations as to which laws a country should emulate if a country wished to develop its stock markets.<sup>81</sup> However, as discussed below, the findings of La Porta et al and the policy proposals made as a result have been challenged by a number of academics. These academics champion public enforcement as the key to strong financial markets.

### **Existence of Laws vs. Enforcement of Laws**

One of the earliest studies on the impact of enforcement was undertaken in 2002 by Utpal Bhattacharya and Hazem Daouk.<sup>82</sup> Their study looked at the impact of enforcement of insider trading laws in stock markets on the cost of capital. They considered 103 countries, 87 of which had insider trading laws. They found, however, that prosecutions had only taken place in 38 of these countries. They concluded that the introduction of insider trading laws

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<sup>80</sup> Ana Carvajal & Jennifer Elliott, "The Challenge of Enforcement in Securities Markets: Mission Impossible?" (August 2009) [IMF Working Paper No. 09/168], online: SSRN <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1457591](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1457591)> at 5.

<sup>81</sup> World Bank, "Institutional foundations for financial markets" (2006), online: World Bank <<http://siteresources.worldbank.org/inttopaccfinser/Resources/Institutional.pdf>> as cited by Howell E Jackson & Mark J Roe, "Public and Private Enforcement of Securities Laws: Resource-Based Evidence" (2009) 93 J. Fin. Econ. 207.

<sup>82</sup> Bhattacharya, *supra* note 77.

did not change the cost of capital. However after the first prosecution of insider trading laws the cost of capital decreased significantly:

[T]he easy part – the establishment of insider trading laws – is not associated with a reduction in the cost of equity. It is the difficult part – the enforcement of insider trading laws – that is associated with a reduction in the cost of equity in a country.<sup>83</sup>

This is consistent with other studies that suggest that it is not the existence of laws that is important to financial market development, but credible enforcement.<sup>84</sup>

In relation to the first prosecution they hypothesize:

It is important to note that the first enforcement of a law, however perfunctory it might be, is an event of paramount importance. The first prosecution signals to the world that we have gone from a regime where there have been no prosecutions to a regime where there has been at least one prosecution; this implies that the probability of future prosecutions has had a discrete jump up.<sup>85</sup>

Interestingly Bhattacharya's study found that enforcement of insider trading laws is a relatively recent phenomenon:

Insider trading laws existed in 87 countries, but enforcement, as evidenced by prosecutions, had taken place in only 38 of them. Before 1990, the respective numbers were 34 and 9. This leads us to conclude that the existence and the enforcement of insider trading laws in stock markets is a phenomenon of the 1990s.<sup>86</sup>

One of the problems with Bhattacharya's study is that it only measures the first prosecution, not how often the laws are used, and it also has no adjustment for the stringency of the insider trading laws or penalties.<sup>87</sup> This was answered to some extent by two later studies,

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<sup>83</sup> Bhattacharya, *supra* note 77 at 104.

<sup>84</sup> See for example Katharina Pistor, Martin Raiser & Stanislaw Gelfer, "Law and Finance in Transition Economies" (2000) 8(2) *Econ of Transition* 325.

<sup>85</sup> Bhattacharya, *supra* note 77 at 85.

<sup>86</sup> Bhattacharya, *supra* note 77 at 77.

<sup>87</sup> Beny, *supra* note 51, conducted a study in 2007 on the impact of insider trading laws. In relation to enforcement, Beny used part of Bhattacharya's data, namely, the proxy for enforcement was whether or not insider trading laws were enforced prior to 1994. Beny also added to her regressions some aspects of the stringency of the insider trading laws by adding the elements of whether or not monetary penalties exceeded illicit profits and whether or not insider trading was a criminal offence. Beny concluded that insider trading laws

one by Laura Beny and one by Arturo Bris, which seem to show that harsher laws results in fewer instances of insider trading and will result in better stock market outcomes, including more dispersed equity ownership, more informative stock prices and more liquid stock prices. Beny's study in 2005 added to the analysis the stringency of insider trading laws, and, in particular, whether insider trading was a criminal offence. She found that the first prosecution (as measured by Bhattacharya) together with the strength of the insider trading prohibition did matter to stock market development. She found that "the possibility of stringent sanctions (especially criminal sanctions), rather than the breath of the prohibition, seems the pivotal feature of the insider trading prohibition" and that stronger sanctions were associated with more dispersed equity ownership, more informative prices and more liquid stock markets.<sup>88</sup> A study by Bris in the same year also seemed to suggest that harsher laws work better at reducing the incidence of insider trading. However this study, which measured the incidence of abnormal price movements surrounding takeover announcements, also suggested that tough insider trading laws could also result in an increase in the profitability of insider trading. This is because fewer insider traders can mean more dramatic price increases when the information is eventually made public.<sup>89</sup>

One difficulty with studies considering the importance of enforcement to the cost of capital is that the issue of causality has not yet been conclusively proven, that is, whether enforcement is the real reason behind the reduction of the costs of capital or it is just a coincidence. This is because countries with strong enforcement of insider trading laws, such as the US, may have better stock market outcomes based upon other reasons.

### **Studies of Capital Market Outcomes by La Porta, Lopez-de-Silanes and Shleifer**

Since the mid-1990s, La Porta et al have been working on what they view as a gap in the literature, namely, the use of statistical analysis to determine how differences in the laws of

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did contribute to efficient capital markets in the sense that tougher insider trading laws correlated with less concentrated ownership, better stock price accuracy and more liquid stock prices.

<sup>88</sup> Beny, "Do insider trading laws matter? Some preliminary comparative evidence" (2005) 7(1) *Am L & Econ Rev* 144 at 174.

<sup>89</sup> See A Bris, "Do Insider Trading Laws Work?" (2005) 11(3) *Eur Fin Management* 267.

countries impact on corporate finance. For example, in 1998, La Porta et al, assisted by Robert Vishny from the University of Chicago, undertook a study looking at the laws covering the protection of shareholders and creditors in 49 countries.<sup>90</sup> They compiled a data set of laws and coded these with numbers. For example, a country scored a one if the law prescribed that there was one vote for each share and zero otherwise. They then grouped countries according to their legal origins.<sup>91</sup> From their results they concluded that countries with common law origins provide superior shareholder protection than countries with civil law systems. As a result, they argued, companies with common law legal systems can access external finance more easily and should grow more quickly to the benefit of the economy as a whole.<sup>92</sup>

In 2006 La Porta et al conducted another study using a similar method to determine whether public enforcement, disclosure laws and/or private enforcement benefited stock markets.<sup>93</sup> Again the study surveyed attorneys from 49 countries, including Canada, the UK, Australia, USA and Germany, to establish a database of rules and regulations in relation to securities laws.<sup>94</sup> The study also encoded the laws with numbers. For example, a country scored a one if the prospectus issued for a newly listed firm had to disclose the compensation of each of the directors and key officers, a half if only the aggregate compensation of executives had to be disclosed and a zero if there was no requirement to disclose such amounts. This method was repeated with a number of elements in relation to disclosure standards in order to produce what was called a 'Disclosure Requirements Index'. Laws in relation to the civil liability of those associated with the prospectus were treated in the same way to develop a 'Liability Standards Index'. A 'Public Enforcement Index' was also created in the same way, coding laws in relation to the powers of the regulator in relation to misstatements in a prospectus. Each of these indexes were compared with a number of elements indicating the

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<sup>90</sup> Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny "Law and Finance" (1998) 106 J Pol Econ 1113.

<sup>91</sup> *Ibid* at 1122.

<sup>92</sup> *Ibid* at 1152.

<sup>93</sup> Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, "What Works in Securities Laws?" (2006) 61 J Fin 1 at 1.

<sup>94</sup> *Ibid*.

strength of the particular stock market, including stock market capitalisation, ownership concentration, the number of initial public offerings and the number of domestic firms.

The study concluded that there was little evidence that public enforcement benefited stock markets, but there was strong evidence that laws mandating disclosure and facilitating private enforcement benefited stock markets.

One of the key problems with the study was that the Public Enforcement Index measured, not how often the regulator brought enforcement proceedings, but only the existence of public enforcement powers of the regulator. However the Bhattacharya study had provided some evidence that it is not the existence of laws that is important, but whether they are used by the regulator. This is presumably because unenforced laws can simply be ignored and therefore effectively have no impact.<sup>95</sup> This is one of the key reasons why La Porta et al's findings, particularly in relation to the impact of public enforcement, have been criticised.<sup>96</sup>

The study also suffers from some other problems namely:

1. The laws measured centred only around civil and criminal liability for a misleading prospectus. It did not measure other important areas of securities regulation such laws dealing with takeovers, continuous disclosure and market abuse. The impact of public enforcement verses private enforcement for these other areas could, therefore, be quite different.
2. It appears to be biased towards US laws and institutions. For example, a country received a lower score for public enforcement if the country did not have separate government agencies in charge of supervising banks and stock exchanges or if the members of the regulator were unilaterally appointed by the executive. So on this

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<sup>95</sup> Bhattacharya, *supra* note 77.

<sup>96</sup> See Howell E Jackson & Mark J Roe, *supra* note 81 at 210; Mathias M Siems, "What Does Not Work in Comparing Securities Laws: A Critique on La Porta et al.'s Methodology" (2005) 16(7) I.C.C.L.R. 300; John C Coffee, "Law and the Market; The Impact of Enforcement" (2007) 156 U Pa L Rev 268.

measurement the US scored a one, Australia scored .67 and the UK scored zero.<sup>97</sup> However it is questionable as to whether just because a stock exchange regulator is physically separate, rather than combined under a large umbrella organisation, it is necessarily less responsive and accountable. Furthermore, the appointment of the members of the Securities Exchange Commission in the US, the Financial Services Authority in the UK and the Australian Securities and Investments Commission in Australia have more to do with the constitutional arrangements of the particular country than an attempt by Government to influence the regulator.

3. To make the study workable, La Porta's et al had to limit the number of laws coded for the study. Therefore judgements were made as to which laws were the most important and were to be measured. For example there is no measurement of the liability for a misleading prospectus of the underwriter.
4. There are other problems with coding laws with numbers. Coding laws with numbers fails to take account differences in how laws operate. It also attributes weightings that may not be accurate. This was one of the main criticisms of the study by Mathias Siems, discussed below.<sup>98</sup>

### **Attack on the Methodology of La Porta et al**

Mathias Siems, a Professor from the University of East Anglia in the United Kingdom, was one of the first academics to challenge the findings of La Porta et al. His primary criticism was their methodology.<sup>99</sup>

Siems questioned the use of mathematical modelling for analysing countries' legal systems which he views as too simplistic, at least the way it is used by La Porta et al. His reasoning is that it is difficult to classify legal rules across countries as laws can operate quite differently:

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<sup>97</sup> La Porta, *supra* note 93 at 15.

<sup>98</sup> Siems, *supra* note 96.

<sup>99</sup> *Ibid.*

[T]he devil may be in the details. La Porta et al. did not pay enough attention to differences in the micro-structure of the law, which are often of crucial importance. The question itself of whether in the cases of a misleading prospectus there was a shift of the burden of proof of causality is insufficient, because various details can mean that what appears to be the same rule works completely differently.<sup>100</sup>

In relation to the measurement of public enforcement, Siems says:

[T]he complexity of public enforcement is also disregarded. In the La Porta et al. index, countries get, for instance, a “1” if directors can be held criminally liable when negligently unaware that the prospectus is misleading. It is therefore, for example, not taken into account what kind of sanction is imposed, although a very minor sanction probably does not justify a “1”. Moreover, there are, once again, various general differences in criminal law and criminal procedure of the 49 countries. These differences were most often not even mentioned in the reports of the local lawyers, because the legal system of each country was usually only described within three to five pages.<sup>101</sup>

Siems believes that a proper analysis of comparative law must be based on, not the existence of laws, but on their functionality, in that there may be different laws which achieve a similar effect.<sup>102</sup>

Siems also argues that the La Porta et al study is flawed because the foundations of the study, as well as the way the questions were framed, reflect a US approach to securities law. For example, La Porta et al considers as an important factor in investor protection the disclosure requirements of prospectuses. This reflects a fundamental principle of US securities regulation which may not be universally accepted in all countries. Some other countries may place a greater focus on merit regulations as an important tenet of investor protection.<sup>103</sup> For example China requires companies seeking a public listing meet specific financial viability tests.<sup>104</sup>

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<sup>100</sup> *Ibid* at 302.

<sup>101</sup> *Ibid*.

<sup>102</sup> *Ibid* at 303.

<sup>103</sup> *Ibid*.

<sup>104</sup> See generally R A Huang “The Regulation of Securities Offerings in China: Reconsidering the Merit Review Element in light of the Global Financial Crisis” (2011) 41 Hong Kong L.J. 261.

Siems argues that La Porta et al should not draw strong conclusions from their study given the limitations he identifies. At best, Siems argues, the La Porta's et al study should only be the basis for further research.<sup>105</sup>

### **Alternative Proxies for Public Enforcement**

Howell E. Jackson and Mark J. Roe from Harvard Law School were also critical of the La Porta et al study.<sup>106</sup> Like Siems, Jackson and Roe see the La Porta et al study as problematic due to the difficulty in reliably classifying laws across countries and weighing the importance of each law.<sup>107</sup> However, Jackson and Roe find that the basic flaw with the study is that it measured enforcement based upon the regulators' powers, rather than on the actual use of those powers.<sup>108</sup>

Jackson and Roe point to the research into insider trading by Bhattacharya and Daouk, which found that the key issue was whether a regulator used their powers, not the existence of the powers.<sup>109</sup> At a theoretical level, Jackson and Roe question whether private enforcement will prove superior to public enforcement, although both have their advantages and disadvantages:

A public enforcement system is degraded because public actors have mixed and often weak incentives to do their jobs well and because they often suffer from poor information of both general market and specific firm conditions. But a private enforcement system is subject to collective action and free rider effects among dispersed investors, to slow and inept judiciaries, to lawyers' rent-seeking, and to the potential inability of private enforcement to visit severe monetary penalties on wrongdoers. On the positive side, public enforcement could be run by public-regarding policymakers and invoke sharp criminal, financial, and reputational penalties

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<sup>105</sup> Siems, *supra* note 98 at 305. Interestingly, although Siems seems uncomfortable with the 'law by numbers' approach, he subsequently joined with some other academics to undertake a study which also coded laws by numbers, albeit with what was said to be coding for functionality (rather than just the existence of laws) and with a cross-sectional analysis over time. This study produced results contrary to La Porta et al's 1998 paper in relation to the importance of legal origins to investor protection; see John Armour et al, "Shareholder Protection and Stock Market Development: An Empirical Test of the Legal Origins Hypothesis" (2009) 6(2) *J. Empirical Legal Stud.* 343.

<sup>106</sup> Howell E Jackson & Mark J Roe, *supra* note 81.

<sup>107</sup> *Ibid* at 210.

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

<sup>109</sup> *Ibid.*



that deter egregious wrongdoing, while private enforcement actions could be brought by well-informed actors with well-aligned incentives.<sup>110</sup>

Jackson and Roe doubt whether private enforcement, as least as it is practiced in the United States, will produce better stock market outcomes because of fundamental problems with how private enforcement operates:

Private securities lawsuits in the United States (1) often provide meagre returns to wronged plaintiffs, (2) usually do not visit their costs on the wrongdoing actors inside public firms, because the wrongdoers can usually transfer the costs to others, and (3) often just transfer losses from one innocent group shareholders to another innocent group, with large fees obtained by the lawyers for both sides ... Private securities litigation via class actions to remedy the disabling effects of shareholder dispersion often results in class action attorneys controlling the litigation in ways that do not fully benefit dispersed shareholders. ... And private enforcement cannot provide a wholly or even largely self-sufficient system of securities regulation, as the transactions costs of private remedies for even basic issues like insider trading stymie private enforcement from being fully effective. Litigation-based forms of private enforcement can cover only certain kinds of corporate wrongdoing. Indeed, the major securities reform statutes of the 1930s were enacted to address these shortcomings of private enforcement ... and the Securities and Exchange Commission (SEC), a public regulator, has played a major role in American securities markets ever since.<sup>111</sup>

In response to the study by La Porta et al, Jackson and Roe conducted their own empirical study using securities regulators' budgets and staffing levels as the proxies for enforcement intensity. They replicated La Porta et al's regressions but substituted these resource based measures for enforcement intensity instead of the index developed by La Porta et al. Jackson and Roe found the same results for disclosure, (i.e. increased disclosure is present in stronger markets) but found that public enforcement is overall as important as disclosure for explaining financial market outcomes and more important than rules governing private civil liability. They found that allocating more resources to public enforcement is positively

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<sup>110</sup> *Ibid* at 208.

<sup>111</sup> *Ibid* at 209.

associated with robust capital markets as measured by market capitalization, trading volume, the number of domestic firms and the number of initial public offerings.<sup>112</sup>

Jackson and Roe recognised that perhaps a better measurement of enforcement intensity would be enforcement outcomes, but did not pursue this due to the unavailability of the data and problems of interpretation.<sup>113</sup> For example, a low number of actions by a regulator may be the result of the existence of a powerful regulator that deters persons from breaking the law. In addition, outcomes may not capture, for example, informal discussions or settlements that are not made public.<sup>114</sup>

Although Jackson and Roe find that public enforcement is co-related with stronger markets, they do not reach any conclusion as to why this is the case. They suggest that it may be because increased resources may enable a regulator to conduct market surveillance and look for wrongdoing and other problems which may need rule-making fixes. Higher budgets may also mean more resources for investigations making it easier for the agency to bring enforcement actions and enabling it to seek large financial and criminal penalties. Those penalties may also have a reputational impact resulting in additional financial costs for the offender. In addition agencies with more resources engage more staff able to devise more sophisticated and targeted regulatory rules. Higher budgets may also mean that more informal enforcement through administrative guidance.<sup>115</sup>

One key problem with the Jackson study is causation. Just because higher resources for securities regulators co-relate with better market outcomes this does not prove that one causes the other. It may be that stronger financial markets increase the call for better

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<sup>112</sup> *Ibid* at 208.

<sup>113</sup> Jackson has commenced a study of enforcement outcomes but, to date, has only obtained data from the UK, US and Germany and has not been able to reach any conclusions. See Howell E Jackson, "Variations in the Intensity of Financial Regulation: Preliminary Evidence and Potential Implications" (2007) 24 *Yale J on Reg* 253.

<sup>114</sup> Jackson, *supra* note 81 at 211.

<sup>115</sup> *Ibid* at 235.

resourced regulators and governments respond.<sup>116</sup> However, as Jackson and Roe point out, causation is also an issue with the study conducted by La Porta et al.<sup>117</sup>

Jackson and Roe caution against drawing policy recommendations from the results of their study. Their aim seems to be to stop the La Porta et al's study forming the basis of policy:

The best evidence now available is that public enforcement is no less valuable for financial market outcomes than private enforcement such as disclosure and, given the weak results for private enforcement's liability measure, perhaps liability is less important. Hence, World Bank units that promote private over public enforcement are making policy without empirical backup, because the resource-based evidence is inconsistent with private enforcement being superior to public enforcement for building good securities markets.<sup>118</sup>

### **Analysis by Coffee of the Jackson and Roe Study**

Although Jackson and Roe caution against using their study as a basis for policy, other academics have not been as reticent. In particular, Professor John Coffee from Columbia University has taken these findings to contend that the intensity of public enforcement in the United States is probably the reason the United States has the lowest cost of capital and the reason non-U.S. firms exhibit a listing premium when they list on a US exchange.<sup>119</sup>

Coffee argues that policy makers take note of the importance of public enforcement as a factor in stock market development:

...enforcement intensity affects the cost of capital. If this hypothesis is accepted, then it has dramatic implications for securities regulators: their mission should not be simply to protect investors, but to reduce the cost of capital and thereby enhance gross domestic product. The literature on securities regulation has long underplayed this public regarding role, but non investors as well as investors depend on the efficiency of securities regulation, as the costs of underenforcement fall on the economy as a whole.<sup>120</sup>

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<sup>116</sup> *Ibid* at 233.

<sup>117</sup> *Ibid* at 234.

<sup>118</sup> *Ibid* at 238.

<sup>119</sup> Coffee, *supra* note 96.

<sup>120</sup> *Ibid* at 310.

Coffee conducted a review of comparative research on enforcement, considering both the La Porta et al study and the findings of Jackson and Roe. Coffee is very critical of La Porta et al. He is critical of their methodology in relation to which he states he “could fill an entire article”.<sup>121</sup>

Coffee is also critical of La Porta et al using the existence of the powers of securities regulators as the gauge of public enforcement rather than the use of those powers, and describes La Porta et al’s conclusion as to the relative unimportance of public enforcement as “breathhtaking”.<sup>122</sup>

Part of the reason, it seems, that Coffee advocates the results of the Jackson and Roe study so strongly is because, since 1999, Coffee has postulated a theory he has called the “bonding hypothesis”.<sup>123</sup> In brief, this is that the reason non-U.S. firms exhibit a listing premium when listing on a US exchange is that they reduce their agency costs, that is, the prospect that management will not act in the best interests of shareholders. By subjecting themselves to the SEC’s higher disclosure standards and the greater prospect of enforcement in the United States these non-US firms are received more positively by investors. He argues that the Jackson and Roe results support this hypothesis.<sup>124</sup>

### **Cumming, Groh and Johan Study**

Recently the findings of the Jackson and Roe study have been taken further by Professors Cumming, Groh and Johan. They conducted an empirical analysis on fraud in the markets in

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<sup>121</sup> *Ibid* at 250. Specifically, Coffee levels the following criticisms:

(1) Although French inefficiency is assumed, France in fact experienced greater economic growth than the United Kingdom over most of the period since 1820. French civil law seems, then, to have worked adequately, at least for France.

(2) The data supporting the conclusion that common law countries have economically outperformed civil law countries are largely driven by the spectacular economic failure of Latin America over the prior century, but whether Latin America should be deemed to be of French civil law origin is highly debatable.

(3) The LLS&V coding system is suspect, with some critics charging that it has been inconsistently applied.

(4) Vivid counter examples can be given of both economies that have developed rapidly from civil law origins and others that have stagnated notwithstanding their common law origins; and

(5) Many doubt that law ranks anywhere near as high as structural factors, such as geography, openness to trade, or colonial endowments

<sup>122</sup> *Ibid*.

<sup>123</sup> *Ibid* at 236.

<sup>124</sup> Coffee, *supra* note 96.

Europe. They measured the level of detected fraud against resources of authorities responsible for the supervision of the markets, the level of cooperation of these authorities and the seriousness of the penalties prescribed for fraud. Cumming, Groh and Johan found that the level of resources is associated with an increase in detected cases of fraud. They also found that formalized cooperation agreements between supervisory authorities within a country are associated with a decrease in fraud cases. They also found that an increase in the minimum imprisonment is associated with a decrease in fraud cases.<sup>125</sup>

### **Is Public Enforcement Important to Stock Markets?**

Despite some evidence that public enforcement is important, a number of questions remain. It does seem that the impact of private enforcement on stock market development is uncertain. Both Jackson and Roe and Coffee question whether private enforcement will send the right signals to the markets, given that private enforcement often involves just a transfer of wealth from existing shareholders to past shareholders with the persons who were responsible for the loss, usually the directors, having a limited role in the proceedings. Furthermore, given the criticisms of the study by La Porta et al, their conclusion as to the importance of private enforcement on stock market development must be open to doubt.

However, although it seems that public enforcement is important to stock market development, this issue is not yet settled. At a theoretical level, it can be argued that this should be the case, as the fact that a securities regulator does not enforce the laws should impinge upon investor confidence, investors being wary of investing in a market that is not fair for all participants and where investors may lose their investment to unscrupulous operators. A reduction in the number of investors in a particular market should then result in an increase in the cost of capital in that particular market. The empirical evidence done by Jackson and Roe does support this hypothesis showing that public enforcement co-relates with stronger stock markets.

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<sup>125</sup> D Cumming, A Groh & S Johan "Same Rules, Different Enforcement: Market Abuse in Europe", TILEC Discussion Paper, 19 February 2014, online: <<http://ssrn.com/abstract=2399064>>.

However, the issue of causality remains unresolved and requires further research. It may be that the only reason why public enforcement is so intense in some countries such as the United States is because of the high number of retail investors in the United States compared to other countries. With the rise of retail investors and ownership of companies becoming more dispersed, this creates a political demand for investor protection through increased enforcement efforts, and governments may respond accordingly.<sup>126</sup> Another reason why the cost of capital may be lower in some countries may be to do with the effectiveness of a country's legal institutions and/or the countries' securities regulation mandating and enforcing disclosure obligations.<sup>127</sup> Robert Prentice suggests yet another reason why the US may have the lowest cost of capital. He suggests the reason is because the United States has the largest most liquid markets in the world, with the largest number of investors.<sup>128</sup> The US dollar is also the most dominant currency in the world and the one in which many governments hold their foreign reserves. This may also contribute to the strength of the US markets. If, as has been suggested<sup>129</sup>, the US dollar declines as the world's dominant currency, this may result in the decline in the strength of US markets.

### **What is the Optimum mix of Public Enforcement Options?**

Furthermore, if public enforcement intensity is important, the optimum level of public enforcement has not been established. Nor it been established what the optimum mix is between public enforcement remedies which may be available to securities regulators, such

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<sup>126</sup> Coffee, *supra* note 96. Interestingly, the only other country that appears to have a similar level of enforcement intensity as the US is Australia. (Coffee, *supra* n 96 at 281.) By world standards Australia has a high level of retail investors. (see ASX, "2010 Australian Share Ownership Study" (2010), online: ASX <[http://www.asx.com.au/documents/resources/2010\\_australian\\_share\\_ownership\\_study.pdf](http://www.asx.com.au/documents/resources/2010_australian_share_ownership_study.pdf)> at 30). Further research needs to be done to determine whether Australia's stock markets are, because of the level of enforcement intensity, significantly stronger than they would otherwise be.

<sup>127</sup> See e.g. a study conducted by L Hail and C Leuz measuring the effectiveness of a country's legal institutions and securities regulations in which they concluded that from countries with more extensive disclosure requirements, stronger securities regulation and stricter enforcement mechanisms have a significantly lower cost of capital (L Hail & C Leuz, "International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?" (2006) 44(3) J. Accounting Research 485). However, it should be noted that this study builds on a number of the data sets and proxies formulated by La Porta et al and, like La Porta, only measures enforcement based on the existence of rules rather than actual enforcement.

<sup>128</sup> Robert A Prentice, "Regulatory Competition in Securities Law: A Dream (That Should Be) Deferred" (2005) 66(6) Ohio St LJ 1155 at 1195.

<sup>129</sup> See e.g. R Frisk, "The Demise of the dollar", *The Independent* (6 October 2009), online: The Independent <<http://www.independent.co.uk/news/business/news/the-demise-of-the-dollar-1798175.html>> at 5.

as criminal, civil and administrative remedies. Public enforcement of securities laws, particularly criminal prosecutions, are very expensive for the regulator and, to date, no empirical research has been conducted on the relative costs and benefits of enforcement intensity. In particular, the high intensity of criminal prosecutions in the United States may not be necessary to obtain the lowest cost of capital. Perhaps, the same results could be achieved by lower enforcement intensity or a different mix of criminal prosecutions and regulatory procedures at a lower cost.

The optimum level of public enforcement has been one of the main criticisms of Coffee's conclusions. Coffee has come under particular attack from Ellis Ferran, an academic from the University of Cambridge, who takes issue with Coffee's criticism of the Financial Services Authority's (FSA) (the predecessor of the FCA) cooperative approach to its role in the markets, consistent with the FSA's then principles-based approach to financial regulation.<sup>130</sup>

Coffee was critical of the approach of the FSA which does not often pursue formal sanctions:

Some regulators may advise, request, and even admonish, but are slow to punish. Others may believe that punitive fines generate a desirable general deterrent effect, and that the greater danger lies in using overly mild penalties that can be easily absorbed as a cost of doing business. In this regard, the FSA and the SEC appear to be located at opposite ends of the continuum. Indeed, both agencies publicly proclaim as much. In 2006, the FSA's then-chairman said that his agency was "emphatically not an enforcement-led regulator." In contrast, it is a virtual truism to portray the SEC as primarily an enforcement agency. Yet ironically, the FSA has considerably more formal authority over the London Stock Exchange than the SEC has over U.S. exchanges; indeed, the FSA even possesses authority to determine the listing rules of the London Stock Exchange, while the SEC faces severe constraints on its ability to amend stock exchange rules.

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<sup>130</sup> Ellis Ferran, "Capital Market Competitiveness and Enforcement" (2008) [unpublished], online: SSRN <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1127245](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1127245)>.

Although the FSA has more than ample legal authority, it is reluctant to use it and strives to employ other means of influence in preference to enforcement actions.<sup>131</sup>

Ferran, however, believes that Coffee has not established a sufficient basis for the UK abandoning its approach to regulation, which focuses more on ex ante compliance-promoting strategies than ex post sanctions. Ferran points out that if the UK's strategy of promoting ex ante compliance is working, there will be a less of a need for it to engage in formal ex post enforcement.<sup>132</sup> Ferran is also critical of Coffee's measurements of enforcement:

The article tends mainly to use the term 'enforcement' in the rather narrow traditional sense of formal sanctions imposed via legal processes rather than in the broader sense now often used in regulatory contexts to embrace a wide range of strategies from persuasion to criminal penalties and licence revocations that countries use to promote compliance.<sup>133</sup>

Ferran believes that a more inclusive definition of enforcement would show that the FSA was more successful:

A point that is not fully developed in the Coffee article is that the interplay between different types of formal enforcement (criminal prosecutions, administrative sanctions under the market abuse regime administered by the FSA, and FSA sanctions for breach of rules and/or principles applying to the regulated community) is important in this context. When the full range of sanctions that can be applied to market misconduct is examined, the number of successful cases is revealed to be larger than that mentioned by Coffee in the article.<sup>134</sup>

Ferran is also critical of Coffee's supporting data and points to the fact that there is a listing premium on the London Alternative Investment Market (AIM), despite the fact that it is supervised by the FSA:

The Coffee thesis relies heavily on the availability of valuation premiums for foreign firms that list in the US. However, the supporting data cited by Professor Coffee has been questioned. In

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<sup>131</sup> Coffee, *supra* note 96 at 276.

<sup>132</sup> Ferran, *supra* note 131 at 4.

<sup>133</sup> Ferran, *supra* note 131 at 3.

<sup>134</sup> Ferran, *supra* note 131 at 7.



particular, the US Committee on Capital Markets Regulation has recently identified a number of significant concerns with a key study by Doidge *et al* cited in the Coffee article (Committee on Capital Markets Regulation). The concerns are:

- o First, if there really is a listing premium, the decline in the number of foreign companies seeking a US listing indicates that it is also the case that increasingly few foreign companies are finding it appealing.
- o Second, the presence of a premium could indicate some real benefit from listing in the US, but it could also reflect market segmentation.
- o Third, there may be a significant self-selection problem because better companies cross-list in New York – properly controlled for such self-selection, the NYSE premium drops to 8% versus 5% in the over-the-counter market.
- o Fourth, even higher listing premiums are available on other markets— Doidge *et al*'s own data shows a 27% premium on AIM in 2005.<sup>135</sup>

However, despite Ferran's criticism of Coffee and his data, Ferran's main issue seems not to be whether formal enforcement is necessary, but the level of intensity of formal enforcement. She admits that formal sanctions and enforcement are an important part of a credible regulator and that perhaps the UK has not yet reached the correct balance:

Maintaining confidence in the financial system and reducing financial crime are fundamental, symbiotically related, regulatory objectives. It is thus crucial from a public interest perspective for the FSA to prioritize market cleanliness and to accommodate within its measured risk-based approach to the imposition of penalties or other formal sanctions a credible commitment to cracking down on insider dealing and other forms of deliberate misconduct. Although a risk-based approach implies that some instances of even deliberate wrongdoing may not be prioritized because they are too low-level to have strategic repercussions, this has to be balanced against the danger that tolerance could lead to some forms of malpractice becoming so widespread that its cumulative effect is strategically dangerous.<sup>136</sup>

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<sup>135</sup> Ferran, *supra* note 131 at 4.

<sup>136</sup> Ferran, *supra* note 131 at 5.

To this extent Ferran acknowledged that the FSA's own research seems to show that it needs to do more to address the issue of insider trading in its market.<sup>137</sup> The FSA, and now its successor the FCA, seem to have also taken this view and has, since 2010, ratcheted up its criminal enforcement efforts in relation to market abuse.<sup>138</sup>

### **Enforcement Techniques may be Complementary**

Whether or not regulators adopt a persuasive compliance based approach to enforcement or a more stringent ex post sanctions approach, investing substantial resources in enforcement may have a significant and even a compounding effect of deterring breaches of securities laws particularly if regulators adopt a range of enforcement strategies and each part complements the others.

Jackson & Howe did not attempt to identify which part of an investment in public enforcement was important to financial market outcomes but suggested that high enforcement budgets allowed more sophisticated market surveillance, resulting in better detection of securities violations and well-resourced investigations give the potential for severe sanctions. In addition Jackson and Howe suggested more resources would facilitate more targeted rules.<sup>139</sup> Perhaps each of these components in a regulators enforcement strategy are complementary to each other and compounds impact of enforcement on financial market outcomes.

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<sup>137</sup> In 2006, the Financial Services Authority of UK commissioned a study that measured price movements ahead of trading statements and takeover announcements made by companies included within the FTSE index. Price movements before announcements might indicate insider trading. The project found that, at least in relation to takeover announcements, there was an increase in price movements before announcements between 2000 and 2004 followed by a decline between 2004 and 2005, but the level remained high (see Financial Services Authority, "Measuring Market Cleanliness" Occasional Paper Series (23 March 2006), online: Financial Services Authority <<http://www.fsa.gov.uk/pubs/occpapers/op23.pdf>>; Financial Services Authority, "Updated Measurement of Market Cleanliness" Occasional Paper Series (25 March 2007), online: Financial Services Authority: <<http://www.fsa.gov.uk/pubs/occpapers/op25.pdf>>.

<sup>138</sup> See e.g. comments of Chief Executive Officer of the FSA Hector Sants that the FSA has pledged to become a tougher regulator in the wake of the worst financial crisis, and that people "should be frightened" of the FSA in C Binham "UK FSA to Lose Enforcement Power to Crime Agency (Update 1)", *Bloomberg BusinessWeek*, (28 May 2010), online: Businessweek.com <<http://www.businessweek.com/news/2010-05-20/u-k-fsa-to-lose-enforcement-power-to-crime-agency-update1-.html>>.

<sup>139</sup> Jackson, *supra* note 81 at 235

Although there is limited evidence to support the complementary effect of enforcement, in theory at least such a result seems likely. This is due to the fact that better detection through market surveillance could result in better targeted rules addressing particular problem areas and also targeted monitoring of particular market participants known to be likely to breach the rules. In addition possible perpetrators of securities offences may become aware of increased enforcement efforts of securities regulators, thereby increasing the perception by such potential perpetrators that they will be caught. This could act to deter such perpetrators as the potential costs of being caught outweigh the potential benefits. Aitken, Cumming and Zhan have shown that more detailed trading rules and increased surveillance seems to reduce the incidence of insider trading and market manipulation, even though the participants are not aware of the extent of that surveillance. However they also found that profits from such market abuse seem to increase, suggesting that perpetrators only engage in market abuse if the profits are substantial, outweighing the costs of detection.<sup>140</sup>

In addition increasing enforcement through better detection, higher sanctions and targeted rules may lead to financial institutions, perhaps fearing the high reputational costs associated with being associated with securities offences, to increase resources in compliance departments. Studies into reputational penalties associated with corporate crime show that corporations pay substantial reputational penalties, over and above, penalties imposed by regulators or courts.<sup>141</sup> This flow on effect of increased internal monitoring from compliance departments may also work to deter potential offenders within such firms from engaging in breaches of securities rules.

### **Enforcement as a Part of a Regulatory Strategy**

In sum, although the empirical evidence is not conclusive and there is a debate about the necessary intensity of enforcement and mix of enforcement strategies, there does seem to

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<sup>140</sup> M Aitken, D Cumming & F Zhan “Exchange Trading Rules, Surveillance and Suspected Insider Trading” (2015) *Journal of Corporate Finance* (forthcoming).

<sup>141</sup> See C Alexander “On the nature of the reputational penalty for corporate crime: evidence” (1999) 42 *J. of Law and Economics* 489 and J Karpoff, D Lee and Martin G “The cost to firms of cooking the books” (2008) 43 *J. of Financial and Quantitative Analysis* 581.

be a general consensus that some level of public enforcement is important to reducing fraud and maintaining robust stock markets and this should include prosecution and the imposition of sanctions. If such sanction based enforcement is not part of a regulatory system there is likely to be an erosion of credibility of the regulators and market confidence and the strength of the market is likely to diminish.<sup>142</sup> Furthermore, and in recognition of this fact, governments are increasingly committing to increasing enforcement as part of their regulatory strategies. A 2009 report of a G-20 working group emphasised enforcement as a key issue:

Achieving the objectives of the regulatory framework requires not only sound regulation but also effective enforcement. No matter how sound the rules are for regulating the conduct of market participants, if the system of enforcement is ineffective – or is perceived to be ineffective – the ability of the system to achieve the desired outcome is undermined.

It is thus essential that participants are appropriately monitored, that offenders are vigorously prosecuted and that adequate penalties are imposed when rules are broken. A regulatory framework with strong monitoring, prosecution, and application of penalties provides the incentives for firms to follow the rules. This, in the end, adds to the framework's credibility and enhances investor confidence in the financial system.<sup>143</sup>

There are, of course, other parts of a regulatory system that can also have an impact in reducing market abuse and thereby work towards improving market integrity. Supervision, or ex ante methods of regulation, by securities regulators and self-regulatory organizations are an important part of the framework of securities regulation and work towards education of market participants and deterring securities law violations, including market abuse.<sup>144</sup> Self-regulatory organizations also engage in ex post methods, taking action against market participants who engage or enable others to engage in market abuse for breaches of market conduct rules or conditions of licences to participate in the market. Usually, however, the terms under which self-regulatory organisations operate require them to refer the more

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<sup>142</sup> See generally Carvajal *supra* note 80.

<sup>143</sup> G-20, *supra* note 14.

<sup>144</sup> Carvajal, *supra* note 70 at 4.

serious instances of market abuse to the regulators.<sup>145</sup>

Improved corporate governance systems may also contribute to a reduction of market abuse. It was corporate governance failures during the 1990s in companies such as Enron that created the opportunity for some to engage in instances of market manipulation and insider trading. Stock market ‘bubbles’ can also create an environment which can lead to increased instances of market abuse, so efforts to ‘deflate’ such bubbles may also lead to reduced market abuse.<sup>146</sup> Furthermore, improving mandatory disclosure by corporations and increasing market transparency can lead to reduced opportunities to engage in market manipulation and insider trading. However, the impact of all of these other strategies, although they will be referred to in part, is generally outside the scope of this dissertation, which is focused on formal sanctions based enforcement strategies of regulators against market abuse and the challenges faced by such regulators.

### **Deterrence**

Underlying the effectiveness of formal sanctions based enforcement strategies to address market abuse is a presumption that they act as a general deterrent to others minded to engage in such offences. Furthermore in order to ensure the maximum deterrent impact of enforcement proceedings it is contended that a regulator needs to have a range of enforcement remedies. Such remedies need to include harsh punishments to deter the most heinous offences even if these severe remedies are not used frequently.<sup>147</sup>

Aiming for general deterrence by the imposition of an appropriate punishment is a long established utilitarian norm of the criminal law. As stated by the Supreme Court of Canada:

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<sup>145</sup> See for example IIROC “IIROC Governance” online:

<<http://www.iiroc.ca/about/governance/Pages/default.aspx>> which sets out the terms under which IRROC has been approved as a self-regulatory organization pursuant to the Securities Acts of the Canadian provinces.

<sup>146</sup> For a detailed analysis of the interrelationship between market abuse and both corporate governance failures and stock market bubbles, see Avgouleas, *supra* note 8 at chapter 3.

<sup>147</sup> As to the need for regulators to be able to exercise a variety of enforcement powers, see Ian Ayers & John Braithwaite, *Responsive Regulation Transcending the Deregulation Debate* (New York: Oxford University Press, 1992).

General deterrence as an aim of sentencing in criminal law is well established: see *R. v. M. (C.A.)*, 1996 CanLII 230 (SCC), [1996] 1 S.C.R. 500, at para. 56; *R. v. Morrissey*, [2000] 2 S.C.R. 90, 2000 SCC 39 (CanLII), at paras. 44 and 46. One of its earliest proponents was Jeremy Bentham. In his view, where the same result cannot be achieved through other modes of punishment and the net benefit to society outweighs the harm imposed on the offender, a deterrent penalty should be imposed and tailored in order to discourage others from committing the same offence. He assumes that citizens are rational actors, who will adjust their conduct according to the disincentives of deterrent penalties .... Similarly, law and economic theorists such as R. A. Posner view deterrent penalties as a kind of pricing system...<sup>148</sup>

The same rationale can be applied to enforcement action, that is that possible offenders, as rational utility maximizers will undertake a cost benefit analysis - weighing up the probability of detection, enforcement action and likely penalties against the possible gains to be made.<sup>149</sup>

However the premise that punishment will deter those considering whether to commit an offence, based upon the assumption that individuals are rational actors, has been the subject of much criticism and scepticism. The effect of punishment is unpredictable<sup>150</sup> and may not be successful in changing the culture of organizations<sup>151</sup> Using sanctions as deterrence may also be particular unsuited for some crimes such as those motivated by social or psychological factors.

Nevertheless white collar crimes, such as market abuse, are typically committed by those who do not come from deprived backgrounds, are not crimes of passion and are often motivated by personal or organizational greed. As such it would seem that white collar crime would more readily fit within the rational actor theory of deterrence and therefore should be

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<sup>148</sup> *Cartaway Resources Corp. (Re)*, 2004 SCC 26 at [52].

<sup>149</sup> See generally RA Posner, "Rational Choice Behavioural Economics and the Law" (1998) 50 *Stan LR* 1551 and M Polinsky and Steven Shavell "The Economic Theory of Public Enforcement of Law" (2000) 38(1) *Journal of Economic Literature* 45.

<sup>150</sup> See Canadian Sentencing Commission, *Sentencing Reform: A Canadian Approach* (1987)

<sup>151</sup> For the limitations of deterrence in relation to changing corporate culture, see e.g. CL Ford, "Toward a New Model for Securities Law Enforcement" (2005) 57 *Admin L Rev* 757; M Condon, "Rethinking Enforcement and Litigation in Ontario Securities Regulation" (2006) 32 *Queen's LJ* 1.

more responsive to the deterrence effect of sanctions and enforcement than other areas of illegal behaviour such as crimes of violence.

Unfortunately the empirical evidence that exists in relation to the ability of sanctions and enforcement to deter white collar crime is somewhat equivocal. For example Braithwaite and Makkai studied nursing home executives and found that little support for the deterrence effect of increased sanctions and enforcement.<sup>152</sup> Yet Klepper and Nagin studied the impact of deterrence on non-compliance with taxation obligations and found that increased sanctions did shift potential offenders toward compliance.<sup>153</sup> In the antitrust area Simpson and Koper found some evidence that increased enforcement and increased sanctions inhibited recidivism. However they also found that the characteristics of the particular industry were more important on the risk of reoffending than enforcement and sanctions.<sup>154</sup> As is referred to above, Cumming, Groh and Johan found an increase in imprisonment was associated with a reduction in fraud detected by those responsible for supervision of the markets in Europe.<sup>155</sup> A review of the literature indicates that there have been no specific empirical studies in relation to the ability of sanctions and enforcement to deter market abuse offences.

Nevertheless despite the absence of strong empirical evidence to prove the deterrent effect of enforcement that does not necessarily mean that punishment and enforcement does not have a deterrent effect. In fact the norm of punishment and enforcement to deter others from committing crime is relied upon by the judiciary and the legislature in most countries to design appropriate punishments which suggests that despite criticism levelled against the norm of general deterrence it is still broadly accepted to be effective. In particular in relation to white collar offences both courts and the legislatures emphasise the need to impose harsher sanctions to deter others from committing similar offences, again based upon the

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<sup>152</sup>J Braithwaite and T Makkai "Testing an Expected Utility Model of Corporate Deterrence" (1991) 25 Law & Soc Rev 7.

<sup>153</sup> S Klepper and D Nagin "Tax Compliance and Perceptions of the Risks of Detection and Criminal Prosecution" (1989) 23 Law & Soc Rev 209

<sup>154</sup> S Simpson and C Koper "Deterring Corporate Crime" (1992) 30 Criminology 347.

<sup>155</sup> Cumming, *supra* note 125.

theory that others are rational actors likely to take into account the severity of sanctions imposed.<sup>156</sup>

#### **Part 4 Difficulties for Regulators in Enforcing Laws Prohibiting Market Abuse**

Public enforcement of securities laws by securities regulators, although usually a key part of their mission, is often the most challenging part:

[R]egulators throughout the world face significant challenges in implementing credible and effective enforcement programs. A combination of the need for extensive resources, strong institutional and political support, and a supportive legal environment make enforcement a particularly difficult challenge and has proven insurmountable in many jurisdictions.<sup>157</sup>

Market abuse, in particular, is difficult to detect, investigate and prosecute. Detection is difficult because legitimate trades have to be sorted from insider trades or manipulative trading. These offences are difficult to investigate as perpetrators may seek to disguise their offence and may leave little in the way of a documentary evidence trail. There is usually no victim to give evidence or report the crime. The regulator has to be able to establish that, usually based solely upon circumstantial evidence, the trades were not made for legitimate reasons. In relation to market manipulation, which involves trades made with ‘manipulative’ intent, the regulator must also prove the state of mind of the accused.<sup>158</sup> The trading is often complex and/or takes place over a period of time adding to the difficulties of detection, gathering evidence and satisfying the person charged with adjudicating the matter that the offence occurred. For example, the practice commonly known as ‘painting the tape’ involves

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<sup>156</sup> For example in *R v Drabinsky* 2011 CarswellOnt 9323 the Ontario Court of Appeal, in reviewing the sentence for a fraud and misrepresentations to investors stated [at 159-160]:

The deterrent value of any sentence is a matter of controversy and speculation. However, it would seem that if the prospect of a long jail sentence will deter anyone from planning and committing a crime, it would deter people like the appellants who are intelligent individuals, well aware of potential consequences, and accustomed to weighing potential future risks against potential benefits before taking action.....

In any event, this court and all other provincial appellate courts have repeatedly held that denunciation and general deterrence must dominate sentencing for large scale commercial frauds.

In relation to an legislation to increase sanctions to deter white collar crime see for example *An Act to Amend the Criminal Code (Capital Markets Fraud and Evidence-Gathering)*, S.C. 2004 , c. 3 and *Standing up for Victims of White Collar Crime Act* S.C. 2011, c. 6.

<sup>157</sup> Carvajal, *supra* note 80 at 2.

<sup>158</sup> See generally DR Fischel & DJ Ross, *supra* note 47.



traders engaging in a series of transactions to create an appearance of activity in a stock with a view to inducing others to invest. As such, this practice can consist of multiple transactions taking place over an extended period.<sup>159</sup> This can add significant complexity to any investigation and subsequent prosecution. Defendants are often well resourced and can afford to invest in defence counsel who may make multiple appeals and/or engage in collateral challenges to the regulators' actions, delaying and possibly thwarting an investigation or prosecution.

Some of the other factors that can impact on the enforcement of market abuse offences by securities regulators are:

1. Capacity

A key component of effective enforcement is regulators having the capacity, in particular sufficient resources, to detect market abuse and then institute and progress enforcement actions. Furthermore, regulators must be actively willing to take action in matters that may be complex and costly to pursue.<sup>160</sup>

2. Technical skills

Tackling market abuse through formal enforcement is a specialised field requiring not just investigatory and legal skills, but skills enabling investigators and lawyers to understand the markets and trading. In addition, due to the complexity of market abuse detection, investigations and prosecutions may require a substantial investment in technology and specialized staff.<sup>161</sup>

3. Political or industry resistance/interference

Regulators need a clear and transparent mandate to bring enforcement action when there are securities violations, and need the ability to conduct enforcement action without

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<sup>159</sup> For a list of common manipulation techniques see Cumming, *supra* note 15 at 462.

<sup>160</sup> Carvajal, *supra* note 80 at 23.

<sup>161</sup> Carvajal, *supra* note 80 at 27.

political interference.<sup>162</sup> Persons who violate securities laws or who may be exposed to prosecution may be persons of substantial wealth or influence. Such persons may seek to influence the actions of the regulator or may attempt to weaken its resolve. Accordingly, to withstand such pressures, regulators need to have a level of independence and be able to pursue their mandate without the possibility of backlash.

#### 4. Legal powers to investigate and bring action

Effective enforcement is contingent upon strong investigative powers. These may include powers to obtain documents and testimony, powers to enter premises and search and powers to intercept electronic communications. A lack of investigative powers will weaken investigations, and may result in action either not being taken or being unsuccessful. Unsuccessful investigations can weaken the role of the regulators and embolden potential offenders.

Regulators need tools that will enable them to take quick action to either restrain funds or detain within their jurisdiction possible offenders. Movement of funds or offenders beyond a jurisdiction can also significantly lessen the impact of an enforcement action.

Regulators also need a range of enforcement penalties in their arsenal such that they can seek an appropriate penalty for the offence. This may include lower level fines and the ability to issue warnings for minor or technical violations, administrative penalties through to the ability to seek significant jail terms for the worst types of offences. Inappropriate penalties may not sufficiently deter other possible offenders.

#### 5. Effective court system

Regulators need the support of an effective court system to pursue actions, including administrative remedies. Such a system needs to support the regulator by being quick for both interlocutory and final proceedings, as delay can reduce both the value of evidence as well as the deterrent impact of enforcement action and can undermine the

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<sup>162</sup> Carvajal, *supra* note 80 at 25.

credibility of the regulator. The court system also has to be free from corruption and have effective mechanisms to enforce judgments and penalties.<sup>163</sup>

## **Challenges may Increase when Securities Regulators tackle Cross Border Market**

### **Abuse**

Cross Border Market Abuse is market abuse that straddles jurisdictional boundaries. That is, not all of the activity that constitutes the market abuse takes place within the jurisdiction of one securities regulator. For example, the perpetrator or perpetrators could be situated in one or more jurisdictions.

Taking enforcement action in relation to an offence where all of the activity did not take place within one jurisdiction increases the challenges for regulators charged with taking such action. For example, the laws of the jurisdiction have to be broad enough to cover situations where offenders may not be within the jurisdiction. Evidence may have to be gathered from other jurisdictions and so regulators may have to obtain the cooperation of foreign regulators to obtain this evidence. However, for various reasons, these foreign regulators may lack the ability to obtain the material or the capacity to share it with their foreign counterparts. Offenders may have to be extradited to face trial and regulators may not be able to compel such an extradition. Regulators may have to obtain oral evidence from witnesses who do not reside within the jurisdiction and they may be unable to compel their attendance at trial. All of this is likely to add to the time, cost and complexity of investigations abroad and the risk that any action taken by regulators will ultimately not be successful.

In addition regulators must be willing, and have the political support, to take action in relation to cross border market abuse that does not impact directly upon their own markets. For example the perpetrators may be situated within the jurisdiction but may trade on a market outside of the jurisdiction. There may be domestic pressures on regulators to not pursue action in such a matter and focus only upon those instances of market abuse which threaten the integrity of the domestic markets. However a failure to take action in relation to such

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<sup>163</sup> Carvajal, *supra* note 80 at 28.

matters will present an opportunity for those who intend to engage in cross border market abuse to structure their trading to avoid enforcement action.

## **Conclusion**

Protecting market integrity is a core objective of securities regulators to protect the fairness of the markets for investors, maintain confidence in the markets and ensure that the markets are efficient. In furtherance of this objective, securities regulators direct resources into the public enforcement of laws that prohibit market abuse and, in particular, laws that prohibit insider trading and market manipulation. Although there is still, and likely will to continue to be, some debate over the level of public enforcement required, some level of enforcement of these laws can be justified. This justification can be grounded upon ensuring the market is normatively 'fair' for participants and, based on empirical evidence, upon the interests of making markets more efficient and thereby lowering the cost of capital.

Yet despite the importance of the role of securities regulators to take action against market abuse in the interests of protecting market integrity, this function is a difficult one. Detecting, investigating and prosecuting market abuse, even if this market abuse takes place wholly within the regulator's own jurisdiction, can be complex, expensive and challenging. These challenges are likely to increase if the market abuse straddles jurisdictions. Furthermore, markets have changed significantly over the last few decades, as opportunities to trade internationally have increased. This may have changed the nature, type and quantity of market abuse that takes place across borders and thereby increased the challenges faced by regulators in effectively dealing with such market abuse. The changes to the markets, whether they have increased opportunities for cross border market abuse and the regulatory response is the focus of the next chapter.

## CHAPTER 2

### OPPORTUNITIES FOR CROSS BORDER MARKET ABUSE

These new trading venues and facilities (*i.e. Alternative Trading Systems*) have provided more competition to existing regulated markets, gaining an increased share of liquidity and attracting a broader range of investors. The increase in trading across different venues has made it more difficult to monitor for market abuse.

European Commission “Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse)”<sup>164</sup>

Compared to say the 1970's today institutions, and even individual investors, have access to a much vaster array of securitized products and trading venues. Furthermore the last few decades has seen brokerage costs fall significantly and the time taken to execute a trade has been reduced to a fraction of a second. Falling costs and rapid execution times have resulted in new participants entering the markets contributing to significant increases in trading volumes.

These changes to the markets have largely been driven by competition between markets which has resulted in reduced brokerage costs for traders and listing costs for issuers. Competition has also increased liquidity, reducing the spread between buy and sell orders, which in turn has decreased the profits that can be made on such spreads. As the profits on such spreads falls this improves liquidity benefiting traders and investors. At the same time, competition has resulted in the development of new products as investors seek new ways to improve the returns on their investments. This has occurred in an environment in which over

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<sup>164</sup> Comment on increased trading on Alternative Trading Systems and other types of OTCs as distinct from regulated exchanges by the European Commission, in European Commission, “Proposal for a Regulation of the European Parliament and of the Council on insider dealing and market manipulation (market abuse)” (20 October 2011) online: Eur-Lex <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0651:FIN:EN:PDF>>.

the last few decades has seen the number of cross border mergers and acquisitions rapidly increase.

Securities regulators have largely welcomed these developments as one of their key objectives includes promoting market efficiency. However, as discussed in Chapter 1, the goals of securities regulators extend beyond promoting the efficiency of markets to also protecting the integrity or fairness of the markets. This requires, as a minimum, that securities regulators work towards preventing market abuse. This is because there is a compelling public interest in regulators taking action to maintain and improve market integrity. Securities markets are vital mechanisms by which corporations can access funds from investors in order to grow. Such investment is dependent to a large extent upon investors having confidence that the market is fair. Market integrity is therefore important to promoting investment, which is, in turn, important to the economic development of a country.

However protecting the integrity of the markets was not a primary concern in the development of markets of the last few decades, the changes being driven by the benefits of efficient markets in terms of reduced costs and investor choice. However a consequence of these changes may be that there has been an impact upon market integrity and the changes may have made markets more susceptible to market abuse and cross border market abuse.

Given that this dissertation is concerned with ascertaining whether securities regulators have kept up with the level of sophistication of the markets, this chapter seeks to outline how and why the markets have changed and become more complex. In addition this chapter also seeks to ascertain how those responsible for securities regulation policy have responded to possible threats to market integrity and possible increases in the susceptibility of markets to market abuse.

In particular this chapter details how, as a result of recent crises in securities markets, securities regulations have been strengthened. However much of the focus of these new regulations has been directed towards a relatively new, and different, regulatory goal – that

of reducing systemic risk.<sup>165</sup> While some of these systemic risk regulatory changes may have incidentally also worked towards improving the integrity of the markets, this has generally not been the primary objective.

To explore these issues, Part 1 outlines the main changes that have taken place to stock markets and securities market trading over the last few decades that may have impacted market integrity. Part 2 considers the risks to market integrity inherent in these changes. Part 3 details the changes in both the architecture of securities regulation and specific regulatory measures that may work towards preserving market integrity. Part 4 then seeks to analyse the policymaker's regulatory responses. The chapter concludes by arguing that up until recently the impact on market integrity has been largely overlooked by regulators in supporting the changes to the markets. If securities regulators and legislators are to maintain and improve market integrity and prevent market abuse in this different and ever evolving trading environment they probably need to do more. In particular more needs to be done to collect trading and other data in a standardized form, to establish procedures and systems to exchange and analyse this data to detect market abuse, and to bring enforcement proceedings in relation to such market abuse.

## **Part 1 Changes to Securities Markets and Trading**

### **The break-down of the exchange monopolies and fragmentation**

Securities markets today bear little resemblance to stock exchanges which operated up until the 1970s and 1980s. Up until that time exchanges around the world were physical trading floors operating within their own protected, often monopolistic, environment, typically defined by national boundaries. While a few exchanges were run by governments, most exchanges

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<sup>165</sup> See IOSCO Principles, *supra* note 37. Reducing Systemic Risk was added as an objective on 10 June 2010, see IOSCO, Media Release, "Global securities regulators adopt new principles and increase focus on systemic risk" (10 June 2010) online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS188.pdf>>. Systemic risks have been defined as "risks that occasion a 'domino effect' whereby the risk of default by one market participant will impact the ability of others to fulfil their legal obligations, setting off a chain of negative economic consequences that pervade an entire financial system." See MJ Trebilcock, *National Securities Regulator Report* (2010), as quoted in *Reference re Securities Act*, 2011 SCC 66 at (103), 3 SCR 837).

were private mutual organizations owned and operated by brokers.<sup>166</sup> Those exchanges were largely self-regulated and subject to only a limited degree of government oversight. Although this system of a single or very few private exchanges for each jurisdiction was largely anti-competitive it was allowed to continue as it delivered a number of benefits:

Governments benefited as they were able to regulate the securities market without the cost and trouble of setting up a very extensive system of supervision and enforcement. Stock exchanges benefited by being recognized by government as the means through which the securities market was regulated. Their members benefited as this enhanced position limited or removed competition, so allowing them to pass on their costs to buyers and sellers of securities. Investors benefited as they had access to a regulated market in which the risk of default or fraud were much reduced. Issuers of securities benefited as they continued to have access to a market where the stocks and bonds they created could be traded.<sup>167</sup>

Nevertheless this anti-competitive environment was not without critics in that, like other anti-competitive environments, exchanges were able, or at least had the capacity, to exercise the power of a monopoly. This gave the exchanges and the member brokers the ability to stifle innovation and make monopolistic profits from high charges levied on brokers, issuers and investors.

Towards the end of the 20<sup>th</sup> century exchanges increasingly came under pressure to change. These changes were influenced first by the fact that from the 1980s institutions took over from individuals as the main investors in securities.<sup>168</sup> The number and size of such institutions grew dramatically as individuals increasingly invested through mutual funds to diversity and reduce the volatility of their portfolios and perhaps also because it became apparent that government benefits for retirement would become less generous in the future, thus compelling individuals to make their own provision for retirement through the use of

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<sup>166</sup> See generally R Michie, "Exchanges in Historical and Global Context" in L Harris, ed, *Regulated Exchanges: Dynamic Agents of Economic Growth* (New York, Oxford University Press, 2010).

<sup>167</sup> *Ibid* at 35.

<sup>168</sup> In 1989 institutions owned 50% of the securities on the NYSE up from 13% in 1949. Institutions did 54.6% of the trading on the NYSE up from 42.4% in 1969. See J O Matthews *Struggle and Survival on Wall Street: The Economics of Competition among Securities Firms* (New York, Oxford University Press, 1994) at 87.



mutual or pension funds.<sup>169</sup> Competition between such funds put pressure on funds to obtain high rates of return. As part of their push to increase returns, these institutional investors pressed governments for changes to the anti-competitive fee structures of exchanges. As a result, governments gradually required the existing exchanges to abandon their anti-competitive practices including fixed commissions and restrictive membership requirements.<sup>170</sup>

Another driver of change was the dramatic improvement in communications and trading technology, and, in particular, the movement from trading floors to screen trading systems.<sup>171</sup> This move to electronic trading enabled the establishment of new regulated exchanges and alternative trading systems (ATS),<sup>172</sup> as barriers to enter the market for securities trading fell. The impetus for establishing ATS (also called electronic communication networks (ECN) or Multilateral Trading Facilities (MTF)) also came from reduced fixed costs, for example location costs, compared to regulated exchanges and by the fact that they often had a lower cost regulatory framework.<sup>173</sup> Established exchanges also faced increased competition from expanded over the counter trading (OTCs).<sup>174</sup> Although OTC dealings have existed for most of the twentieth century, increased technology and communications allowed their expansion.<sup>175</sup> Like ATs, OTCs have competitive advantages of reduced fixed and regulation costs compared to established exchanges. Competition to established exchanges has also come from larger security houses increasingly internalising order matching. This

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<sup>169</sup> See generally Mathews *supra* p83-94 and D Fernando et al, “The Global Growth of Mutual Funds” (May 2003) [World Bank Policy Research Working Paper 3055] online: World Bank <[http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2003/07/08/000094946\\_03062104294247/additional/108508322\\_20041117143517.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2003/07/08/000094946_03062104294247/additional/108508322_20041117143517.pdf)>.

<sup>170</sup> Michie, *supra* note 166 at 28, 37-39 and 43-44. For example, fixed commissions ended on the NYSE in 1975 and on the LSX in 1983.

<sup>171</sup> J Board, C Sutcliffe & S Wells, *Transparency and Fragmentation: Financial Market Regulation in a Dynamic Environment*, (London, Palgrave Macmillian, 2002) at 9.

<sup>172</sup> In the US, these are called electronic communication networks (ECNs). In the United Kingdom, these are referred to as alternative trading systems (ATs) or alternative trading platforms (ATPs), and in Europe, they are referred to as multilateral trading facilities (MTFs). An example of an ECN is Instinet. See Michael Blair & George Walker *Financial Markets and Exchanges Law* (Oxford, Oxford University Press, 2007) at 468 at xlix, 5, 9, 23 and 24.

<sup>173</sup> Blair, *supra* note 172 at 9.

<sup>174</sup> Blair, *supra* note 172 at 5.

<sup>175</sup> Blair, *supra* note 172 at 1.

involves firms setting off positions within their order books and only settling net positions through a formal exchange. The advantage to the firms and their clients of this internal matching is the reduced cost of only having to book net positions on an exchange.<sup>176</sup>

The revolution in communication technologies also resulted in exchanges having to compete for listings. Whereas previously corporations would list their securities on exchanges to which they were geographically connected, corporations were no longer bound to continue this practice. Issuers can now search for the cheapest source of capital wherever it may be in the world.<sup>177</sup> At the same time, there has been a dramatic increase in securitization globally as corporations move away from bank financing to tradable securities based financing.

To maintain market share in the face of these competitive pressures, established exchanges looked to lower costs, primarily through investment in technological change. To raise the capital to invest in such technologies most stock exchanges that were member cooperatives demutualized. Such demutualization involved converting their ownership structure from being owned by brokers to public corporations owned by shareholders. Many also listed the shares of this public corporation on the exchange it operated.<sup>178</sup> In Europe, state owned stock markets converted to public traded corporations.<sup>179</sup> This change in ownership structure made it easier to raise funds through both equity and debt. It was also thought that this would facilitate innovation by changing the incentive structure of the organization that

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<sup>176</sup> Blair, *supra* note 172 at 25.

<sup>177</sup> Avgouleas, *supra* note 8 at 29. For example see the recent IPO by Alibaba Group on the NYSE which raised US\$25 billion. This company's business is based in China. Subscribers to the IPO purchased shares in a Cayman Islands shell corporation which has a contractual right to the profits of Alibaba's assets as foreign share ownership in China is restricted. See R Hsueh "Alibaba, the Golden Child of China's Globalization Strategy", the Huffington Post, 15 October 2014, online: <[http://www.huffingtonpost.com/roselyn-hsueh/alibaba-the-golden-child-\\_b\\_5990116.html](http://www.huffingtonpost.com/roselyn-hsueh/alibaba-the-golden-child-_b_5990116.html)> and M Kitchen "Beware: Alibaba's IPO isn't really selling Alibaba", Market Watch, 7 May 2014, online: <<http://www.marketwatch.com/story/beware-alibaba-ipo-isnt-really-selling-alibaba-2014-05-07>>.

<sup>178</sup> For a list of demutualized exchanges, see JW Carson, "Conflicts of Interest in Self Regulation: Can Demutualized Exchanges Successfully Manage them?" (December 2003) [World Bank Policy Research Working Paper 3183], online: SSRN <[http://papers.ssrn.com/sol3/Papers.cfm?abstract\\_id=636602](http://papers.ssrn.com/sol3/Papers.cfm?abstract_id=636602)>.

<sup>179</sup> Avgouleas, *supra* note 8 at 28.

operated the market to a board of directors focused on maximising profits for shareholders.<sup>180</sup>

### **Consolidation – the rise of global stock exchanges**

Following their conversion to public corporations, exchanges started to invest heavily in new technologies and began consolidating their competitive position by merging with, or acquiring, other exchanges and/or ATs. This was made easier by the fact that many smaller exchanges, deprived of government support and protection, found it hard to compete.<sup>181</sup> For larger exchanges acquiring other exchanges was undertaken to improve their competitive position by acquiring new trading platforms and technology, increasing liquidity and allowing them to move beyond their traditional boundaries into new markets. The growth of the New York Stock Exchange (NYSE) through acquisitions and mergers with other exchanges demonstrates this trend. In 2006 the New York Stock Exchange (NYSE) merged with ArcaEx. ArcaEx was an ECN launched in 2002 which had, in 2005, acquired the Pacific Exchange, an exchange which had been created by the merger of the San Francisco exchange and the Los Angeles stock exchange.<sup>182</sup> In 2007 the NYSE merged with Euronext to form NYSE Euronext. Euronext itself was formed by the consolidation of the Amsterdam Exchange, the Brussels Exchange, the Paris Bourse, the Lisbon exchange and London International Financial Futures and Options Exchange.<sup>183</sup> In 2008 NYSE Euronext acquired the American Stock Exchange.<sup>184</sup> In 2011 Germany's exchange, Deutsche Börse, attempted to merge with NYSE Euronext, but the EU competition regulator ultimately blocked this merger.<sup>185</sup> Then, in 2013, Intercontinental Exchange Inc. successfully took over

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<sup>180</sup> Board, *supra* note 171 at 56.

<sup>181</sup> Michie, *supra* note 166 at 53.

<sup>182</sup> See Intercontinental Exchange, online: Intercontinental Exchange <[https://www.theice.com/publicdocs/ICE\\_at\\_a\\_glance.pdf](https://www.theice.com/publicdocs/ICE_at_a_glance.pdf)>.

<sup>183</sup> *Ibid.*

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

<sup>185</sup> See A Barker, J Grant & J Wilson "Deutsche Börse- NYSE merger blocked" *FT Trading Room* (1 February 2012) online: FT Trading Room <<http://www.ft.com/cms/s/0/3615546a-4cb7-11e1-8b08-00144feabdc0.html#axzz1mBGHsvFQ>>; M De La Merced, J Kanter & J Ewing "NYSE and Deutsche Borse Plan to Call Off Merger" *DealBook NYTimes* (1 February 2012) online: The New York Times <<http://dealbook.nytimes.com/2012/02/01/nyse-and-deutsche-borse-call-off-merger/>>; "EU regulators to

NYSE Euronext.<sup>186</sup> While the creation of Intercontinental Exchange incorporating NYSE Euronext is probably the most extreme example of consolidation, other exchanges have also been involved in seeking to expand by mergers and takeovers of other exchanges.<sup>187</sup> For example, in 2011, the London Stock Exchange (LSE) attempted to take over the TSX Group, which controls, inter alia, the Toronto Stock Exchange, The TSX Venture Exchange and the Montreal Exchange for derivatives. This takeover failed but a rival bid was successful. This rival bid was by the 'Maple Group', a consortium of Canadian banks, pension funds and insurers, which included the owners of the largest ATS in Canada, the Alpha Group.<sup>188</sup>

Notwithstanding these attempts by the large exchanges to maintain market share, increased competition has resulted in a movement away from trading on the large exchanges and trading has become more dispersed over a number of exchanges, ATS's and internal transactions conducted by broker-dealers. For example, in October 2009, the NYSE executed only 20.8% of the consolidated share volume in listed stocks compared to 79.1% in January 2005.<sup>189</sup> This pattern of fragmentation is not confined to NYSE stocks. As demonstrated by Figure 2.1, trading in U.S. stocks now takes place in numerous venues.

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examine ICE, NYSE Euronext merger", *Reuters* (24 April 2013) online: CNBC <<http://www.cnbc.com/id/100667356>>.

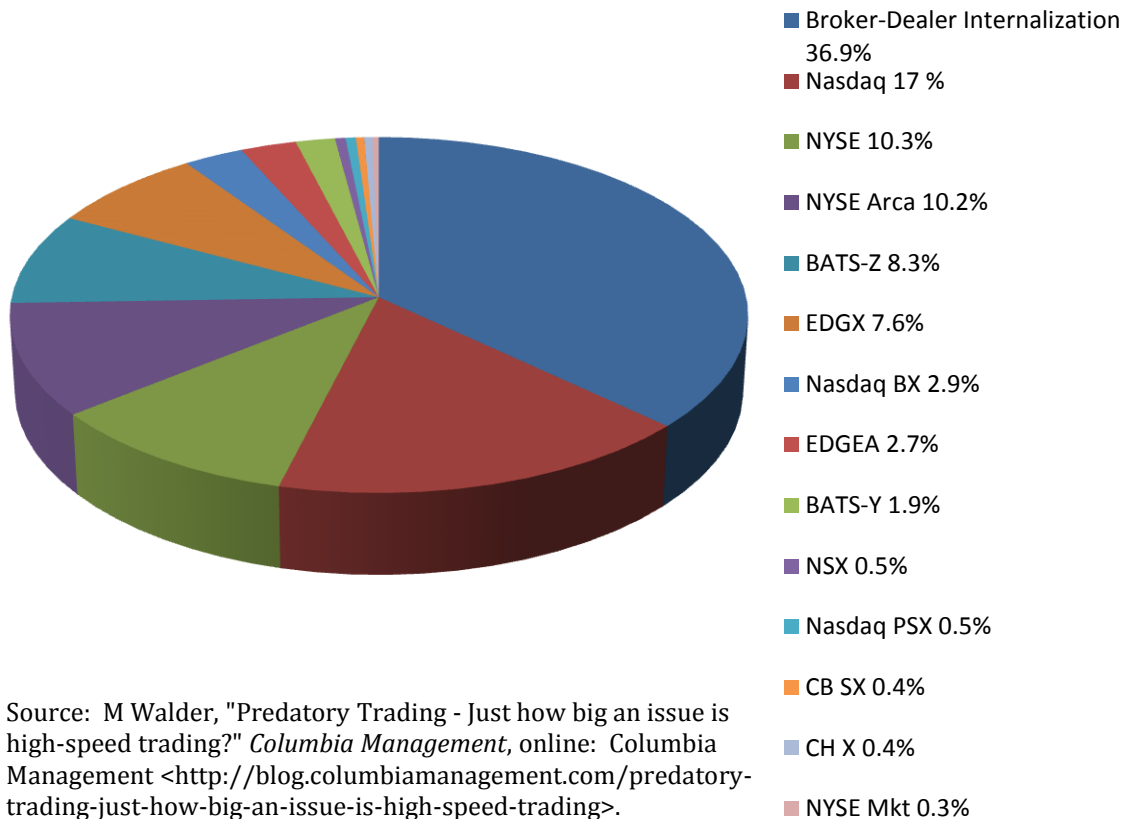
<sup>186</sup> NYSE, News Release, "Intercontinental Exchange Completes Acquisition of NYSE Euronext" (13 November 2013) online: NYSE <<http://www1.nyse.com/press/1388665271901.html>>.

<sup>187</sup> See e.g. the takeover of the Osaka Securities Exchange Co. by the Tokyo Stock Exchange (see T Hasegawa & N Kuboyama, "Tokyo Exchange Enters \$30 Billion Merge wave with Osaka Bid", *Bloomberg* (23 November 2011) online: Businessweek <<http://www.businessweek.com/news/2011-11-23/tokyo-exchange-enters-30-billion-merger-wave-with-osaka-bid.html>>). In April 2011, the Australian Government blocked a takeover bid by the Singapore Stock Exchange for the Australian Securities Exchange (ASX) as being contrary to Australia's national interests. See P Swan, "Swan right to reject Singapore takeover of ASX", *The Australian* (12 April 2011) online: The Australian <<http://www.theaustralian.com.au/business/opinion/swan-right-to-reject-singapore-takeover-of-asx/story-e6frg9if-1226037469640>>.

<sup>188</sup> See P Jordan & L Jeffs, "LSE, TMX abort their merger leaving both in play", *Reuters* (29 June 2011) online: Reuters <<http://www.reuters.com/article/2011/06/29/us-tmx-halt-idUSTRE75S5KL20110629>>; CBC News, "TSX, LSE Takeover Falls Apart" (29 June 2011) online: CBC <<http://www.cbc.ca/news/business/story/2011/06/29/tsx-lse-takeover.html>>; and C French, "Alpha group CEO Schmitt steps down after TMX", *Reuters* (24 September 2012) online: Reuters <<http://ca.reuters.com/article/businessNews/idCABRE88N0VN20120924>>.

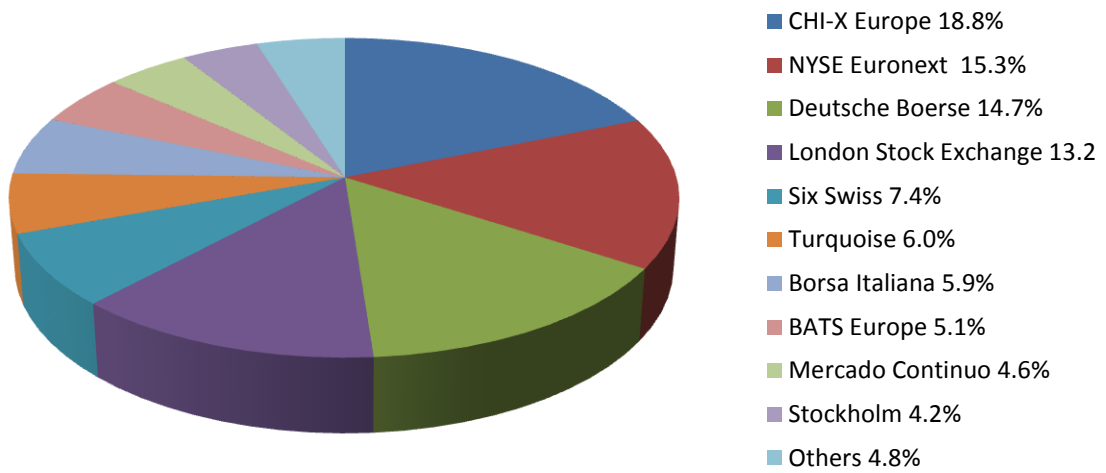
<sup>189</sup> SEC, "Concept Release on Equity Market Structure" (January 2010) online: SEC <<http://www.sec.gov/rules/concept/2010/34-61358.pdf>> at 6; M Walder, "Predatory Trading - Just how big an issue is high-speed trading?" *Columbia Management*, online: Columbia Management <<http://blog.columbiamanagement.com/predatory-trading-just-how-big-an-issue-is-high-speed-trading>>.

### Figure 2.1 US Markets - 2014 Market Share



Similarly trading in Europe has also fragmented, with the LSE's share trading volume falling from 35% in 2008 to 13.2% in 2011<sup>190</sup>. Trading in EU securities also now takes place in multiple venues [Figure 2.2].

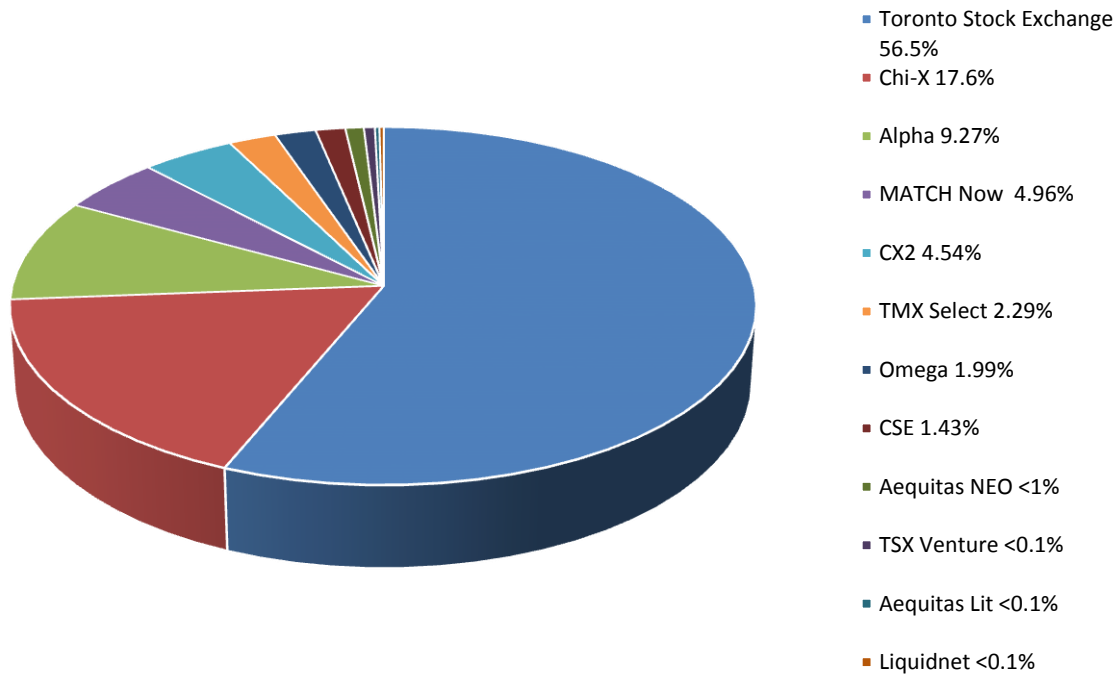
<sup>190</sup> K Lannoo & Piero Cinquegrana, "Capital Markets Regulation Revisited" in L Harris, *supra* note at 134; E Dunkley, "Pan-Europe vs. the Nationals", *The Wall Street Journal* (10 October 2011), online: The Wall Street Journal <<http://online.wsj.com/news/articles/SB10001424052970204138204576602661851424074>>.

**Figure 2.2 EU Markets - 2011 Market Share**

Source: E Dunkley, "Pan-Europe vs. the Nationals", *The Wall Street Journal* (10 October 2011) online: *The Wall Street Journal* <<http://online.wsj.com/news/articles/SB10001424052970204138204576602661851424074>>.

In Canada, although there has been less drift away from the TSX, other trading venues have obtained significant market share (Figure 2.3)

**Figure 3: Canadian Markets – 2015 Market Share**



Source: IIROC "Market Share by Marketplace (for the Four Quarters Ending June 30 2015)" online: <http://www.iroc.ca/industry/marketmonitoringanalysis/Documents/MarketplaceStatisticsReportCur>

### **Cross Border trading and Interconnected Trading Platforms**

The changes outlined above and, in particular, the improvements in trading technologies have increased the ability of brokers and their clients to trade in multiple markets. In fact, responding to demands by investors to trade in multiple venues and products has been another factor driving the consolidation of markets. Consolidated exchanges can enable broker firms to offer investors more choice in the products and locations of trading, which is attractive to individual investors and funds chasing superior rates of return. In an attempt to respond to investor demands for multiple trading opportunities, some exchanges have also developed joint platforms and linkages to increase the ability of investors to trade in different markets.<sup>191</sup>

<sup>191</sup> Blair, *supra* note 172 at 107.

For example, the Intercontinental Exchange now operates 11 major exchanges in Europe and the United States trading more than 12000 listed issues including derivatives, equities, futures, options, fixed-income and exchange-traded products.<sup>192</sup> Intercontinental Exchange U.S. member broker-dealers can apply for access to all of the U.S. markets controlled by the Intercontinental Exchange, and Intercontinental Exchange European member broker-dealers can apply to access all of the European markets controlled by Intercontinental Exchange. Large broker-dealer firms with a presence in both the U.S. and Europe can provide access for their clients to all of these products and markets.<sup>193</sup>

### **Increased Trading in Derivatives**

The last few decades have also seen a dramatic growth in the use of derivatives, again driven principally by investors seeking superior rates of return on their investments and because the number of markets and derivative products has expanded to meet this need. In the decade since 2000, derivatives trading has grown from approximately 8 billion contracts in 2003 to over 25.2 billion contracts in 2011.<sup>194</sup> The range of derivatives has also grown, including derivatives in relation to which the underlying asset of the derivative is traded in another jurisdiction. In addition to the growth of derivatives on exchanges there has been a growth in trading derivatives on the OTC markets from US\$111 trillion at the end of 2001 to US\$633 trillion by the end of 2012.<sup>195</sup>

### **Increased Trading Volumes and ‘High Frequency’ (or algorithmic) Traders**

The falling brokerage costs resulting from increased competition between markets has resulted in significant increases in trading volumes, not just in derivatives, but also in

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<sup>192</sup> Intercontinental Exchange, *supra* note 182.

<sup>193</sup> See e.g. the services offered by the Knight Group, online: KCG <<http://www.knight.com/index.asp>>.

<sup>194</sup> Romain Devai & Grégoire Naacke, “WFE/IOMA Derivatives Market Survey 2011” (May 2012) at 5, online: World Federation of Exchanges <[www.world-exchanges.org/files/statistics/excel/2011\\_IOMA\\_Survey\\_final.pdf](http://www.world-exchanges.org/files/statistics/excel/2011_IOMA_Survey_final.pdf)>.

<sup>195</sup> See Bank for International Settlements, “Statistical Release: OTC Derivatives Statistics at End-June 2013” (November 2013) at 2, online: Bank for International Settlements <[www.bis.org/publ/otc\\_hy1311.pdf](http://www.bis.org/publ/otc_hy1311.pdf)>; Bank for International Settlements, Press Release, 13/2002E, “Rapid Expansion of OTC Derivatives Market in the Second Half of 2001” (15 May 2002) at 1, online: Bank for International Settlements <[www.bis.org/publ/otc\\_hy0205.pdf](http://www.bis.org/publ/otc_hy0205.pdf)>.



equities. Furthermore this growth in trading volumes has been accelerated because electronic trading, low costs and fast execution times has brought about the emergence of 'high frequency' traders who have now become significant market participants. The business of high frequency trading would not have been viable without these developments as it involves using mathematical models to automatically generate thousands of buy and sell orders each day in search of small profits on each trade.<sup>196</sup>

There is no single agreed upon definition of high frequency trading and it is often referred to as algorithmic trading. Yet, in actual fact, high frequency trading is only one type of algorithmic trading. This is because algorithmic trading appeared before high frequency trading and was used as a tool to determine some or all aspects of trade execution like timing, price, quantity and venue. High frequency trading, however, is algorithmic trading where there is a focus on speed of execution and turnover to generate profits. It can also have the following common features:

- It uses sophisticated technological tools for pursuing a number of different trading strategies, ranging from market making to arbitrage;
- Employment of algorithms along the whole investment chain: analysis of market data, deployment of appropriate trading strategies, minimization of trading costs and execution of trades;
- A high daily portfolio turnover and order to trade ratio (i.e., a large number of orders are cancelled in comparison to trades executed);
- Flat or near flat positions at the end of the trading day, meaning that little or no risk is carried overnight, with obvious savings on the cost of capital associated with margined positions;
- Mostly employed by proprietary trading firms or desks; and

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<sup>196</sup> The growth in high frequency trading began principally from a change in 2005 in the SEC rules, which required that brokers fill customer orders at the best available price. This rule led to faster trading speeds as exchanges competed to fill each order, the competition driving down the cost of each trade. See also DK Randall, "How stock trading has changed since 9/11", *Associated Press* (5 September 2011) online: Yahoo News <<http://news.yahoo.com/stock-trading-changed-since-9-11-201335376.html>>.

- It is latency sensitive, that is, the success of its strategies crucially depends upon the ability to be faster than competitors and to take advantage of services such as direct electronic access and co-location.<sup>197</sup>

Figures from the World Federation of Exchanges show that the total number of trades in equity shares has increased by 700% over a decade from under 2 billion in 2000 to over 13 billion in 2009<sup>198</sup>, much of which probably be attributed to high frequency trading.<sup>199</sup> Another consequence of high frequency trading is that the average size of trades has dropped 85% over the last decade from a high of over US\$50 000 in 2001 to less than US\$9 000 in 2013.<sup>200</sup>

### **Direct Electronic Access**

Associated with the growth of high frequency trading has been the growth of brokers offering their clients direct electronic access to markets. This practice allows clients to transmit orders that automatically route through the brokers' infrastructure for execution on the market. Alternatively, the broker allows clients to use its member ID to transmit orders directly to the markets.<sup>201</sup> The attraction of this practice for clients is that it allows them greater control over their trading and reduces execution times for their orders. This is especially important for high frequency traders who engage in trading strategies designed to utilize arbitrage opportunities to make a large number of small gains. The attraction for brokers is that it allows them to 'rent out' their trading facility for profit but, in the absence of

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<sup>197</sup> See IOSCO Technical Committee, *supra* note at 22-23 (Tech Changes Report).

<sup>198</sup> World Federation of Exchanges, "10 Years in Review (2000-2009)" online: World Federation of Exchanges <<http://www.world-exchanges.org/statistics>> at 3.

<sup>199</sup> It was estimated in 2009 that 56 per cent of the equity trading in the US was a result of high frequency trading. See Bank of Canada Financial System Review "The Growth of High-Frequency Trading: Implications for Financial Stability" June 2011 online: <<http://www.bankofcanada.ca/wp-content/uploads/2011/12/fsr-0611-barker.pdf>> which quotes this figure from Sussman, A., L.Tabb and R.Iati.2009."US Equity High Frequency Trading: Strategies, Sizing and Market Structure." Tabb Group Sussman, A., L.Tabb and R.Iati.2009."US Equity High Frequency Trading: Strategies, Sizing and Market Structure." Tabb Group. Sussman, A., L.Tabb and R.Iati.2009."US Equity High Frequency Trading: Strategies, Sizing and Market Structure." Tabb Group.

<sup>200</sup> *Ibid*; World Federation of Exchanges, "WFE 2013 Market Highlights" online: World Federation of Exchanges <[http://www.world-exchanges.org/files/2013\\_WFE\\_Market\\_Highlights.pdf](http://www.world-exchanges.org/files/2013_WFE_Market_Highlights.pdf)> at 2.

<sup>201</sup> See IOSCO Technical Committee Report, "Principles of Direct Electronic Access to Markets" (August 2010) online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD332.pdf>>.

rules prescribed by regulators, little day-to-day management is needed. In 2010 the SEC estimated that 38% of all U.S. stock trading was executed through direct access trading.<sup>202</sup>

## Hedge Funds

The emergence of hedge funds<sup>203</sup> as significant market participants over the last two decades has also had a real impact upon the growth in trading volumes and markets generally. One industry association has estimated that assets in hedge funds in April 2014 were approximately \$2.7 trillion.<sup>204</sup> While assets in hedge funds comprise only a small proportion of global financial assets, they are particularly active players in the markets.<sup>205</sup> This is because hedge funds typically seek alpha returns; in other words, they seek to consistently outperform the market.<sup>206</sup> In seeking alpha returns hedge funds differ from mutual funds in that:

- they may employ significant leverage, which can enhance investors' returns or magnify their losses;
- they may engage in short-selling, allowing positive returns in negative markets; and
- they may deal in derivatives, including options and futures.<sup>207</sup>

Hedge funds are often structured to provide managers high remuneration for producing such alpha returns. Typically managers charge an annual fee of 2% of assets under management plus 20% of returns.<sup>208</sup>

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<sup>202</sup> SEC, Press Release, "SEC Proposes New Rule to Effectively Prohibit Unfiltered Access and Maintain Market Access Controls" (13 January 2010) online: SEC <<http://www.sec.gov/news/press/2010/2010-7.htm>>.

<sup>203</sup> There is no universal definition of hedge funds. However, they are funds that traditionally have not been subject to regulation and typically invest funds on behalf of high net worth individuals or institutions. The funds are not normally open to retail investors and have traditionally been opaque, being privately owned and unquoted. See Howard Davies & David Green, *Global Financial Regulation The Essential Guide* (Cambridge: Polity Press, 2008) at 228.

<sup>204</sup> Hedge Fund Research Inc, Media Release, "Strong Inflows Drive Hedge Fund Capital to New Record in 1Q14" (21 April 2014) online: Hedge Fund Research <[https://www.hedgefundresearch.com/pdf/pr\\_20140421.pdf](https://www.hedgefundresearch.com/pdf/pr_20140421.pdf)>.

<sup>205</sup> A Engert, "Transnational Hedge Fund Regulation" (2010) 11 *Eur Bus Organization L Rev* 329 at 331.

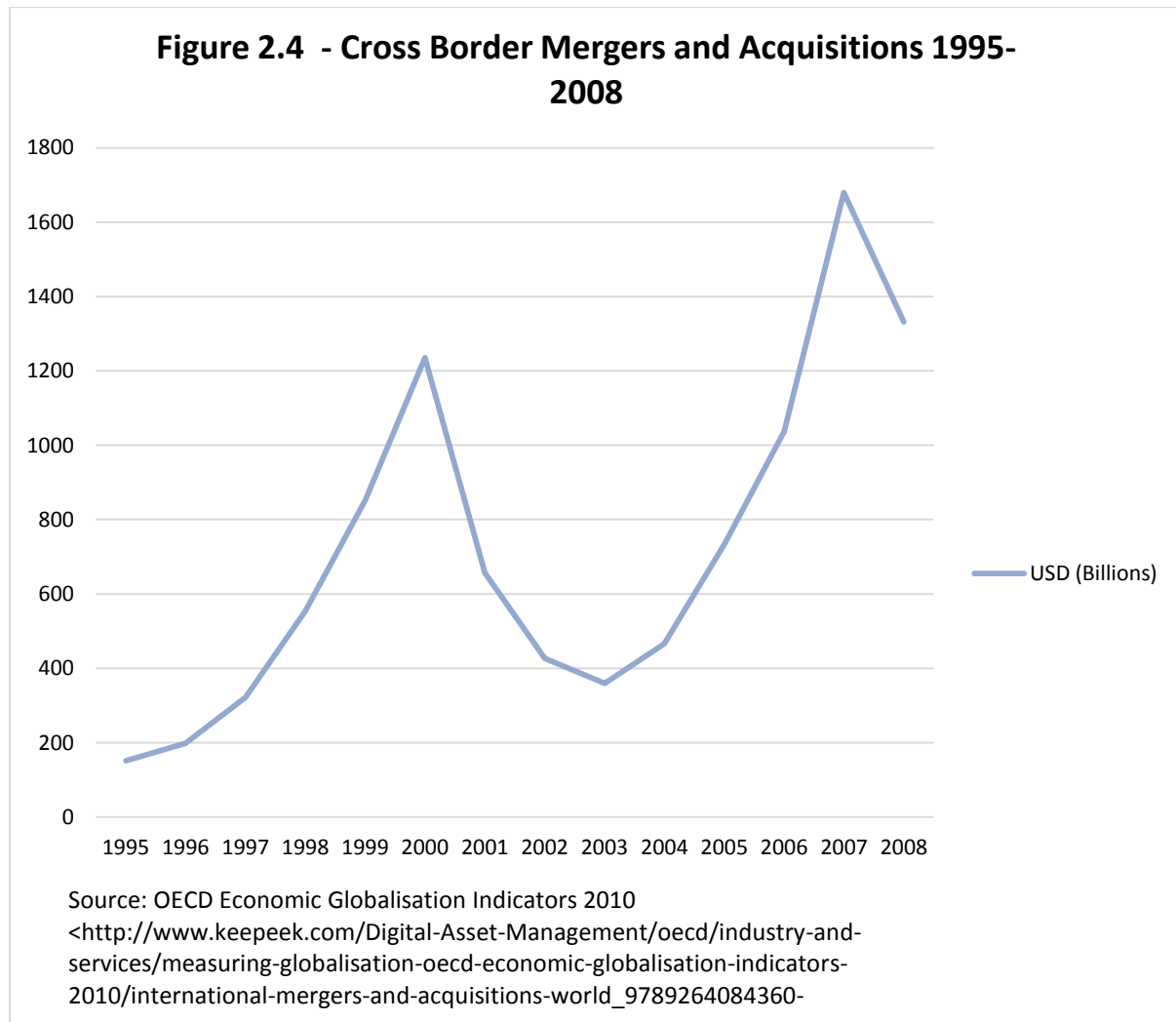
<sup>206</sup> Davies, *supra* note 203 .

<sup>207</sup> D Kaufman, "Alternative investing: Hedge funds unveiled" *Financial Post* (26 May 2010) online: Financial Post <<http://www.financialpost.com/personal-finance/story.html?id=3072572>>.

<sup>208</sup> Davies, *supra* note 203.

## Cross border mergers and acquisitions

Over the last few decades there has been an increase in the number and value of cross border mergers and acquisitions [Figure 2.4]. Whilst the increase has occurred in waves, with rises during economic booms and dips during recessions, the overall trend is upward.



This increase has been driven by a number of factors such as the liberalisation of trade and investment regimes, privatization of public entities, the consolidation of capacity to serve global markets, international competition, technological change and the benefits that can be derived from economics of scale.<sup>209</sup>

<sup>209</sup> Kang, N. and S. Johansson (2000), "Cross-Border Mergers and Acquisitions: Their Role in Industrial Globalisation", *OECD Science, Technology and Industry Working Papers*, 2000/01, OECD Publishing online: <http://dx.doi.org/10.1787/137157251088>.

## **Part 2 The Impact of the Changes on Market Integrity**

### **Risks inherent in the changes**

By any measure, the transformation of securities markets over the last few decades has been remarkable. However, left unchecked, these changes to markets and trading create a risk that the integrity of markets could be undermined.

An enhanced capacity to trade in other markets and the proliferation of ways to trade the same underlying economic interest through derivatives increases the possibility that participants could disguise abusive trading and thereby reduce the probability of detection and prosecution by regulators. For example, a person with inside information on Research in Motion Limited (RIM) could split their trading using different brokers, different trading venues and products. These could include RIM shares on the TSX, RIM options on the Toronto Stock Exchange (TSX) derivatives exchange, RIM shares on NASDAQ and RIM shares on an alternative exchange such as Direct Edge. Splitting their trading in this way would reduce the probability that a trading venue watching only its own market would detect that there was unusual trading taking place because an otherwise noticeable volume of trading from a single source could be disaggregated.

In relation to market manipulation, given the multitude of markets, a person could use a less liquid market to manipulate the price of a security and then trade at this higher level on a more liquid market. Direct access trading could allow those who wish to commit market abuse to access the market directly, rather than through the filter of brokers who, because of their contractual obligations and professional duties, are often able to detect and thereby stop instances of market abuse. Direct access trading may also make it difficult for securities regulators to determine just who is responsible for the trading. It may also make taking enforcement action against a perpetrator of market abuse more difficult as the perpetrator may be outside of the jurisdiction. In addition, clients of brokers who are granted direct

access are generally not subject to the same range of sanctions as brokers.<sup>210</sup> For example in Canada brokers are required to comply with IRROC rules and may be subject to sanctions for breaches of these rules whereas clients are not subject to IRROC rules.

High frequency traders could use their systems and algorithms to engage in the manipulative practices known as ‘spoofing’, ‘layering’, ‘quote stuffing’, ‘quote manipulation and ‘abusive liquidity detection’. These practices are similar, however, spoofing and quote stuffing refer to when a trader engages in a series of orders to give the impression of activity or price movement in a security but the orders are withdrawn before they are executed. For instance, a high frequency trader might post bids for a stock showing that it wants to buy at a certain price. However by the time investors show interest in selling at that price the bids are removed. This can occur in fractions of a second making it difficult to detect.<sup>211</sup> Layering occurs when, for example, as the price of a security moves up a trader takes out the posted asking prices for the security further inflating the price.<sup>212</sup> Quote manipulation refers to entering non-bona fide orders in an attempt to change the best bid or ask. Abusive liquidity detection refers to the entering orders to detect the existence of a large buyer or seller with the intention to trade ahead, rather than with, of this large buyer or seller.<sup>213</sup>

Two reports by IOSCO, in 2010 and 2011, into regulatory issues raised by the changes to the markets concluded that the technological changes and the fragmentation of markets had produced risks of market abuse by high frequency traders and direct market access trading. IOSCO concluded that there is a concern as to whether technological advantages offer high frequency trading firms the possibility of engaging in abusive practices.<sup>214</sup> It also recognized

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<sup>210</sup> See generally IOSCO, *supra* note 201.

<sup>211</sup> See generally Cumming, *supra* note 15 at 456; Chris Rose, "Applying Spam-Control Techniques To Negate High Frequency Trading Advantages", 15 Int'l J Mgmt & Information Systems 105. See also inquiry by the New York Attorney General into actions of High Frequency Traders reported in K Freifeld, "New York's Schniderman seeks curbs on high-frequency traders", *Reuters* (18 March 2014) online: Reuters <<http://www.reuters.com/article/2014/03/18/us-highfrequency-nyag-idUSBREA2H0K120140318>>.

<sup>212</sup> Laurie Carver, "Conspiracy Theory", *Risk* 26:5 (May 2013) 29.

<sup>213</sup> IIROC Notice "Guidance on Certain Manipulative and Deceptive Trading Practices" 14 February 2013, online: <<http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=02A24CF0770E4D238D32E46C4CDA32C1&Language=en>>

<sup>214</sup> IOSCO, *supra* note 38.

that the increasing use of direct access trading creates challenges if proper controls are not implemented, as direct access trading could allow a customer to engage in manipulative trading strategies.<sup>215</sup> However after conducting hearings with market participants, IOSCO concluded that there was not, as yet, clear evidence of the systematic and widespread use of abusive practices by those engaging in high frequency trading.

The existence of hedge funds structured to provide managers high remuneration for alpha returns may motivate some to look for insider trading or market manipulation opportunities. As such, their activities may pose a greater risk to market integrity than other investors. Furthermore, such violations may be more difficult to detect because of the global nature of trading by hedge funds utilizing different markets, products and derivatives. This is because hedge funds can invest across various financial markets, utilizing derivatives and sophisticated techniques including high frequency trading.<sup>216</sup>

The rise in the number of cross border mergers and acquisitions increases the number of people from different countries who may become privy to confidential price sensitive information. This could include persons within the organizations subject to the merger or acquisition, professionals such as law and accounting firms and even regulators. This increases the possibility that a person from outside of a jurisdiction may be tempted to engage in insider trading or tip others to trade.<sup>217</sup>

### **Challenges for Regulators**

Despite the changes in the markets and trading that have taken place over the last few decades and the fact that trading has become more global, markets are still regulated and overseen by national securities regulators, or in the case of Canada, provincial regulators. The role of these securities regulators to preserve the integrity of their markets principally by

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<sup>215</sup> IOSCO, *supra* note 201 at 17.

<sup>216</sup> Thomas C Pearson, "When Hedge Funds Betray a Creditor Committee's Fiduciary Role: New Twists on Insider Trading in the International Financial Markets" (2008-2009) 28 Rev Banking & Fin L 165. See also Engert, *supra* note at 338.

<sup>217</sup> See generally Donald C Langevoort "Cross-Border Insider Trading" (2000) 19 (1) Dickinson Journal of International Law 161.

eliminating unfair trading practices such as insider trading and market manipulation has not changed. However, securities regulators now find that the markets that they have to supervise are quite different from what they were just 30 years ago.

Recognising the potential risks for markets from the new trading environments, Robert Marchman the former Executive Vice President, N.Y. Stock Exchange has commented:

The history of the securities markets teaches us that insider trading is a serious regulatory concern, particularly today, where the volume, complexity of trades, and products, as well as crossborder transactions are redefining capital markets on almost a daily basis.<sup>218</sup>

Other regulators have made similar statements:

Of particular interest to us in Enforcement is the FSA's belief that some hedge funds may be testing the boundaries of acceptable practice with respect to insider trading and market manipulation. In addition, given their payment of significant commissions and close relations with counterparties, they may be creating incentives for others to commit market abuse.<sup>219</sup>

Whereas regulators used to have to only be concerned with trading and the integrity of one market, the ground has shifted so that regulators, in their mission to preserve the integrity of their national markets, now need to take into account issues such as:

- The exponential growth in the volume of orders and trades. This raises issues as to just how regulators can effectively monitor these trades to detect those that may constitute market abuse.
- There are multiple venues to trade the same economic interest, a derivative of that economic interest or a linked trading instrument. As such, regulators need to ensure that multiple markets are monitored at the same time to detect unusual trading.

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<sup>218</sup> See US, *Illegal Insider Trading: How Widespread Is the Problem: Hearing Before Subcommittee on Judiciary*, 109th Cong (2006) at 10.

<sup>219</sup> Margaret Cole, "The UK FSA: Nobody Does It Better?" (Speech delivered at the Fordham Law School, New York, 17 October 2006) online: <[http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1017\\_mc.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2006/1017_mc.shtml)>. See also cases referred to in Pearson, *supra* note 216 at 177.



- Investors have access to multiple markets in different jurisdictions which means that even monitoring all of the markets within a jurisdiction may not be enough to detect market abuse. An increased ability for persons to trade in other markets increases the ability for participants to disguise abusive trading, resulting in a need for cross-border monitoring of markets.
- Even when suspicious trades are detected, investigating these trades can be complex because parts of the transaction of placing of the order and the execution and clearing of a trade may be beyond the jurisdiction of one particular securities regulator. Investigation of such a transaction will require gathering evidence from abroad, adding to its cost and complexity.
- There has been significant growth in the number of market participants. Some of these market participants, such as hedge funds and high frequency traders, may be more likely to, or may have the capacity to, engage in unfair trading practices. The principal operations of such participants may also be situated beyond the jurisdiction of one regulator. For example, many hedge funds trade in US and European markets but are based in locations such as the Cayman Islands, British Virgin Islands and Bermuda.<sup>220</sup>

### **Are the changes to markets and trading actually increasing instances of market abuse?**

In the absence of an appropriate response by regulators it seems clear that the significant changes to markets and trading have increased the opportunities for persons to engage in market abuse and their ability to hide such abuse from detection. However it is very difficult to determine whether this has resulted in persons exploiting these opportunities and

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<sup>220</sup> Hedge Fund Research Inc, Media Release, “Top Hedge Fund Firms Assume Leadership in Industry Recovery” (20 April 2010) online: Hedge Funds Research <[http://www.hedgefundresearch.com/pdf/pr\\_20100420.pdf](http://www.hedgefundresearch.com/pdf/pr_20100420.pdf)>. For a further discussion of the difficulties raised by interconnected markets, particularly in relation to market manipulation see IOSCO Technical Committee, “Investigating and Prosecuting Market Manipulation” (May 2000) online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD103.pdf>>.

whether, in fact, this has resulted in an increase in instances of market abuse which are not being detected or prosecuted.

Measuring the level of market abuse, such as insider trading and market manipulation, has always been extremely difficult because offenders generally disguise their actions when faced with severe penalties.<sup>221</sup> Any attempt to estimate the level of unfair trading practices, or whether they are increasing or decreasing, by questionnaires directed to those in the market yields results that are at best mostly anecdotal and at worst just pure conjecture.<sup>222</sup> Measuring the number of matters detected and investigated each year is also problematic because doing so only measures matters detected by regulators, not the actual number of instances of market abuse. In any event, regulators are often loathe to release figures of matters detected and investigated which do not lead to some sort of administrative action or a prosecution because of privacy concerns or fear of criticism and public scrutiny. Measuring the increase or decrease in matters prosecuted each year as a proxy for the actual level of market abuse taking place in the markets could also be flawed, as variations could be due to multiple factors such as resources allocated, the quality of the investigators, the willingness of witnesses to assist investigations or the complexity of the matters pursued.

Some studies in the finance discipline do provide some empirical evidence of the level market abuse in a market and suggest trends in the instances of market abuse.<sup>223</sup> This work generally involves measuring unusual price movements ahead of significant announcements, such as takeovers or financial results. Price movements just before announcements might indicate insider trading. For example, a number of non-academic studies using this method found that suspicious trading occurred ahead of 49% of all North

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<sup>221</sup> B Cornell & ER Sirri, "The reaction of investors and stock prices to insider trading" (1992) 47 J Fin 1031.

<sup>222</sup> For example, Roman Tomasic attempted to estimate the level of insider trading in Australia in 1988 by interviewing brokers, lawyers and regulators. See R Tomasic, *Casino Capitalism? Insider Trading in Australia* (Canberra, Australian Institute of Criminology, 1991). His methodology was heavily criticised, one commentator comparing it to the investigation of witchcraft in New England: see A Black, 'The Reform of Insider Trading Law in Australia' (1992) 15 UNSWLJ 214 at 218.

<sup>223</sup> See VV Acharya & T C Johnson, "More Insiders, More Insider Trading: Evidence from Private Equity Buyouts" (2009) 98(3) Journal of Financial Economics 500. The authors speculate that the growing participation of hedge funds in equity and debt syndicates may have contributed to the increase in insider trading.

American deals between 2003 and 2007. Another found that pre-bid volume in equity options increased 221% compared to the average for the 50 days prior to the 17 biggest U.S. takeovers in 2006. Yet another study, this time by Acharya and Johnson, suggested that hedge funds are involved in insider trading because of unusual price movements before private equity buyouts. This seems to be because frequently hedge funds are involved in, or offered participation in, the equity and debt syndicates needed to be put in place by the private equity buyer.<sup>224</sup>

In 2006 the then UK securities regulator, the FSA, commissioned a study that measured price movements ahead of announcements of financial statements and takeovers made by companies included within the FTSE index.<sup>225</sup> The project found that, at least in relation to takeover announcements, there was an increase in price movements before announcements between 2000 and 2004 followed by a decline between 2004 and 2005, but the level remained high. The FCA continues to measure such price movements each year in what it refers to as 'market cleanliness' studies.<sup>226</sup> In 2013 it reported that since 2010, it has seen a significant decline in the measure of the market cleanliness statistic for takeover announcements from close to 30% to 15.1% in 2013.<sup>227</sup>

Aitken and Harris have taken this research further with a view to developing proxy for the level of insider trading in a particular market. They measured trading ahead of price sensitive announcements on a number of exchanges over a number of years and made comparisons from year to year as well as between exchanges. They found, for example, that the percentage price change before price sensitive announcements for the TSX has increased between 2003 and 2009, which seems to indicate that insider trading on this exchange

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<sup>224</sup> For a list of these studies see *Ibid* at footnote note 8.

<sup>225</sup> Financial Services Authority, "Measuring Market Cleanliness", [Occasional Paper Series, 23 March 2006] online: FSA <<http://www.fsa.gov.uk/pubs/occpapers/op23.pdf>>; Financial Services Authority, "Updated Measurement of Market Cleanliness" [Occasional Paper Series, 25 March 2007] online: FSA <<http://www.fsa.gov.uk/pubs/occpapers/op25.pdf>>.

<sup>226</sup> See for example FSA Annual Report 2012/2013, online: FSA <<http://www.fca.org.uk/news/firms/fsa-annual-report-2012-13>> at 37.

<sup>227</sup> FCA Annual Report 2013/14, online: FCA <<https://www.fca.org.uk/static/documents/corporate/annual-report-13-14.pdf>> at 39.

became more prevalent over time.<sup>228</sup> A similar study by Beny and Seyhun suggests that insider trading on US exchanges was also becoming more prevalent. They found that the run up of stock prices before takeover announcements on US exchanges was 50 percent higher during 2006 to 2011 than in the period 2000 to 2006.<sup>229</sup>

In relation to cross border insider trading Madura and Marciniak conducted a study to investigate whether information leakages are more pronounced for U.S. targets whose bidders come from countries with less effective insider trading regulations. They also investigated whether information leakages of U.S. targets pursued by foreign bidders are influenced by the degree of cooperation that U.S. regulators have with specific foreign regulators. They found that in the period 1996 to 2011 the increase in the price for the 60 days before the takeover announcement was higher in the case of U.S. targets acquired by foreign bidders with less effective insider trading laws than was the case of U.S. targets acquired by U.S. bidders. They also found that for the period 1996 to 2011 in relation to the foreign takeovers the price for the 60 days before the takeover announcement was lower if the SEC had entered into a bilateral enforcement agreement with the country of origin of the foreign bidder.<sup>230</sup>

Aitken and Harris have also developed a proxy for what could be manipulation in the form of the ramping up of published share prices at the end of the day, called 'end of day price dislocation'. This involves measuring incidences of share price movements at the end of the trading day which were quickly reversed early on the next day.<sup>231</sup> Using this proxy for manipulation, Aitken, Cumming and Zhan measuring 22 stock exchanges around the world from January 2003 to June 2011. They found the increase in high frequency trading made it

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<sup>228</sup> MJ Aitken & FHDeB Harris, "Evidence-Based Policy Making and Financial Markets: A Fairness and Efficiency Framework for Assessing Market Quality" (2011) 6 *The Journal of Trading* 22.

<sup>229</sup> LN Beny & HN Seyhun, "Has illegal insider trading become more rampant in the United States? Empirical evidence from Takeovers" in SM Bainbridge, ed, *Research Handbook on Insider Trading* (Northampton, USA: Edward Elgar, 2013).

<sup>230</sup> J Madura & M Marciniak "Bidder country characteristics and informed trading in U.S. targets" (2014) 29 *Int. Fin. Markets, Inst. And Money* 256.

<sup>231</sup> Aitken, *supra* note 228.

more difficult to manipulate end of day closing prices.<sup>232</sup> Frino and Lepone also used this proxy and came to the same conclusion, namely that that high frequency trading made it more difficult to manipulate end of day closing prices. In addition, they measured the level of ‘ticking’ as a proxy for manipulation. Ticking refers to a price movement that is linked to the activities of one specific trader. They found that high frequency trading had no statistically significant impact on the level of unusual ticking.<sup>233</sup>

Such studies are not without their limitations. For example, measuring price increases before announcements does not distinguish between true insider trading and trades triggered by rumours, persons establishing a position in a stock before a possible takeover announcement<sup>234</sup> or by persons who merely follow the lead of others. The prevalence of high frequency trading may also contribute to amplifying price movements. Some of these studies have also been criticised for perhaps underestimating the problem of market abuse because of the small windows of trading chosen for analysis.<sup>235</sup> Furthermore, such studies also do not measure how and if the ability to trade across markets and products is changing the nature and number of instances of market abuse due to perpetrators now having an enhanced ability to structure their transactions to avoid detection and/or prosecution.

Nevertheless, these studies do provide some evidence of the level of market abuse in markets. Furthermore the results of the Madura and Marciniak study seem to suggest that insider trading may be more pronounced when price sensitive information spreads beyond a jurisdiction, perhaps indicating that those outside of the jurisdiction perceive that they are

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<sup>232</sup> D Cumming F Zhan and M Aitken “High Frequency Trading and End of Day Price Dislocation” (28 October 2013 online: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2145565](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2145565)> .

<sup>233</sup> A Frino and A Lepone “The impact of high frequency trading on market integrity: an empirical examination”, Foresight Government Office for Science, 4 May 2012, online: <[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/289032/12-1057-dr24-impact-high-frequency-trading-on-market-integrity.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/289032/12-1057-dr24-impact-high-frequency-trading-on-market-integrity.pdf)>.

<sup>234</sup> See for example A Aspurs, S Foley and A Frino “Does insider trading explain price run-up ahead of takeover announcements?” (2014) 54(1) *Accounting & Finance* 25. This study considered whether other factors namely media reports of rumours of takeovers, public notifications of substantial shareholders and bidders taking a toehold in a stock could account for price run ups prior to takeovers in Australia in a ten year period from 2000 to 2009. They showed that the activity generated from these three areas could explain a significant proportion of the pre-bid share price run-up.

<sup>235</sup> See for example. the discussion in Chapter 9 of Barnes, *supra* note 9.

less susceptible to being prosecuted than those within the jurisdiction. The Madura and Marciniak study also seems to suggest that increasing cooperation between securities regulators can have a positive impact in lessening the instances of cross border insider trading and thereby contribute to protecting the integrity of markets within a securities regulator's jurisdiction.

Despite these studies and advances in measuring the level of unusual price movements ahead of significant announcements there is still no definitive way to measure how the changes to the markets are impacting upon the level of market abuse. What is clear is that more research is needed in this area and more work done to strengthen the results that have already been collected. Given that protecting market integrity is a key goal for securities regulators and that market integrity is of critical importance to the confidence of investors, securities regulators should be fostering further research in this area to effectively measure increases and decreases in market integrity.<sup>236</sup>

In addition given the trends suggested by these studies and the increased opportunities to engage in market abuse presented by market developments, there does appear to be a case for increasing regulation, bolstering the ability of securities regulators to take action against market abuse and fostering cooperation between regulators to take action against cross border market abuse. Like all regulation this will come at a cost. The changes to the markets have been allowed to flourish as these changes have improved the efficiency of the markets, reducing transaction costs for investors. Even new participants have added to the efficiency of the markets as, for example, high frequency traders and hedge funds have increased the volume of trades which increases the liquidity of the markets. The trade-off of increased regulation and enforcement is likely to be a reduction in innovations in market structure, as well as possibly restricting the activities of the new participants. This may, in turn, reduce efficiency gains. However, a balance needs to be struck between market integrity and

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<sup>236</sup> One organisation that is attempting to develop proxies to measure market integrity is Capital Markets CRC Limited. See <http://www.cmcrc.com/>.

market innovations driven by the need to increase efficiency. It seems that the pendulum may have swung too far in terms of innovation at the expense of integrity. As such, it seems that tighter regulation and supervision of markets is required.

### **Part 3 How has Regulation of Trading and the Supervision of Markets Adapted to the New Environment?**

Although the regulation of securities markets has also changed over the last few decades, the changes have not been as dramatic as the transformations to the markets. As has been referred to, market regulation and market supervision is still a national concern. One change that has occurred, partly in response to market privatization and fragmentation, is that in some parts of the world there has been a movement away from governments allowing markets to regulate themselves as Self-Regulatory Organisations (SROs) to governments taking a more direct role. In North America, where SROs still have responsibility for a large part of regulating the markets, the character of those SROs has changed significantly.

In terms of specific regulatory changes directed towards protecting market integrity in the changed trading environment, the response has been limited. After the global financial crisis of 2008 there was a flurry of activity by securities regulators to introduce stricter regulation for new market participants who emerged as significant players - such as hedge funds and high frequency traders. These new regulations were also directed at newer forms of trading that have flourished such as direct electronic access and OTC derivatives trading. These new regulations gained support due, perhaps, to an evolving awareness that government regulation is not the enemy of efficient markets but a valuable instrument in controlling market excesses. However the main rationale put forward for the regulations was that such regulation was needed to address systemic risk concerns.<sup>237</sup> Such regulations were said to be needed to address the risk to the markets posed by specific traders and trading and to protect the markets from future instability. Yet although this has been the principle

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<sup>237</sup> See generally M Condon "Products, Perimeters and Politics: systemic risk and securities regulation" in Cynthia A. Williams et al, eds, *The Embedded Firm: Corporate Governance, Labor, and Finance Capitalism* (Cambridge: Cambridge University Press, 2011).

justification, these new regulations may, indirectly, also work toward improving and preserving market integrity.

### **Closer supervision of markets by government**

One important difference in the regulation of markets that has emerged in the last three decades has been a trend in some parts of the world to move away from the use of self-regulatory organizations to monitor the markets and enforce rules. Instead government regulators are now taking a more active role in market supervision.<sup>238</sup>

Historically the scope of self-regulation of markets varied across jurisdictions. For example, Europe has never extensively used self-regulation to govern its markets, the predominate view being that regulation is a public function.<sup>239</sup> On the other end of the spectrum is the U.S. which has historically made extensive use of self-regulation for its markets.<sup>240</sup> This United States model of self-regulation was influential throughout the second half of the 20<sup>th</sup> century in terms of the structure of stock markets and securities legislation in other countries

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<sup>238</sup> An SRO is a private, nongovernmental organisation which establishes rules of conduct for its members or participants, supervises compliance with those rules and enforces compliance with rules by investigating potential violations and taking disciplinary action against those members or participants found in breach. The authority of SROs to operate is usually based on law or the delegation of power by a statutory regulator, but it may also be based on a contract with regulated firms. See also J Carson, "Self Regulation in Securities Markets" [World Bank Policy Research Working Paper, January 2011] online: World Bank <[http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2011/01/24/000158349\\_20110124091038/Rendered/PDF/WPS5542.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2011/01/24/000158349_20110124091038/Rendered/PDF/WPS5542.pdf)> at 5.

<sup>239</sup> *Ibid* at 25.

<sup>240</sup> Self-regulation in the US has existed since the establishment of the SEC in 1934. Prior to the Great Depression the US markets were largely unregulated by government. It was widespread manipulation and speculation that led to the collapse of the markets in 1929, and the Great Depression that made apparent the need for government regulation. Accordingly, government regulation of the markets became part of the New Deal agenda in the United States during the 1930s. The *Securities Exchange Act*, 15 USC § 78 (1934) saw the establishment of the Securities Exchange Commission overseeing the exchanges, although a high degree of self-regulation was maintained by the stock exchanges. (See ME Parrish, *Securities Regulation and the New Deal* (New Haven: Yale University Press, 1970) at 230. See also generally J Seligman, "Cautious Evolution or Perennial Irresolution: Stock Market Self-regulation During the First Seventy Years of the Securities and Exchange Commission" (2004) 59 *Bus Law* 1347. At the time it was argued by those in Congress putting forward this model that without self-regulation any government regulatory body charged with regulating the markets would be too large and could prove to be ineffective. (See OH Dombalagian, "Demythologizing the Stock Exchange: Reconciling, Self-regulation and the National Market System" (2005) 39 *U Rich L Rev* 1069 at 1076.) Some commentators have since argued that the self-regulatory model is really a historical accident that was only adopted because it was more convenient for Congress to assign regulatory powers to exchanges because they already had some of the regulatory infrastructure in place. See S Gadinis & HE Jackson, "Markets as Regulators: A Survey" (2007) 80 *S Cal L Rev* 1239 at 1249; M Mendelson & JW Peake, "'Intermediaries' or Investors': Whose Market Is It Anyway?" (1994) 19 *J Corp L* 443 at 444.



such as Canada, Japan, Korea, the UK and Australia.<sup>241</sup> One advantage of self-regulation over government regulation is said to be that SROs may require the observance of ethical standards which go beyond government regulations. Another is that SROs may offer considerable depth and expertise regarding market operations and practices and may be able to respond more quickly and flexibly than the government authority to changing market conditions.<sup>242</sup>

However the wave of demutualisation that occurred in stock exchanges around the world in the late 20<sup>th</sup> Century brought the self-regulatory model of market supervision into question. Demutualisation created a new set of problems primarily related to the stock exchange's dual role of being both a market operator and a regulator of the market. Although this has always given rise to potential conflicts of interests, many believed that this change to a public company structure exacerbated the possibility of potential conflicts of interest.<sup>243</sup> Perhaps more significantly, the switch to a public company results in a shift in priorities. In an exchange owned and operated by brokers regulating the exchange was usually a key focus because eliminating unfair trading practices directly benefitted the owners who were also the participants. However a public company's primary motive is profit for its shareholders. Regulation and the elimination of unfair trading practices are only tangentially linked to this profit motive, as an attribute of the exchange which may attract trading and listings, such trading and listings being drawn towards fairer and more transparent markets. This disconnect could lead, over time, to a reduction in resources that exchanges will be willing to

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<sup>241</sup> See generally Carson, *supra* note 238. For example, up until the 1990s, Australia's markets were regulated in much the same way as those of the United States, with Australia's securities regulator responsible for licensing the markets, supplemented by the ASX regulating its markets and its market participants by enforcing its rules. (see VR Goldwasser, *Stock Market Manipulation and Short Selling* (Melbourne: Centre for Corporate Law and Securities Regulation, 1999) at 39. IOSCO still promulgates a co-regulation model, similar to that which exists in the US, as an appropriate model for new markets. See IOSCO Principles, *supra* note 37. This has been criticised as essentially backward looking, based on US regulations and institutions in the heyday of the 1990s, as they existed prior to the great soul-searching of the post-Enron era. See C Jordan & P Hughes, "Which way for Market Institutions: The Fundamental Question of Self-Regulation" (2007) 4 Berkeley Bus LJ 205 at 225.

<sup>242</sup> IOSCO Principles, *supra* note 39 at 10.

<sup>243</sup> See Carson, *supra* note 178, at 6-17. See also RS Karmel, "Turning Seats into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges" (2002) 53 Hastings LJ 367; AM Fleckner, "Stock Exchanges at the Crossroads" (2006) 74 Fordham L Rev 2541; C Bradley, "Demutualization of Financial Exchanges: Business as Usual?" (2001) 21 Nw J Int'l L & Bus 657.

allocate to this regulatory function.<sup>244</sup> Furthermore, the growth in new markets raises the issue of whether it is efficient for each exchange or market to regulate itself.

These issues prompted some countries to modify, or even abandon, the self-regulatory model by shifting more functions back to the government regulator. In Hong Kong for example responsibility for surveillance of the market for possible insider trading and market manipulation is now shared between the government regulator, the Hong Kong Securities and Futures Commission (SFC) and the Hong Kong Exchange.<sup>245</sup> The SFC has responsibility for broker regulation but the exchange retains market regulation to the extent of its business rules. The United Kingdom, France, Mexico and Australia have also adjusted their regulatory responsibilities with an expanded role for the government regulator.<sup>246</sup> In Australia, for example, the government regulator is now responsible for all of the surveillance of all of the exchanges and ATs, enforcing broker-dealer rules and laws against market misconduct. Exchanges in Australia are now only responsible for listings requirements.<sup>247</sup>

One advantage of governments taking over regulation of the markets is the reduction in regulatory duplication. With the existence of both an SRO and a government regulator within a jurisdiction overseeing a market or markets, there is likely to be some overlapping of roles and conflict in relation to whose role it is to take action in any particular circumstance. For example, in the U.S. and Canada detection of market misconduct through surveillance of the markets is undertaken by SROs, as is the enforcement of broker-dealer rules. However, if securities laws have been violated the matter must be handed over to the government

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<sup>244</sup> See generally Carson, *supra* note 178.

<sup>245</sup> See A Main, "Two is Better than One in Surveillance", *The Australian* (13 July 2009), online: Parliament of Australia <<http://parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;adv=yes;orderBy=customrank;page=0;query=Two%20is%20better%20than%20one;rec=5;resCount=Default>>. See also Jordan, *supra* note 241 at 210.

<sup>246</sup> See Carson, *supra* note 178 at 23.

<sup>247</sup> In Australia, the surveillance functions of the Australian Securities Exchange were being transferred back to the public regulator, the Australian Securities and Investments Commission in 2010. See The Treasurer, Wayne Swan MP and the Minister for Financial Services, Superannuation and Corporate Law, Chris Bowen MP, Joint Media Release NO.013, "Reforms to the supervision of Australia's financial markets" (24 August 2009) online: Australian Government <<http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2009/013.htm&pageID=003&min=ceba&Year=&DocType=0>>.

regulator (the SEC in the U.S, provincial securities regulators in Canada) to take action. This can lead to inefficiencies, delay, and as a result, perhaps less than optimal regulatory outcomes.<sup>248</sup>

In the U.S. and Canada, although self-regulation remains an important part of the regulatory framework, regulatory functions have been moved away from the exchanges themselves and towards SROs that are independent of market operators.<sup>249</sup> Initially regulatory functions were spun off into separate self-regulatory bodies for each exchange,<sup>250</sup> but now, in response to fragmentation of markets, the trend is to consolidate these SROs into one SRO, such as the Financial Industry Regulatory Authority (FINRA) in the U.S. and the Investment Industry Regulatory Organization of Canada (IIROC) in Canada. IIROC performs regulatory functions for all of the markets in Canada, except mutual fund dealers which are governed by their own SRO, the Mutual Fund Dealers Association (MFDA).<sup>251</sup> In the US FINRA performs these functions for almost all of the markets in the US.<sup>252</sup> Although these

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<sup>248</sup> For example, Carson, *supra* note 238 at 14-15 quotes a World Federation of Exchanges survey from 2005 that found that “exchanges’ regulatory roles showed extensive use of cooperative or shared regulation instead of a clear division of responsibilities. The lack of a clear separation of roles often leads to unnecessary duplication and delays resulting from protracted discussion and debate on policy and initiatives. It can also produce conflict, and even competition, over roles and policy. The greater the degree of co-involvement in issues and initiatives, the more time that must be devoted to coordinating between regulators and SROs. Cooperation is beneficial and necessary among regulators; but when regulators occupy the same fields it can lead to inefficiencies and delay in responding to problems.”

<sup>249</sup> Roberta Karmel argues that these consolidated SROs are only a facade of self-regulation while in reality there has been a shift to more government oversight. See R Karmel quoted in Jordan, *supra* note 241 at 233.

<sup>250</sup> Carson, *supra* note 178 at 8. Initially, the solution adopted by some exchanges was to distance themselves from their regulatory functions by moving their surveillance and regulatory functions into a separate subsidiary. For example, initially the New York Stock Exchange created a separate subsidiary, NYSE Regulation Inc with a board of directors comprised of a majority of directors unaffiliated with any other NYSE board (see See *NYSE Regulation*, online: < [www.nyse.com/regulation](http://www.nyse.com/regulation) >). Over time, however, more and more of NYSE’s functions have been moved to FINRA; see FINRA, News Release, “FINRA to Perform NYSE Regulation’s Market Oversight Functions” (4 May 2010) online: FINRA < [www.finra.org](http://www.finra.org) >. FINRA was formed from the merger of some of the functions of NYSE Regulation and NASD Regulation. As to the reason for the merger, contrast Christopher W. Cole, “Is the Consolidation of NASD and the Regulatory Arm of NYSE a Bull or a Bear for U.S. Capital Markets” (2007) 76 UMKC L Rev 1351; Yesenia Cervantes, ““FIN RAH!”... A Welcome Change: Why the merger was necessary to preserve U.S. Market Integrity” (2008) 13 Fordham J Corp & Fin L 829. Similarly in Canada initially regulatory functions were moved from the TSX to a separate company called Market Regulation Services Inc. (MRS). MRS was jointly owned by the TSX and the Investment Dealers Association and the TSX and the TSX Venture exchange retained MRS to provide these regulatory services. See Condon M “Technologies of Risk? Regulating Online Investing in Canada” (2004) 26 Law & Policy 411 at 429.

<sup>251</sup> Mutual Fund Dealers Association “Our History” online: MFDA < <http://www.mfda.ca/about/history.html>>.

<sup>252</sup> FINRA’s 2013 Annual Report it stated that by 2015 it will conduct cross market surveillance across 99 percent of the market for US listed equities, see FINRA Annual Report 2013 online: <<http://www.finra.org/web/groups/corporate/@corp/@about/@ar/documents/corporate/p534386.pdf>>.

consolidated SROs do not eliminate the problem of duplication and overlap of roles with the government regulator, they have the advantage of being a more efficient arrangement for markets, particularly new markets, which can outsource regulatory functions to these organizations rather than having to set up their own regulatory branch. As such costs are ultimately passed on to traders, low regulatory costs can also work to keep down trading costs. Accordingly, this shift to consolidated SROs has not met significant opposition from the securities industry or regulators.<sup>253</sup>

***a) Consolidation of regulatory functions and its impact on market integrity***

One benefit that is emerging from this trend of moving functions to consolidated SROs or back to the government regulator is that, in an environment of fragmented markets, fewer bodies within a jurisdiction become responsible for undertaking surveillance and monitoring the markets within that jurisdiction for possible instances of market abuse. This allows for the possibility of cross market surveillance within the jurisdiction to detect unfair trading practices, such as insider trading and market manipulation, by building of a more complete picture of what is occurring in one security across markets. For example, in Canada, as IIROC conducts surveillance for all of the exchanges and ATS markets, this allows it to conduct surveillance across markets in Canada. Consolidation of regulatory functions can also facilitate the regulator undertaking cross-asset surveillance (or cross-product) surveillance, that is conducting surveillance over the markets to detect unusual trading across, not only the security, but derivatives related to the security and also even instruments that are not a derivative but have an economic relationship to the security.

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<sup>253</sup> However, this shift toward independent consolidated SROs does seem to eliminate what is said to be one of the key benefits of SROs compared to direct government supervision, that is, that SROs are expert in market operations and practices. If the SRO is truly independent, those employed by it are not likely to have the same knowledge of the markets or their market knowledge is likely to diminish over time. This may make them subject to attack from market operators and participants who may believe that this lack of market knowledge may result in them not regulating in their best interests. Furthermore, such SROs are not subject to the same scrutiny as government regulators, raising issues of transparency and accountability. (See generally NS Ellis, LM Fairchild & HD Fletcher, “The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation” (2010) 7 Berkeley Bus LJ 102). In addition, although SROs free government from having to fund the supervision of the markets as SROs fund their organization by fees levied on markets and brokers, having SROs levy fees eliminates a potential source of government revenue. As such, even in countries such as the U.S. and Canada, with the strongest history of self-regulation, there may be pressure in the future for the regulatory functions exercised by these SROs to be transferred to government regulators.

Cross-market surveillance should contribute towards the preservation of market integrity in an environment of fragmented markets where such fragmentation may be used by perpetrators to disguise market abuse. There is currently, however, a lack of empirical evidence that conducting cross market surveillance results in markets which may be of higher integrity. A study by Cumming and Johan looked at cross market surveillance in 2005 across 25 jurisdictions. They showed that where cross market surveillance was undertaken it correlated with higher trading volumes, greater numbers of listed companies and higher market capitalization.<sup>254</sup> This may suggest that such surveillance was either detecting or deterring (because of the possibility of detection) market abuse and that this had a positive impact on the quality of those markets. One problem with drawing this conclusion is that it did not prove causation. It may be that larger jurisdictions, which may already be characterised as having higher trading volumes and a higher market capitalization, are more likely, and have the resources, to invest in cross market surveillance. Nevertheless perhaps the results of the study make sense, in that cross market surveillance should increase the likelihood of detection of market abuse which should, in turn, contribute to the overall quality of the market.

The SEC has also recognised the importance of cross market surveillance to preserving the integrity of markets. FINRA conducts cross market surveillance on the markets which it supervises. In addition the SEC has also recognised that fragmentation has meant that the data that is collected by SROs such as FINRA is not uniform, complicating the process of detecting market abuse across markets:

The Commission therefore believes that the regulatory data infrastructure on which the SROs and the Commission currently must rely generally is outdated and inadequate to effectively oversee a complex, dispersed, and highly automated national market system. In performing their oversight responsibilities, regulators today must attempt to cobble together disparate data from a variety of existing information systems lacking in completeness, accuracy, accessibility, and/or timeliness –

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<sup>254</sup> Cumming, *supra* note 15.

a model that neither supports the efficient aggregation of data from multiple trading venues nor yields the type of complete and accurate market activity data needed for robust market oversight.<sup>255</sup>

In response the SEC has adopted Rule 613 which is designed to require the implementation of what is called 'a consolidated audit trail'.<sup>256</sup>

The proposal for the rule arose out of what has been called the 'Flash Crash' that occurred on 6 May 2010 when the prices of many U.S. based equity products experienced an extraordinarily rapid decline and then recovered.<sup>257</sup> The investigation into this event exposed a serious weakness in the monitoring of trades on U.S. markets. Although the trades occurred on one day the reconstruction process took months as, in order to determine its cause, investigators had to reconstruct the trades from a multitude of different data and systems maintained by different markets.<sup>258</sup>

Currently, the SEC must rely on data from FINRA, exchanges, and firms, such as mutual funds and bank trading desks, to track the market. Further, the SEC is unable to track a large amount of trading every day. Additionally, as was the case with the Flash-Crash report, the lack of a central repository for data can lead to significant delays in diagnosing what went wrong after an irregular market event.<sup>259</sup>

It was not until 2015, some five years after the Flash Crash, that the SEC brought charges against the person the SEC alleges is responsible for this event.<sup>260</sup>

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<sup>255</sup> SEC Adopting Release No. 34-67457; July 18, 2012 online: SEC <<http://www.sec.gov/rules/final/2012/34-67457.pdf>> at 5.

<sup>256</sup> SEC Rule 613 "Consolidated Audit Trail" online: SEC <<https://www.sec.gov/divisions/marketreg/rule613-info.htm>>.

<sup>257</sup> SEC, Report of the staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues, "Findings regarding the Market Events of May 6, 2010" (September 30, 2010) online: SEC <<http://www.sec.gov/news/studies/2010/marketevents-report.pdf>>.

<sup>258</sup> Mary L. Schapiro, "Remarks at the Society of American Business Editors and Writers (SABEW) Annual Convention" (Speech delivered at the Society of American Business Editors and Writers (SABEW) Annual Convention, 15 March 2012), online: SEC <<http://www.sec.gov/news/speech/2012/spch031512mls.htm>>.

<sup>259</sup> R Karmel "IOSCO's Response to the Financial Crisis" (2012) 37 J. Corp. L. 849 at 900.

<sup>260</sup> See L Lopez "A trader faces charges in connection with the 2010 'Flash Crash'", Business Insider, 21 April 2015, online: Business Insider <<http://www.businessinsider.com/a-trader-has-been-arrested-for-contributing-to-the-2010-flash-crash-2015-4>>.

Rule 613 requires SROs to develop a plan for this consolidated audit trail. Once fully implemented the consolidated audit trail will require exchanges, SROs and their members trading National Market Securities (NMS) securities to submit detailed trading data to a central repository in a standardized form. This will include quotes and orders as well as information in relation to where the order originated any modifications to the order, cancellations, routing and execution. Certain data will have to be reported by 8 am following the trading day. SROs and their members are also required to synchronize the business clocks they use to record transactions. It is also proposed that each customer would be assigned a unique customer identifier that would be required to be used by that customer in all of that customer's orders, regardless of the market or broker that was used to conduct the trading. SROs and the SEC would have access to this central authority to search for indications of market abuse.<sup>261</sup> The proposed system is designed to allow the better design and use of surveillance systems to detect market irregularities, including market manipulation and insider trading which occur across markets.<sup>262</sup> The release which accompanied the proposal for the rule stated:

The Commission preliminarily believes that with today's fast, electronic and interconnected markets, there is a heightened need for a single uniform electronic cross-market order and execution tracking system that includes more information than is captured by the existing SRO audit trails, and in a uniform format. Such a system would enable SROs to better fulfil their regulatory responsibilities to monitor for and investigate illegal activity in their markets and by their members. Further, the Commission preliminarily believes that such a system would enable the Commission staff to better carry out its oversight of the NMS for securities and to perform market analysis in a more timely fashion, whether on one market or across markets.<sup>263</sup>

FINRA has backed SEC in need for this rule. The Chairman of FINRA stated:

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<sup>261</sup> SEC Rule 613, *supra* note 256.

<sup>262</sup> S Luparello, "Market surveillance considerations in a cross-border trading", online: World Federation of Exchanges <<http://www.world-exchanges.org/news-views/views/market-surveillance-considerations-cross-border-trading-environment>>.

<sup>263</sup> SEC Release, "Consolidated Audit Trail", online: SEC <<https://www.sec.gov/rules/proposed/2010/34-62174.pdf>> at 31.

A generation ago, the vast majority of activity occurred on the equity market that listed the security. Today, orders are routed to some 50 competing platforms. This complex environment creates opportunities for traders seeking unfair advantage to manipulate markets. How? By exploiting inconsistencies or gaps created when the responsibility of regulatory oversight is divided. Regulatory gaps and splintered oversight make it possible for trading abuses—such as market manipulation, marking the close and front-running customer orders—to be carried out furtively across multiple markets, with a reduced chance of detection....The most effective way to surveil for these trading practices across the wide range of market centers is to consolidate audit trail data in a single place so that violative trading practices can be more readily identified.<sup>264</sup>

One concern that has been raised is the maintenance of the privacy of such data.<sup>265</sup> However, while privacy concerns are not irrelevant and while steps should no doubt be taken to protect data, privacy concerns should not be allowed to trump the need to preserve market integrity. In the interest of protecting market confidence for the good of the economy as a whole there needs to be an acceptance that, in exchange for access to the markets, market participants must be prepared to disclose information to regulators.

#### ***b) Cross border market surveillance***

As connections between markets multiply and investors are presented with a wider choice of products and markets the need for cross border market surveillance arises. Failure to undertake such surveillance leaves open the opportunity for perpetrators of market abuse to avoid detection and therefore punishment simply by structuring their trading across markets in different jurisdictions.

To enable cross border market surveillance to take place, trading data has to be collected and exchanged between SROs or government regulators in various jurisdictions in a

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<sup>264</sup> Rick Ketchum, “Testimony Before the Subcommittee on Securities, Insurance, and Investment Committee on Banking, Housing, and Urban Affairs United States Senate” (Testimony delivered at the Subcommittee on Securities, Insurance, and Investment Committee on Banking, Housing, and Urban Affairs United States Senate, May 20, 2010) online: FINRA <<http://www.finra.org/Newsroom/Speeches/Ketchum/P121509>>.

<sup>265</sup> See AL Nazareth, “SEC Proposes Consolidated Audit Trail” (4 July 2010) online: Harvard Law School Forum on Corporate Governance and Financial Regulation <<http://blogs.law.harvard.edu/corpgov/2010/07/04/sec-proposes-consolidated-audit-trail/>>.



standardized form for comparison. This raises the issue of whether appropriate mechanisms exist to enable this collection and exchange process to take place and, if so, whether the information is exchanged in a timely manner so that market abuse can be detected and investigated. Timely detection and investigation is critical, as the sooner an investigation can be initiated, the more likely evidence may be captured and preserved. This timely capture of evidence can have the effect of significantly enhancing the prospects of a successful enforcement action.

Although there do appear to be some procedures whereby market regulators and SROs share information for the purposes of cross border market surveillance, the effectiveness and extent to which these mechanisms are used is far from clear. There is certainly no one central repository or single body responsible for collating and sharing information between regulators and SROs responsible for conducting surveillance of markets for possible market abuse.<sup>266</sup> Some SROs do have bilateral agreements to cooperate on regulatory matters and the supervision cross border trading.<sup>267</sup> However, such cooperation arrangements are by no means universal. IOSCO does have a Multilateral Memorandum of Understanding (MMoU) whereby securities regulators can exchange information for enforcement purposes.<sup>268</sup> This MMoU standardizes the process by which securities regulators who are members of IOSCO and have signed the MMoU can obtain information from other member securities regulators for enforcement purposes. It provides a framework of procedures to obtain information from other securities regulators necessary to facilitate the enforcement of a wide range of domestic laws prohibiting securities fraud, including insider trading and stock market manipulation. However, this MMoU was designed principally for the ad hoc provision of

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<sup>266</sup> In 2007, the Technical Committee of IOSCO released a report concerning, inter alia, information sharing for the purposes of surveillance, but did not make any specific recommendations concerning arrangements for such information sharing; See IOSCO Technical Committee, “Multi-jurisdictional Information Sharing for Market Oversight” (April 2007) online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD248.pdf>>.

<sup>267</sup> See e.g. AMF and FINRA, Joint News Release, “AMF and FINRA sign MoU on financial market surveillance and supervision” (29 October 2009) online: FINRA <<https://www.finra.org/newsroom/2009/amf-and-finra-sign-mou-financial-market-surveillance-and-supervision>>.

<sup>268</sup> See IOSCO, “Multilateral Memorandum of Understanding Concerning Consultation and the Exchange of Information” online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD386.pdf>>.

information for enforcement actions after securities fraud such as market manipulation have been detected, rather than the day-to-day information exchange demanded for surveillance of markets for market abuse.<sup>269</sup>

IIROC, FINRA and many of the large exchanges are members of the Intermarket Surveillance Group (ISG), an organization that states on its website that its objective is to be a “framework for the sharing of information and the coordination of regulatory efforts among exchanges trading securities and related products to address potential intermarket manipulations and trading abuses.”<sup>270</sup> The ISG was created in 1981 by the major U.S. exchanges and since 1990 the ISG has allowed non-U.S. exchanges to become members.<sup>271</sup> However this is a private organization whose governance and operations are essentially opaque, in that it provides no public information as to how it is governed and little information on how it operates, what information is exchanged between members or how often. It is also unclear from publically available information whether delay in exchanging information is a significant issue. The ISG also appears to have no secretariat or permanent staff and so must be reliant on the activities of its members for its effectiveness.<sup>272</sup> Furthermore, the ISG does not allow government regulators who are responsible for surveillance to become members. Moreover, its terms of membership provide that SROs are not allowed to convey information obtained through the ISG to a government regulator without the consent of the provider.<sup>273</sup>

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<sup>269</sup> See generally J Austin, “IOSCO’s Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information – A model for international regulatory convergence?” (2012) 24(4) *Crim LF* 393.

<sup>270</sup> Intermarket Surveillance Group, “Organization Overview” online: Intermarket Surveillance Group <<https://www.isgportal.org/isgPortal/public/overview.htm>>.

<sup>271</sup> *Ibid.*

<sup>272</sup> See a letter from Andrew Dodsworth, the Chairman of the ISG to the World Federation of Exchanges, Mr. Dodsworth states that the ISG has no secretariat or permanent staff and all of the work of the ISG is done on effectively a pro bono basis by members. He also states that the costs of membership is \$10-15,000 for U.S. members and \$3-5000 for Non-US members. Letter from A Dodsworth (15 May 2011) “International cooperation amongst market operators does exist.” online: World Federation of Exchanges <<http://www.world-exchanges.org/news-views/views/international-cooperation-amongst-market-operators-does-exist>>.

<sup>273</sup> Intermarket Surveillance Group, “Membership Information” online: Intermarket Surveillance Group <<https://www.isgportal.org/isgPortal/public/membership.htm>>.

Certainly in recommending the introduction of the consolidated audit trail the SEC appeared to be somewhat critical of the ISG's operations. It stated that because the SEC does not currently have direct access to all data, to analysis a trade a request has to be made to the ISG but that:

It can take days or weeks, depending on the scope of the information requested, to receive responses to requests. Once the responses to its requests for information are received, the Commission, or any SRO undertaking the same task, must commit a significant amount of time and resources to process and cross-link the data from the various formats used by different SROs before it can be analyzed and used for regulatory purposes.<sup>274</sup>

In addition, even if information can be collected and exchanged in a timely manner, the software and expertise needed to conduct cross border market surveillance (that is, software that can analyse the data for trading irregularities indicating possible market abuse) is costly and complex. Aitken and Harris estimate that it would cost approximately \$150 million initially and \$50 million each subsequent year, to maintain and run a real time cross market surveillance capability for all European exchange-traded markets<sup>275</sup>. Cumming and Johan state:

Cross-market surveillance (including cross-product, cross-market within a country and cross-border), involves much greater technical sophistication that is not easily replicated by an exchange for the following reasons. The level of sophistication of financial trading patterns across different products (such as derivatives and securities) is much more complicated (and our data below suggest many surveillance authorities in different countries do not appear to be aware of the ways in which traders can carry out manipulative cross-market trades). Computer software to detect cross-market manipulations to pick up patterns of trading across markets requires significantly greater sophistication than the simple single-market trading alerts. External surveillance providers such as SMARTS Group do provide cross-market surveillance, but such productized or customized solutions come at a substantially higher cost both for the development of the technology and the on-going surveillance effort. Surveillance staff members need to

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<sup>274</sup> SEC *supra* note 256 at 31.

<sup>275</sup> Aitken, *supra* note 228 at 30.

coordinate surveillance across the different markets monitored, which requires proper organizational alignment among all those involved. As well, for cross-market and cross-border surveillance there needs to be formal information sharing arrangements and coordination of surveillance for cross-market and cross-border surveillance to be legally authorized, permissible and effective. Such coordination is further complicated by the protectionist policies arising from the commercial self interest of the respective markets and the related cross jurisdictional legality issues. In short, cross-market surveillance is much more costly and complicated than single-market surveillance.<sup>276</sup>

They also found that at the time of their study there was a “dearth of cross-market surveillance in most jurisdictions in the world”. This is perhaps a reflection of the stated costs and complexity of cross-market surveillance as well as the self-interests of the markets leading to them being adverse to exchanging information.<sup>277</sup>

### **Recent regulatory changes which may impact on market integrity**

As has been referred to above, hedge funds, high frequency trading, direct electronic access and trading derivatives on OTC markets may pose specific threats to market integrity. In the wake of the global financial crisis regulators introduced new regulations regarding these issues, although the focus for such regulations has generally been systemic risk concerns rather than protecting market integrity. Indirectly, however, most of these initiatives may well assist regulators in protecting market integrity because most require additional disclosure of information to regulators. The more information regulators have access to the more likely it is that regulators will be in a position to use this information in their endeavours to detect market abuse.

#### **a) Hedge Funds Regulation**

Although hedge funds have traditionally been the subject of less regulation than other market participants this situation is changing. Many countries have regulations preventing

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<sup>276</sup> Cumming, *supra* note 15 at 464.

<sup>277</sup> Cumming, *supra* note 14 at 503.

hedge funds from being offered to retail investors<sup>278</sup> and now there is a new focus on regulating hedge funds in order to make these funds and their activities more transparent to regulators. In June 2009 the IOSCO Technical Committee released a report suggesting that hedge funds operating in a given jurisdiction should be registered and also that hedge funds disclose to regulators information such as their risk management controls. Although directed mainly towards systemic risk issues, this report also stated that regulators should be able to share information about hedge fund exposures that may impact upon market integrity issues.<sup>279</sup>

In tandem with this report, many securities regulators began requiring hedge funds operating within their jurisdiction to register and disclose information about their operations and trading positions. For example, the Council of the European Union introduced the 'Alternative Investment Fund Managers Directive'. This requires members of the EU to legislate to introduce rules for offshore funds and managers located in non-EU countries and requires hedge funds to, amongst other things, obtain authorization to operate in the EU and provide authorities with information about their internal risk management arrangements, including instruments in which they trade and exposures.<sup>280</sup> New registration and reporting requirements have also been introduced in both the U.S.<sup>281</sup> and Canada.<sup>282</sup> In the U.S. these requirements include that large funds must report certain information relating to that fund's exposures, leverage, risk profile, and liquidity to the regulators.

This changing focus on the regulation of hedge funds is primarily directed towards the systemic risk that such funds may pose for the markets and giving regulators the ability to

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<sup>278</sup> Davies, *supra* note 203 at 236.

<sup>279</sup> IOSCO Technical Committee, Media Release, "IOSCO publishes principles for hedge funds regulation" (22 June 2009) online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS148.pdf>>. See also IOSCO Technical Committee, "Hedge Funds Oversight" (22 June 2009) online: IOSCO <<https://www.iosco.org/library/pubdocs/pdf/IOSCOPD293.pdf>>.

<sup>280</sup> Council of the European Union, Press Release. "Council adopts EU rules for alternative investment fund Managers" (27 May 2011) online: Mayer Brown <[http://www.mayerbrown.com/public\\_docs/122250.pdf](http://www.mayerbrown.com/public_docs/122250.pdf)>.

<sup>281</sup> See *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub L No 111-203 §§ 404, 406, 124 Stat 1376; SEC, News Release, "SEC Approves Confidential Private Fund Risk Reporting" (26 October 2011) online: SEC <<http://www.sec.gov/news/press/2011/2011-226.htm>>.

<sup>282</sup> *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, OSC NI 31-103, online: OSC <<http://www.osc.gov.on.ca>>.

monitor the exposures by hedge funds so that they do not build up positions which may cause major market instability. The focus is not on preventing hedge funds from engaging in market abuse. However it is possible that regulation requiring registration, supervision and submission of regular data concerning the exposures of hedge funds to securities regulators may, albeit indirectly, assist regulators to better monitor the operation of such funds for potential market abuse violations. For example, a hedge fund which is heavily invested in a particular derivative of an asset may be more likely to attempt to manipulate the price of the underlying asset. Disclosure of its exposures to the regulator may allow the regulator to link it to any such manipulation of any securities linked to this asset.

***b) High Frequency Trading and Direct Electronic Access***

New regulations were also adopted in some countries, such as the US, in relation to high frequency trading and direct electronic access by brokers. Again these rules are primarily directed to systemic risk concerns rather than toward preserving market integrity - although the additional disclosure of information required may assist regulators in this respect as well.

For example, in 2010 the SEC adopted a new rule requiring brokers to have risk controls and supervisory controls in place before they grant clients direct electronic access to the markets.<sup>283</sup> In 2013 Canada securities regulators also introduced a rule requiring that all market participants that access markets have risk management and supervisory controls in place.<sup>284</sup> Similarly IOSCO has produced principles for direct electronic access, recognising the regulatory challenges that such access poses to markets.<sup>285</sup> IOSCO remains neutral on the question of whether jurisdictions should allow direct access trading but advises that if they chose to such jurisdictions should ensure that market intermediaries have automated

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<sup>283</sup> See SEC, Media Release, “SEC Adopts New Rule Preventing Unfiltered Market Access” (3 November 2010) online: SEC <<http://sec.gov/news/press/2010/2010-210.htm>>.

<sup>284</sup> *Electronic Trading and Direct Electronic Access to Marketplaces*, OSC NI 23-103, online: <<http://www.osc.gov.on.ca/en/6097.htm>>.

<sup>285</sup> IOSCO Technical Committee Report, *supra* note 201 at 6; IOSCO states that the regulatory challenges include market abuse, fairness concerns in relation to execution advantages based on the type and geographic location of the connectivity arrangements and issues of capacity and the potential need for rationing bandwidth in relation to algorithmic trading.

controls in place limiting risk and must obtain adequate information about the client before such trading can be undertaken.

In response to systemic risk concerns in relation to high frequency trading the SEC has issued a “large trader” rule that requires firms whose trades equal or exceed 2 million shares a day, \$20 million a day, 20 million shares a month or \$200 million a month, to provide disclosure of more information to allow the SEC to track their trading through different markets.<sup>286</sup>

In Canada the OSC has approved the TMX group introducing a rule allowing a short order processing delay, or ‘speed bump’ to discourage high-frequency traders operating on its ATS Alpha marketplace. This requires orders to be on the market for a minimum time before they can be withdrawn. The ‘speed bump’ can be avoided but only if the trader places an order above a fixed order size. The TMX was prompted to introduce such a change to trading on this exchange in response to competition from a new ATS, Aequitas NEO Exchange (‘Aequitas’). Aequitas is an ATS designed to be a securities market which discourages the participation of high frequency traders.<sup>287</sup> Aequitas was set up by the Royal Bank of Canada (RBC) following the success of IEX in the US. IEX is an ATS set up by RBC in 2013 and also designed to discourage trading by high frequency traders by, inter alia, the use of ‘speed bumps’. Since its establishment IEX has captured 1% of the market share of trading in US stocks and is the fourth ranked ATS for stocks trading in the S&P 500.<sup>288</sup>

In Europe the European Parliament has approved the Markets in Financial Instruments Directive (‘MiFID II’) which requires countries in Europe to regulate high frequency trading

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<sup>286</sup> See *SEC Rule 13h-1*, 17 CFR §§ 240, 249 (2011) online: SEC <<http://www.sec.gov/rules/final/2011/34-64976.pdf>>.

<sup>287</sup> See TMX Group “TMX Group announces regulatory approval of TSX Alpha Exchange model”, 15 April 2015, online: <<http://www.tmx.com/newsroom/press-releases?id=307>> and B Shecter “TMX Group to install ‘speed bump’ to slow HFT traffic, ahead of Aequitas launch” *Financial Post*, 22 October 2014, online: <<http://business.financialpost.com/news/fp-street/tmx-group-to-install-speed-bump-to-slow-hft-traffic-ahead-of-aequitas-launch>>.

<sup>288</sup> B Shecter “Flash Boys hitting speed bumps as new trading platforms gain momentum”, *Financial Post*, 29 November 2014, online: <<http://business.financialpost.com/news/fp-street/flash-boys-hitting-speed-bumps-as-new-trading-platforms-gain-momentum>> . Also see generally M Lewis *Flash Boys* (NY: W.W. Norton & Company Inc. 2014).

due to systemic risk concerns and the potential for high frequency trading to be used for market manipulation.<sup>289</sup> MiFID II requires that all firms who use algorithmic trading techniques are required to be registered.<sup>290</sup> In addition such firms are required to maintain for a period of five years details of their trading algorithm, the name of the person in charge of the algorithm and the execution factors of the algorithm.<sup>291</sup>

In response to MiFID II in 2013 Germany enacted The Prevention of Risks and Abuse in High-Frequency Trading Act.<sup>292</sup> Pursuant to this Act all firms engaged in high frequency trading who are not already licenced by BaFin are required to obtain a licence from BaFin and become subject to its supervision.<sup>293</sup> This Act also provided that BaFin can require disclosure of algorithms used, the system used for trading, trading strategies and trading limits.<sup>294</sup>

This Act also expands the definition of market manipulation to include buy or sell orders that are placed, changed or cancelled on a market by means of a computer algorithm if they:

- disrupt or delay the functioning of the trading venue, or are likely to do so; or
- make it more difficult for other persons to identify genuine purchase or sell orders on the trading system, or are likely to do so; or
- create or are likely to create a false or misleading signal about the supply of or demand for a financial instrument.<sup>295</sup>

This Act also requires that exchanges charge separate fees for the excessive usage of exchange systems, in particular due to a disproportionately high number of order entries,

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<sup>289</sup> European Council Directive 2014/65/EU on markets in financial instruments (MiFID II) [2014] OJ L 173/349.

<sup>290</sup> *Ibid*, Article 2.

<sup>291</sup> *Ibid*, Article 21-23.

<sup>292</sup> See BaFin “Algorithmic Trading and High Frequency Trading”, online:

<[http://www.bafin.de/EN/Supervision/StockExchangesMarkets/HighFrequencyTrading/high\\_frequency\\_trading\\_artikel.html](http://www.bafin.de/EN/Supervision/StockExchangesMarkets/HighFrequencyTrading/high_frequency_trading_artikel.html)>. and translation of the High Frequency Trading Act, online:

<[http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/hft\\_en.html?nn=4707014](http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/hft_en.html?nn=4707014)>.

<sup>293</sup> *Ibid*, Article 2.

<sup>294</sup> *Ibid*, Article 1.

<sup>295</sup> *Ibid*, Article 5.



modifications or cancellations.<sup>296</sup> Exchanges are also required by the Act to ensure that there are circuit breakers to ensure an orderly determination of the exchange price even when prices fluctuate significantly and to maintain an appropriate ratio between order entries, modifications and cancellations on the one hand and actually executed orders on the other.<sup>297</sup>

### **c) OTC derivatives**

In response to the 2008 global financial crisis and the problems caused by collateralized debt obligations traded through OTC markets, there was a push by regulators to improve the transparency of OTC derivatives. This problem was best expressed by the Chairman of the World Federation of Exchanges:

The pendulum has swung too far and the grand experiment in “competition” led to “excessive fragmentation” of price discovery. Multiple trading venues, with different regulatory requirements with respect to disclosure, have led to deterioration in the transaction information available. The information available to regulators needs to be systematized and OTC transaction information needs to be captured in some form or other within regulators’ purview.<sup>298</sup>

To that end, the solution is said to be that standardized OTC derivatives trades should be registered in a regulated repository or cleared through a regulated central repository.<sup>299</sup> Such regulation may assist improving market integrity if such a central repository could gather

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<sup>296</sup> *Ibid.*, Article 1.

<sup>297</sup> *Ibid.*

<sup>298</sup> World Federation of Exchanges, News Release, “News and Views – letter to IOSCO” (1 September 2010) online: World Federation of Exchanges <<http://www.world-exchanges.org/news-views/news/wfe-chairman-brodsky-and-wfe-regulation-task-force-letter-iosco-fragmentation>>.

<sup>299</sup> See for example S Macbeth, “Lighting the lamp, or how regulators can help themselves monitor global OTC derivatives market” (16 May 2011), online: World Federation of Exchanges <<http://www.world-exchanges.org/news-views/views/lighting-lamp-or-how-regulators-can-help-themselves-monitor-global-otc-derivatives->>; International Monetary Fund, *Global Financial Stability Report: Meeting new challenges to stability and building a safer system* (April 2010) online: IMF <<http://www.imf.org/external/pubs/ft/gfsr/2010/01/pdf/chap3.pdf>> at chapter 3; IOSCO, Media Release, “IOSCO and CPSS consult on policy guidance for central counterparties and trade repositories in the OTC derivatives market” (12 May 2010) online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS182.pdf>>. In the U.S. this is reflected in Title VII of the *Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010*, entitled the *Wall Street Transparency and Accountability Act of 2010*, which established a new regulatory framework for regulatory and supervisory oversight of the over-the-counter (“OTC”) derivatives market, including mandatory clearance of some derivatives through a clearing entity accepted by the CFTC and SEC.

data in a standardized form about the trading of such derivatives. This data could be then analyzed to look for trading irregularities which could indicate market abuse.

In compliance with this recommendation in relation to OTC derivative trade reporting some countries, including the US, the EU and Canada have moved to implemented regulations requiring reporting of OTC trades. For example in Ontario now all OTC derivative transactions existing involving at least one Canadian counterparty must be reported to a designated trade repository.<sup>300</sup>

In addition, in 2011, the Technical Committee of IOSCO recommended that regulators build a comprehensive framework for conducting market surveillance of these markets, the objective of this framework being to monitor the market in order to detect and deter manipulation or abusive trading.<sup>301</sup>

#### **Part 4 Has the Regulatory Response been Sufficient?**

In the interests of protecting and enhancing the economy as a whole, securities regulators are entrusted with the responsibility of ensuring that markets are efficient *and* fair. Given this goal of market efficiency it is not surprising that the changes to markets and market trading that have occurred over the last few decades have been supported, rather than hindered, by securities regulators, because the markets have become more efficient. However perhaps of some concern is that, notwithstanding that market integrity or fairness is also a key objective of securities regulators, little attention, at least until relatively recently, seems to have been given to if and how these changes have impacted that issue and, if so, how trading on these fragmented markets can be effectively monitored to detect market abuse.

One possible reason for this apparent lack of concern is that, as is referred to above, it has been difficult to empirically measure changes in market integrity when, by contrast, changes in market efficiency can be easily measured. It has been difficult to measure the level of

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<sup>300</sup> Ontario Securities Commission Rule 91-507 *Trade Repositories and Derivatives Data Reporting*, online: <[http://www.osc.gov.on.ca/documents/en/Securities-Category9/rule\\_20140915\\_91-507\\_unofficial-consolidation-derivatives-data-reporting.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category9/rule_20140915_91-507_unofficial-consolidation-derivatives-data-reporting.pdf)>.

<sup>301</sup> IOSCO Technical Committee, "Principles for the Regulation and Supervision of Commodity Derivatives Markets Report" (15 September 2011) online: <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf>>.

insider trading or market manipulation in a market and whether this is changing over time. As is indicated in Part 3, some research is now being undertaken to attempt to empirically measure changes in market integrity. This research is valuable, but even in the absence of such metrics, just because market integrity does not lend itself to easy measurement does not mean that it ought to be overlooked. The level of insider trading and market manipulation has always been difficult to measure but that does not mean that it does not occur or that regulators should not devote resources to detecting and prosecuting abuses. The transformation that has taken place in markets and trading over the last few decades has created more opportunities to undertake and disguise market abuse and, moreover, has fostered market participants who may be encouraged by such changes to engage in such abuse.

Maintaining and improving market integrity in this era of fragmented markets and a global trading environment may prove to be difficult and costly but it is not impossible. It would necessarily involve three elements – improving data collection by regulators and SROs across all markets, fluid and information data exchange between regulators and SROs and improved data analysis by regulators and SROs to detect trading anomalies. Furthermore, it requires closer links and the exchange of evidence between international regulators and SROs to bring enforcement action in relation to any market abuse that is detected.

In relation to the necessary first step – the collection of data - a stronger regulatory framework may be needed. In relation to US markets, once the consolidated audit trail is fully implemented, this will provide a standardized collection of data. Critically also this will provide clearer data in relation to the activities of each client. In addition the recent focus on obtaining information from hedge funds, high frequency traders, OTC derivatives trades and expanding the records required to be retained for direct electronic trading is a step in the right direction, although the information and data obtained should not be restricted to information in relation to systemic risk concerns. All securities regulators should acknowledge that they require information for the purpose of protecting the fairness of the

markets, and to that end, should ensure regulations are in place to obtain all of the information they need from these market participants - ideally in a standardized form to enhance the ease of analysis.<sup>302</sup> Similarly, a stronger regulatory framework is needed in terms of collecting trading data in a standardized form worldwide, which can be used for market surveillance analysis. This would necessarily include data such as the identity of the client and the broker, and details of the orders and trades, including changes and cancellations. An appropriate standard set of trading data, including these elements, needs to be developed. This standard may arise from the consolidated audit trail rule made by the SEC. However if the standard is to become an international standard, an international body such as IOSCO may have to take the lead in its development. This would require such an international body to gather input from other national securities regulators and SROs as to what should be comprised in this standard.

Secondly, the process and capacity to exchange data may need to be improved. Ideally one international organization should have the capacity to facilitate this exchange of information. As it is in the interests of regulators and SROs alike to stamp out market abuse a properly governed and transparent organization, perhaps under the auspices of IOSCO, would probably gain support.<sup>303</sup> Although the ISG may also be just such an organization, the fact that it is unable to pass on information easily to government regulators seems to be a significant limitation. There are also real issues as to its lack of transparency in relation to its governance and operations if it is to be responsible for organizing the exchange of private information about market participants between regulators. Furthermore, as an organization comprised of essentially private organizations, such as exchanges and SROs, it may not be

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<sup>302</sup> S Luparello, Vice President, FINRA, has stated that “Regulators must develop unified standards and procedures to govern the content, timing and publication of information for equities transactions regardless of the quoting or execution venue.” see Luparello, *supra* note 262.

<sup>303</sup> See generally Jordan, *supra* note at 241, who argue that a form of self-regulatory international body may be necessary, or as a gap filler where there is no international regulator. See also Luparello, *supra* note 262, in which he states “[r]egulators must establish an appropriate governance mechanism for developing and implementing these measures on a cross-border basis. This will doubtless be complex, but there are a variety of vehicles—such as a college of regulators and bilateral or multilateral agreements—that could be used to address this challenge. Another option is to place the surveillance function in a regulatory utility funded by various market centers, but subject to oversight through an agreed mechanism.”

sufficiently focused on the public interest of eliminating market abuse and may be too easily swayed by arguments to limit regulation because of competitive and cost pressures on its members.

Thirdly, regulators and SROs will need to invest heavily in technology and research to undertake both cross market surveillance and cross border surveillance analysis on the data that has been collected. Although this will be costly given the complexity of markets, such technology needs to be developed if regulators are to maintain market integrity in the face of ever evolving markets. Sufficient funding must be obtained from market participants to support these costs given the critical importance of market integrity to maintaining market confidence.

Finally, taking successful enforcement action against market abuse requires the development of close links between international regulators and SROs to gather evidence in relation to any market abuse that is detected. If the offending behaviour crosses international boundaries, the regulator who takes action must obtain evidence and information from other jurisdictions to prosecute the matter. Here there has been some progress over the last decade. The IOSCO MMoU appears to be improving the frequency and speed in which securities regulators exchange information to allow enforcement action to take place.<sup>304</sup> Given that most of the world's securities regulators have now signed this MMoU, or have committed to sign this MMoU, the use of this MMoU to exchange evidence is a trend that is likely to continue.<sup>305</sup>

A regulatory shift to focus on market integrity as suggested above will require substantial commitment from regulators and SROs internationally and will come at a substantial cost. As there is a lack of hard data that market manipulation and insider trading is flourishing in the new trading environment there will probably be criticism that the benefits do not outweigh the costs. However, if such an investment is not made it may become apparent over time that

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<sup>304</sup> See further Chapters 5 and 6.

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

the preservation of market integrity is not a primary goal of regulators, but one that is secondary to market efficiency. Given the importance of fairness to promoting confidence in the markets, this will be a difficult position for regulators to maintain.

## **Conclusion**

The transformation of the markets which has occurred over the last few decades has been revolutionary. Yet although the securities regulators' objective to preserve market fairness or integrity has remained constant throughout, their ability to meet this objective seems not have kept pace. They could of course relegate market integrity as a secondary goal and acknowledge that the markets are unfair but that it is simply too costly and too difficult to remedy. This, however, is unlikely to be a palatable option.

Regulators are now confronted with markets that present significant challenges to their capacity to detect and take action against market abuse, which is a key component of their mission to enhance market confidence. Markets have moved rapidly and irreversibly into the 21<sup>st</sup> century and securities regulators seem to have no option but to also similarly adapt their detection, investigation and enforcement practices.

Some steps have been taken by policymakers to address the increasing sophistication of the markets and to work towards the goal of maintaining the integrity of the markets. The introduction of the consolidated audit trail, tighter restrictions on direct electronic access to markets, standardising OTC trading and closer monitoring of hedge funds will go some way in assisting regulators in detecting and deterring market abuse. However it is relevant to note that most of these changes were driven by specific instances which exposed weakness in the integrity of the markets rather than regulators being proactive in protecting the integrity of the markets. For example the consolidated audit trail was instigated because of the 'flash crash' incident in 2010 and changes to OTC trading and hedge fund monitoring was instigated by systemic risk concerns arising out of the global financial crisis.

Going forward it seems that regulators may need to be more proactive in protecting the markets from market abuse. This could possibly include improving and standardizing the collection of trading data, developing organisations and mechanisms to share this data and developing systems to analyse this data to detect market abuse.

This chapter has examined the changes to the markets, the opportunities for cross border market abuse and some of the recent changes to the regulation of the markets that may work towards protecting the integrity of the markets. The response of securities regulators to the changes to the markets is further developed in the next two chapters. These seek to ascertain trends in relation to the types of cases of cross border market abuse that have been identified, how detection, investigation and enforcement mechanisms have developed in response to these cases and, on the basis of this information, continues to examine ways in which regulators could develop systems to improve the detection, investigation and prosecution of market abuse.

### Chapter 3

## **ISSUES OF DETECTION, INVESTIGATION AND ENFORCEMENT OF CROSS BORDER MARKET ABUSE – PERSPECTIVES OF SECURITIES REGULATORS**

Three trials for markets offences started in March and April this year, and these trials are expected to be concluded by July. These trials are the most complex and lengthy we have brought and demonstrate the increase in the size, complexity and international nature of cases we are prepared to undertake. Each of our insider dealing prosecutions in the last year has represented an escalation in magnitude from those brought in previous years.

UK Financial Services Authority *Enforcement Annual Performance Account 2011/12* <sup>306</sup>

As outlined in chapter 2, over the past few decades the markets and trading have become increasingly international in character which may have enhanced opportunities for cross border market abuse. This in turn may have had an impact upon the kinds of cross border market abuse matters that securities regulators detect, as well as the types of matters they choose to investigate and prosecute. As such, the focus of this chapter and the next is to consider the impact of the changes as viewed through the lens of securities regulators who are charged with protecting the integrity of the markets by detecting, investigating and prosecuting cross border market abuse. This analysis is undertaken to reveal whether or not securities regulators efforts in detecting and deterring cross border market abuse are keeping pace with the increasing sophistication of the markets

Contained within this analysis is the observation that just as the markets and trading have changed, securities regulators have been able to change their detection, investigation and enforcement methods and have had the capacity to adapt. Accordingly, these chapters will

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<sup>306</sup> FSA *Enforcement Annual Performance Account 2011/12* online:  
FSA<<http://www.fsa.gov.uk/static/pubs/annual/ar11-12/enforcement-report.pdf>> at 9.



also examine evolving approaches to the ways in which securities regulators have adapted to the transformation of the markets and the success or otherwise of these responses.

In this chapter the scope of the detection, investigation and enforcement powers of the regulators are considered together with the limitations of these powers. This analysis is reinforced by responses from interviews undertaken by the author of senior employees of securities regulators involved in investigations in relation to the changes they have observed over the last ten years.<sup>307</sup>

As such, Part 1 sets out the enforcement powers of the regulators to take action against market abuse. Part 2 of this chapter expands upon the material from the preceding chapters and outlines, from the point of view of securities regulators, how the transformations to the markets have altered the nature of cross border market abuse. The focus of Part 3 is on how cross border market abuse is currently detected and what difficulties securities regulators are encountering in investigating and prosecuting those matters once they are detected. Part 3 also considers issues that have arisen in relation to how securities regulators are working with their counterparts in other countries. Part 4 reflects upon some of the key factors that may impact upon the success or failure of a prosecution of cross border market abuse. Finally, Part 5 then seeks analyse the responses in relation to key issue of this dissertation, namely has the enforcement efforts of securities regulators against market abuse and cross border market abuse kept pace with the increasing sophistication of the markets.

### **Part 1 The securities regulators powers to take action against market abuse**

The regulators the focus of the analysis in this chapter are Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) in Germany, the Financial Conduct Authority (the FCA) in the UK, the Australian Securities and Investments Commission (ASIC) in Australia, the Securities and Exchange Commission (the SEC) and the Ontario Securities Commission

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<sup>307</sup> Although the employees were employed by the regulators, it should be noted that the views expressed are not the views of the securities regulators but are just observations and comments based upon individual experiences and any analysis and conclusions need to be taken in that context. The enforcement staff were interviewed on the following dates: ASIC on 8 July 2011; OSC on 11 June 2012; FCA on 28 August 2012; BaFin on 31 August 2012; FINRA on 9 September 2013; IIROC on 2 May 2014; the SEC on 21 May 2014.

(the OSC) in Canada. Because of the importance self-regulatory organizations in Canada and the USA, staff from Investment Industry Regulatory Organization of Canada (IIROC) and the Financial Industry Regulatory Authority (FINRA) were also interviewed.

### **The Powers of the Securities Regulators**

In Germany BaFin is the principal agency responsible for taking action against market abuse. It can take administrative action and also refers criminal violations to the public prosecutor. Germany has six exchanges based in Berlin, Hamburg-Hannover, Munich, Stuttgart, Dusseldorf and Frankfurt which conduct their own market surveillance. These exchanges can take action in relation to breaches of the rules of the exchange but must refer instances of market abuse to BaFin.<sup>308</sup> Supervision of the rules of these exchanges is undertaken by stock exchange supervision authorities of the State where the exchange is situated.<sup>309</sup>

Canada does not have a national securities regulator. Each of the provinces and territories is responsible for enforcing the provisions in their Securities Act. However all of these Acts restrict market abuse.<sup>310</sup> The provincial and territorial securities regulators, such as the OSC,

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<sup>308</sup> Until 2007 there was also an exchange in Bremen, see *Country Finance Germany 2012* (New York: The Economist Intelligence Unit, 2012) at 60.

<sup>309</sup> BaFin “Securities Supervision” (2013), online: BaFin <[http://www.bafin.de/EN/BaFin/FunctionsHistory/SecuritiesSupervisionAssetManagement/securities-supervision-assetmanagement\\_node.html](http://www.bafin.de/EN/BaFin/FunctionsHistory/SecuritiesSupervisionAssetManagement/securities-supervision-assetmanagement_node.html)>.

<sup>310</sup> *Securities Act*, RSO 1990, c S.5, ss 76, 126.1; *Securities Act, 2004*, SBC 2004, c 43, ss 27-31; *Securities Act*, RSA 2000, c s-4, ss 93.3, 147; *The Securities Act*, RSM 1988, c 550, ss 108, 112.3; *Securities Act*, SNB 2004, c s-5.5, ss 69, 89; *Securities Act*, RSNS 1989, c 418, ss 81-82; *The Securities Act, 1988*, SS 1988-89, c s-42.2, ss 55.1, 55.11-12; *Securities Act, 1990*, RSN 1990, c s-13, ss 76-77; *Securities Act*, SNWT 2008, c10, ss 102, 152-153, 155; *Securities Act*, SNU 2008, c12, ss 102, 152-153, 155; *Securities Act*, SPEI 2007, c17, ss 102, 152-153, 155; *Securities Act*, SY 2007, c16, ss 102, 152-153, 155; *Securities Act*, CQLR, c V-1.1, ss 68, 89, 187-190. The problems that this fractured system of enforcement causes for Canada has been the subject of much academic criticism. For example Puri who states:

A key criticism of regulatory enforcement in Canada..., is the complexity and inefficient allocation of resources that our duplicative and fragmented enforcement system causes. Many resources have to be spent on co-ordinating and co-operating amongst provincial and territorial securities commissions, SROs and criminal law authorities. Other criticisms include a lack of enforcement in high profile cases, delays between detection of misconduct and action, and delays in adjudication. As well remedies are only effective at the provincial level and there can be significant variation in the range of sanctions and maximum penalties from province to province. A common perception is that each of the 13 commissions is pursuing its own enforcement agenda with no common setting of priorities. A final concern relates to the lack of accountability of each of these institutions, particularly because there is confusion amongst stakeholders as to who is responsible for criminal matters versus and regulatory matters.

can take administrative action, civil action and can refer criminal instances of market abuse to the provincial prosecution authorities.<sup>311</sup> IIROC, the self-regulatory body for brokers, regulates all investment dealer firms in Canada. The Securities Act of each province requires that all investment dealers to must be members of IRROC if they wish to operate in Canada.<sup>312</sup> IIROC also regulates trading on debt and equity marketplaces in Canada, including all exchanges and ATSS. IIROC can also take action against brokers and firms who are members if these entities breach IIROC's market integrity rules.<sup>313</sup>

In the UK the FCA is the regulator of all markets, brokers and financial advisors. It can take administrative action and civil action in relation to market abuse and impose penalties or take disciplinary action against authorised persons.<sup>314</sup> It can bring regulatory criminal actions and refers more serious criminal offences to the Crown Prosecution Service.<sup>315</sup> From 1 April 2013 the FCA took over these responsibilities from the Financial Services Authority (the FSA) which had previously exercised these powers.

In the US the Securities and Exchange Commission (SEC) is the primary government agency in the United States responsible for pursuing enforcement action against market abuse. It has broad powers which include initiating court proceedings for the imposition of civil penalties and can also seek cease and desist orders.<sup>316</sup> It can also impose administrative remedies on brokers and firms.<sup>317</sup> Market abuse violations which are wilful, and therefore criminal, can be referred by the SEC to the US Department of Justice for

P Puri, *A Model for Common Enforcement in Canada: The Canadian Capital Markets Enforcement Agency and the Canadian Securities Hearing Tribunal* (Research study for the Expert Panel on Securities Regulation, 2008), online: Osgoode Hall <<http://www.osgoode.yorku.ca/research/search-publications>> at 9.

<sup>311</sup> *Securities Act*, RSO 1990, c S.5, ss 122, 127; *Securities Act, 2004*, SBC 2004, c 43, ss 81, 83; *Securities Act*, RSA 2000, c s-4, ss 194, 200; *The Securities Act*, RSM 1988, c 550, s 138; *Securities Act*, SNB 2004, c s-5.5, ss 179, 184; *Securities Act*, RSNS 1989, c 418, ss 129, 135; *The Securities Act, 1988*, SS 1988-89, c s-42.2, ss 131, 135.7; *Securities Act*, 1990, RSN 1990, c s-13, ss 122, 127; *Securities Act*, SNWT 2008, c10, s 164; *Securities Act*, SNU 2008, c12, ss 164; *Securities Act*, SPEI 2007, c17, ss 164; *Securities Act*, SY 2007, c16, ss 164; *Securities Act*, CQLR, c V-1.1, ss 195, 195.2, 196, 200, 203, 208.1.

<sup>312</sup> See for example *Securities Act*, RSO 1990, c S.5, s.25-32.

<sup>313</sup> IIROC, *Universal Market Integrity Rule* at Rule 2.2, online: IIROC <<http://www.iiroc.ca/industry/rulebook/Pages/UMIR-Marketplace-Rules.aspx>>.

<sup>314</sup> *Financial Services and Markets Act 2000* (UK), c 8, ss 118, 129.

<sup>315</sup> FCA, Report, "How we enforce the Law", online: FCA <<http://www.fca.org.uk/firms/being-regulated/enforcement/how-we-enforce-the-law>>.

<sup>316</sup> *Securities Act*, 15 USC §§ 8A, 20(d) (1933); *Securities Exchange Act*, 15 USC §§ 21B(a), 21C (1934).

<sup>317</sup> *Securities Act*, *supra* note 86 at § 8(d); *Securities Exchange Act*, *supra* note 86 at § 15(b)(4).

prosecution.<sup>318</sup> FINRA, the self-regulatory body for brokers, regulates most broker dealer firms in the US. FINRA also regulates trading on almost all of the exchanges and ATSS in the US. FINRA can take action against brokers and firms who are members and who are directly involved in or otherwise facilitate market abuse.<sup>319</sup>

Australia's securities regulator, the Australian Securities and Investments Commission (ASIC), is the sole agency responsible for taking action against market abuse in Australia. It can seek civil remedies including seeking the imposition of civil penalties by a superior court.<sup>320</sup> It can bring regulatory criminal prosecutions and investigates criminal cases of market abuse which then are referred to the Commonwealth (Federal) Director of Public Prosecutions.<sup>321</sup>

ASIC primarily prosecutes market abuse offences criminally, not by way of a civil action. Therefore ASIC is put to a higher burden of proof and must be able to satisfy the court of each of the elements of the offence beyond a reasonable doubt. Although it can bring civil actions for market abuse, it is still put to a relatively high burden of proof for such matters. As such ASIC usually opts to bring criminal prosecutions for market abuse because of the deterrent value of such prosecutions.<sup>322</sup>

Through its Markets Disciplinary Panel, ASIC can also take disciplinary action against licenced market participants for breaches of its market integrity rules.<sup>323</sup> Until 2010 there was only one main securities exchange operator in Australia, the Australian Securities Exchange (the ASX) which dominated the market for listed securities. The ASX also conducted its own

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<sup>318</sup> *Securities Act*, *supra* note 86 at §§ 24, 20(b); *Securities Exchange Act*, *supra* note 86 at §§ 32(a), 21(d).

<sup>319</sup> See "FINRA Rules", online: FINRA

<[http://finra.complinet.com/en/display/display.html?rbid=2403&element\\_id=607](http://finra.complinet.com/en/display/display.html?rbid=2403&element_id=607)>.

<sup>320</sup> *Corporations Act 2001* (Cth), s 1317G.

<sup>321</sup> ASIC, Information Sheet 151, "ASIC's Approach to Enforcement", online: ASIC < <http://asic.gov.au/about-asic/asic-investigations-and-enforcement/asic-s-approach-to-enforcement/> >.

<sup>322</sup> Although ASIC can seek a penalty against a perpetrator for market abuse by bringing a civil action, referred to as "civil penalty" cases, it has not experienced a high level of success in bringing such actions. For the reasons why see J Austin "A Rapid Response to Questionable Trading - moving towards better enforcement of Australia's securities laws" (2009) 27 C&SLJ 203.

<sup>323</sup> ASIC, "Markets Disciplinary Panel", online: ASIC < <http://asic.gov.au/regulatory-resources/markets/markets-disciplinary-panel/>>.

disciplinary proceedings for breaches of its market integrity rules.<sup>324</sup> In August 2010 the disciplinary function over all licenced market participants was transferred to ASIC. In the same year the market for ASX listed securities started to fragment with ASIC allowing a new provider (Chi-X Australia) to also trade in ASX listed securities.<sup>325</sup>

## **Part 2 Impact of the changes to the markets on market abuse**

It is clear that the transformation of securities markets over the last few decades has presented new challenges for securities regulators in terms of their enforcement activities. While some of their enforcement work has remained relatively constant, factors such as the globalization of markets, improvements in technology, fragmentation of the markets and the rise of new types of market participants have all had an impact upon the types of market abuse matters that are detected and how regulators strategize to effectively deal with these cases.

Most regulators reported that they are detecting and investigating significantly more instances of market abuse that have a cross border dimension than they were a decade ago. This increase has been driven by a complex combination of globalization, interconnected markets, increases in the speed of trading and the proliferation of ways to trade the same economic interest.

In relation to market manipulation matters in particular, some regulators report that a significant proportion of these matters seem to have some element of the activity that took place outside of the jurisdiction. For example, BaFin currently investigates about 30 cases of insider trading a year and about 100 market manipulation cases. The majority of these cases of market manipulation have elements of the activity that were conducted outside of

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<sup>324</sup> At the time there were four other small exchanges, the National Stock Exchange of Australia (NSX), the Bendigo Stock Exchange (BSX) and the Asia Pacific Stock Exchange (APX), however these exchanges were not permitted to trade in ASX listed securities.

<sup>325</sup> ASIC Annual Report 2011, online: ASIC <  
[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/annual-report-2010-11.pdf/\\$file/annual-report-2010-11.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/annual-report-2010-11.pdf/$file/annual-report-2010-11.pdf) > at 2.

Germany. By way of contrast only approximately 5% of these insider trading cases have elements of the activity that were conducted outside of Germany.<sup>326</sup>

The aspect of the activity that occurs outside of the jurisdiction can also differ between insider trading cases and market manipulation cases. In relation to insider trading, frequently the only foreign aspect of the investigation is that the perpetrator has a bank account in another country to deposit the proceeds or trades through a family member or broker in that other jurisdiction. In some cases it appears that this may have been done to disguise the activity from the scrutiny of the authorities. For example, a person with inside information resident in Germany may use a bank account in Switzerland to deposit the proceeds of their insider trading.<sup>327</sup>

By way of contrast, in market manipulation matters, the schemes appear to be more organized and there may be different aspects of the behaviour that takes place outside of the jurisdiction. For example, the perpetrators may use a foreign website to disseminate information to 'pump' the price of the securities as part of a pump and dump market manipulation scheme. Alternatively, the perpetrators may not be situated in the jurisdiction where the trading took place and may be conducting transactions such as wash sales or matched orders from outside of the jurisdiction.<sup>328</sup> Furthermore, given that the perpetrators of these schemes operate across jurisdictions, they have an enhanced capacity to move the activity if an investigation commences in a particular jurisdiction. This can then frustrate the efforts of the enforcement staff who may discover that by the time an investigation is complete, those involved have ceased the activity in one country and shifted their illicit activities elsewhere.<sup>329</sup>

A significant percentage of cross border market manipulation cases detected by securities regulators appears to be concentrated in the lightly regulated, or penny stock markets, in the

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<sup>326</sup> Interview with BaFin.

<sup>327</sup> Interview with BaFin.

<sup>328</sup> Interview with BaFin.

<sup>329</sup> Interview with FINRA

US and Germany. In Germany, in 2012 Deutsche Börse closed the market which was most susceptible to such manipulation being the First Board of the Open Market. Although it has now been closed it will take several years for BaFin to deal with the large number of market manipulation matters which took place on this market because of the time lag between detection, investigation and then prosecution. However BaFin anticipates that because this market is now closed the number of market manipulation cases should fall.<sup>330</sup> In the US the approach has been to ramp up enforcement efforts by, for example, suspending trading in dormant companies. FINRA has also been active in taking action against brokers who have facilitated manipulative trading in these markets with a view to deterring brokers from acting for such clients.<sup>331</sup> In addition the SEC has been actively working with the FBI using co-operators to gather evidence against persons who systematically engage in large scale pump and dump schemes. This can lead to more compelling evidence being gathered against the perpetrators of these schemes which, in turn, can lead to quicker and more successful prosecutions.<sup>332</sup>

Despite detecting more instances of cross border market abuse, it is not possible for regulators to conclude whether this is because there is more cross border market abuse occurring or because they are just getting better at detecting such matters. Certainly over the last decade there have been significant improvements in systems and methodologies aimed at detecting market abuse, such as more sophisticated software which analyses news reports which may cause price movements in securities. Additionally, information that is obtained can be analysed in more sophisticated ways. For example, FINRA now retains data in relation previous instances of unusual trading and can mine this data for patterns as new instances of unusual trading are detected. This may allow FINRA to detect more instances of, for example, systematic insider trading.<sup>333</sup>

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<sup>330</sup> Interview with BaFin.

<sup>331</sup> Interview with FINRA.

<sup>332</sup> Interview with the SEC

<sup>333</sup> Interview with FINRA.

## **New Market Participants**

New participants in the market who have emerged over the last decade, in particular, high frequency (or algorithmic) traders, have changed the nature of some market abuse that is detected. Most high frequency trading is arguably positive for the market and works to improve liquidity. However, some trading strategies are manipulative, such as igniting interest by spoofing, layering or quote stuffing, and there are a number of variations in such manipulative trading strategies. For example, spoofing of orders used to be confined to outside of the spread between the highest offer to buy and lowest offer to sell a security, but can now even occur inside the spread even though this carries the risk that a trade will be executed. Often, the victims of such manipulative techniques are other algorithmic traders who must then engage in defensive strategies to protect themselves from manipulation. This can lead to what is akin to a 'cat and mouse' game, where defensive strategies are met with a response from the other trader, causing further modifications to trading strategies.<sup>334</sup>

Investigating algorithmic trading for possible market abuse can be highly challenging and resource intensive. For instance, almost invariably the investigator first has to unravel the algorithm to determine if the trading strategy is actually manipulative and then, if it is manipulative, analyse whether or not it can be proven to have violated the law.<sup>335</sup>

Furthermore, as high frequency traders often seek to profit by making only pennies per trade on a large number of trades, a huge volume of data necessarily has to be analysed to investigate the allegation effectively. Because of this intrinsic complexity in investigating possible market abuse by high frequency traders which, in turn, requires a high commitment of technology resources, in 2012 IIROC changed its fee structure. As a self-regulatory body IIROC is non-profit and works on a cost recovery basis from its members. The new fee structure is based upon the numbers of orders and trades made by a member and as such

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<sup>334</sup> Interview with FINRA.

<sup>335</sup> Interview with FINRA.



high frequency traders are being levied higher fees to reflect the technology resources IIROC needs to monitor these market participants.<sup>336</sup>

Another issue is the speed at which the trading takes place. Sometimes the orders are placed so extraordinarily quickly that the time clocks of the market or markets simply cannot record sufficient granular detail of the precise time in which the orders were placed to enable a full reconstruction of the exact sequence of events. Because of this, regulators are working to improve the detail of the time stamping of orders and trades and to coordinate the time clocks of different markets.<sup>337</sup>

In the last few years there have been several cases in the US and the UK in which securities regulators have been able to prove cross border market manipulation by high frequency traders. These cases are centred in these jurisdictions probably because the US and the UK are leaders in innovations in market structure. For example, US markets are characterised by high levels of liquidity, fragmentation, high speeds of information transfer, high speeds of trading and efficient linkages between markets. These characteristics of US market structure result in very efficient markets with low execution costs. However, these same characteristics may make the markets more prone to market manipulation techniques, such as layering and spoofing. As other markets alter their market structure, fragment and execution costs are reduced as a result, regulators of those other markets may start to observe similar problems develop in their markets.<sup>338</sup>

### **Part 3 Detection and Investigation Issues**

#### **Detection Issues**

In detecting instances of cross border market abuse, detection methods do not differ markedly from those which are used to detect market abuse which takes place wholly within the jurisdiction of a regulator. The most frequent methods of detection are market

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<sup>336</sup> Interview with IIROC. It reported that the majority of its members were in favour of this change.

surveillance, suspicious transactions reports and information by way of complaints, tip offs or whistleblowers.

### **a) Market surveillance**

The main way in which market abuse is detected is unusual trading identified by market surveillance. However surveillance practices around the world vary significantly, particularly in relation to which kind of organization is responsible for conducting market surveillance as well as the level of cross market and cross asset surveillance.<sup>339</sup>

In relation to the organization responsible for conducting surveillance, in Australia, market surveillance is undertaken solely by ASIC the securities regulator. In Canada and the US, market surveillance is undertaken principally by one self-regulatory organisation being IIROC in Canada and FINRA in the US. In Germany and the UK surveillance is principally undertaken by the individual trading venues.<sup>340</sup>

In US and Canada, the self-regulatory bodies, FINRA and IIROC, conduct surveillance over most of the markets. This allows FINRA and IIROC to conduct cross market surveillance. As is referred to in Chapter 2, in order to further enhance its detection of market abuse, under the direction of the SEC, FINRA is developing a consolidated audit trail whereby all data from all of the markets will be collected in a consistent form and consolidated.<sup>341</sup> The consolidated audit trail will require brokers to enter into one central data point, accessible by FINRA, customer information in relation to trades and orders. From a market surveillance point of view, this system should greatly enhance the transparency of the market, allowing FINRA to quickly track trading patterns of market participants across different trading

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<sup>337</sup> See discussion in The Board of IOSCO “Technological Challenges to Effective Market Surveillance Issues and Regulatory Tools,” Final Report, April 2013, online: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD412.pdf> at 15.

<sup>338</sup> Interview with FINRA.

<sup>339</sup> See generally IOSCO Report, *supra* note 337. In this report IOSCO surveyed those responsible for market surveillance in a number of countries including Canada, Australia, the US, the UK and Germany. It reported significant variations such as the organization responsible for undertaking market surveillance, how such surveillance is conducted, data collection practices, and the level of cross-market and cross-asset surveillance.

<sup>340</sup> See generally Chapter 2 in relation to the historical reasons why this function has been allocated to different organisations in different countries.

<sup>341</sup> See SEC Rule 613, *supra* note 256.

venues. However this increase in surveillance capacity is likely to be expensive to develop and maintain, particularly given it is estimated that this will eventually evolve into the second largest database in the world.<sup>342</sup>

In Canada brokers and clients of brokers who have direct electronic access to markets or clients who have a routing arrangement are required to use a client identifier at the time of entry of the order. This information is available to IRROC in real time.<sup>343</sup> In 2005 the CSA proposed a project, called the Trade Reporting and Electronic Audit Trail Standards (or 'TREATS') to develop a consolidated audit trail to collect, in a standard form, information on orders and trades and to allow IIROC to analyse trades and orders by way of a unique customer identifier.<sup>344</sup> It appears that this project was cancelled in 2009 because of the sheer size and complexity of the project and uncertainty about whether market integrity would actually be enhanced as a result.<sup>345</sup> It may also have been cancelled because brokers lobbied extensively against it. As such, in Canada, like other markets, in most cases information in relation to which retail customer placed an order has to be obtained by investigators via an information request directed to the broker who placed the order. Accordingly this information is not immediately accessible to the organisation conducting market surveillance.<sup>346</sup>

In Australia, surveillance is undertaken by ASIC, not an exchange or self-regulatory body. Until relatively recently, there was only one dominant exchange, the ASX. As such, Australia had not experienced the fragmentation of the markets that has occurred in other countries and therefore it was not necessary to conduct cross market surveillance. Since 2011 a number of new exchanges and ATs have been licenced to trade ASX listed securities. Drawing from the experience of other jurisdictions, ASIC is aware that as markets become

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<sup>342</sup> Interview with FINRA.

<sup>343</sup> Interview with IRROC.

<sup>344</sup> See CSA Staff Notice, online: CSA <[http://www.nbsc-cvmb.ca/nbsc/uploaded\\_topic\\_files/23-302-CSAN-25-Apr-05-e.pdf](http://www.nbsc-cvmb.ca/nbsc/uploaded_topic_files/23-302-CSAN-25-Apr-05-e.pdf)>.

<sup>345</sup> See Strikeman Elliott, Canadian Securities Law post, January 12, 2009, online: Strikeman Elliott <<http://www.canadiansecuritieslaw.com/2009/01/articles/securities-law-compliance/regulators-shelve-transaction-reporting-and-electronic-audit-trail-system-treats-project/>>.

<sup>346</sup> Interview with IIROC.

fragmented this may give rise to opportunities for persons to conduct manipulation across markets. ASIC has therefore taken steps to design and implement its surveillance systems with a view to enhancing its capacity to conduct cross market surveillance.<sup>347</sup>

In Europe, no single entity conducts surveillance over all European markets and generally each individual market still conducts surveillance over its own market. For example in Germany each of the six regional exchanges still have separate surveillance units which conduct surveillance for their own market only. Each of these exchanges is required to report suspicious trading to BaFin. BaFin also receives consolidated trade data from all of these six exchanges for analysis. In addition, through ESMA, BaFin has access to data from all executed trades from all markets in Europe.<sup>348</sup>

#### ***b) Suspicious Transactions Reports***

Another important method of detection for regulators in the EU is the system which requires banks and brokers to report transactions suspected to be market abuse directly to the securities regulator.

In the EU, banks and brokers are required to file suspicious transaction reports in relation to suspected market abuse directly to securities regulators. The system of requiring brokers in Europe to report suspected instances of market abuse can be traced to the first *Market Abuse Directive* (MAD), which was formulated in 2001 and implemented in 2005 through the *Market Abuse Regulations*.<sup>349</sup> This states that:

Member States shall require that any person professionally arranging a transaction in financial instruments who reasonably suspects that a transaction might constitute insider dealing or market manipulation shall notify the competent authority without delay.<sup>350</sup>

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<sup>347</sup> Interview with ASIC. See also ASIC Media Release “13-316MR ASIC's next generation market surveillance system commences”, 25 November 2013, online: ASIC <<http://asic.gov.au/about-asic/media-centre/find-a-media-release/2013-releases/13-316mr-asics-next-generation-market-surveillance-system-commences/>>.

<sup>348</sup> Interview with BaFin. BaFin reports that it has the responsibility for taking action against market abuse, the regional exchanges can take action for violations of their rules and can impose a maximum fine of \$250,000.

<sup>349</sup> MAD, *supra* note 12.

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

Each report must set out the facts that justify the suspicion. This includes information such as the account used, the date and time of the transaction, the price, the volume and whether it is a proprietary trade or a customer trade. MAD also required European regulators to forward a copy of any suspicious report to all other supervisory authorities of organised securities markets within the EU who may be affected by the report.<sup>351</sup>

MAD was implemented in Germany by section 10 of the *Securities Trading Act*.<sup>352</sup> As a result, all banks, investment services providers and multilateral trading facilities are obliged to report to BaFin transactions that they suspect may constitute insider trading or market manipulation. Although the organization may execute the trade that is the subject of the report, it is prohibited from informing the person that it has made such a suspicious transaction report.<sup>353</sup>

A second *Market Abuse Directive* (MAD II)<sup>354</sup> and regulations (MAR)<sup>355</sup> recently adopted by the European Commission is designed to, inter alia, increase the number and perhaps quality of these reports. These changes will strengthen the system of reporting suspicious trades in a number of ways. First, market intermediaries will be required to not only report suspicious trades but also have compliance systems in place to detect market abuse. Second, the obligation to report will also include an obligation to report suspicious

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<sup>351</sup> See *Securities Trading Act* s10 (2) and Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions [2004] OJ L162/70.

<sup>352</sup> See *Securities Trading Act* s 10, online:

<[http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg\\_101119\\_en.html?nn=2821360#doc2684270bodyText15](http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg_101119_en.html?nn=2821360#doc2684270bodyText15)> which provides:

Reporting of suspicious transactions

- (1) Investment services enterprises, other credit institutions, asset management companies (Kapitalanlagegesellschaften) and operators of off-exchange markets on which financial instruments are traded are obliged to notify the Supervisory Authority without undue delay of any facts giving rise to suspicion that a transaction with financial instruments is in contravention of a prohibition or requirement pursuant to section 14, section 20a, section 30h or section 30j....

<sup>353</sup> See *Securities Trading Act* s 10.

<sup>354</sup> Directive 2014/57/EU of the European Parliament and of the Council of 16 April 2014 on criminal sanctions for market abuse (market abuse directive) [2014] OJ L173/179.

<sup>355</sup> Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, [2014] OJ L173/1.

unexecuted orders and over the counter transactions.<sup>356</sup> Finally, and perhaps most significantly, member states are required to set sanctions so that a failure by a market intermediary to report a suspicious transaction, or a failure to have in place proper compliance systems to detect market abuse, will attract a penalty. As a minimum member states are to prescribe a maximum administrative penalty of not less than €1 million for a natural person and €2.5 million or 2% of turnover for other legal persons.<sup>357</sup> In exercising their powers to impose administrative sanctions member states are required to cooperate with each other and coordinate their enforcement activities.<sup>358</sup>

BaFin receives between 10 and 20 of these suspicious transaction reports each month, and half of all of the cases that BaFin investigates are sourced from these reports. The reports include trading on the exchanges and the OTC markets.<sup>359</sup>

In the US, although it is not an important method of detecting market abuse, the failure to report a suspicious transaction has become an important enforcement tool for FINRA. This is particularly the case when a client, rather than a broker itself, has engaged in market abuse. In such a situation FINRA has no power to take action against the client. However it may be able to take enforcement action against the broker for failure to make a report of the suspicious transaction or for failing to have proper compliance systems in place.<sup>360</sup> In Canada IIROC also receives reports from market intermediaries of suspicious transactions and can take action against these intermediaries if their actions or negligence enabled a client outside of the jurisdiction to engage in market abuse.<sup>361</sup>

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<sup>356</sup> *Ibid* at Article 16. Article 16(2) which obliges Member States to have in place laws that require:

“Any person professionally arranging or executing transactions shall establish and maintain effective arrangements, systems and procedures to detect and report suspicious orders and transactions. Where such a person has a reasonable suspicion that an order or transaction in any financial instrument, whether placed or executed on or outside a trading venue, could constitute insider dealing, market manipulation or attempted insider dealing or market manipulation, the person shall notify the competent authority as referred to in paragraph 3 without delay.”

<sup>357</sup> *Ibid* at Article 30(1)(i)-(j).

<sup>358</sup> *Ibid* at Article 31.

<sup>359</sup> Interview with BaFin.

<sup>360</sup> Interview with FINRA.

<sup>361</sup> Information provided by IIROC.

**c) Complaints, whistleblowers and tip offs**

All securities regulators have systems whereby individuals and organizations can voluntarily report instances of suspected market abuse directly to the regulator. These systems of voluntary reporting are variously referred to as complaints, tips offs or whistleblowers programs. Most regulators regularly receive a large number of such reports. Whilst these reports are important, making use of them can be resource intensive. This is because given the high volume of reports, regulators are required to sift through a large amount of material, or invest in software systems that can do this, to ascertain real and verifiable instances of what may be market abuse.

However, despite the resources required to be committed to this method of detection, an advantage of voluntary reporting as a method of detection is that it may result in the discovery of market abuse schemes which would not have been discovered using any other detection method. Another advantage is that it may give regulators the opportunity to gather direct evidence of market abuse, even real time evidence while the abuse is occurring. By way of contrast, gathering evidence after the event usually results in a less compelling form of evidence, such as circumstantial evidence, which requires the adjudicator deciding the case to make inferences to conclude that the offence occurred.<sup>362</sup>

Except for the SEC, regulators do not offer a reward in exchange for voluntary information leading to a successful enforcement action against market abuse. This SEC offer rewards due to the enacting in 2010 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.<sup>363</sup> This Act inserted a provision into the *Securities Exchange Act* enabling the SEC to make monetary awards to individuals who voluntarily provide original information that leads

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<sup>362</sup> Interview with the SEC.

<sup>363</sup> See *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub L No 11-203 § 922(a), 121 Stat 1894 (2010), which inserted a new § 21F into the *Securities Exchange Act*.

to a successful enforcement action which results in the imposition of a sanction of over US\$1million. The amount of the award is to be between 10-30% of the penalty imposed.<sup>364</sup>

However, on one view offering rewards for voluntary information may be disadvantageous and may actually cause problems. This is because by not offering payment may result in the regulator receiving more reliable information. This is arguably because a person has to feel genuinely aggrieved to make a report without the promise of a reward.<sup>365</sup>

## **Investigation Issues**

### **a) Case selection**

After possible instances of market abuse have been detected, the number and type of matters that are selected for investigation depends upon the case selection procedures of the particular regulator. Some regulators seem to investigate the majority of instances of market abuse that have been detected whereas others select only certain cases which fit within a specific area which has been targeted for enforcement action.

In Australia, for example, before resourcing an investigation ASIC may consider the impact of enforcement action, including whether particular conduct should be the targeted, as well as how difficult it will be to prove the breach. ASIC primarily pursues market abuse matters criminally. The reasons for this approach are that first the penalties available for criminal contraventions are significantly greater than for civil penalty contraventions and hence the deterrent effect is likely to be greater. Second ASIC finds that the evidence either exists or it does not - there being no significant difference, as a practical matter, between the standard of proof for civil penalty and criminal matters.<sup>366</sup>

In each case of market abuse ASIC will make an assessment as to how likely evidence to support the charge is or will become available. ASIC, like all regulators, has limited resources to commit to its enforcement activities. In addition the mandate of ASIC, like most

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<sup>364</sup> See generally SEC, “Annual Report on the Dodd-Frank Whistleblower Program Fiscal Year 2011” (November 2011), online: SEC <<http://www.sec.gov/whistleblower/reportspubs/annual-reports/whistleblower-annual-report-2011.pdf>>.

<sup>365</sup> Interview with FINRA.

<sup>366</sup> Interview with ASIC.



regulators, is focused on preserving the integrity of markets situated within its jurisdiction and maintaining confidence in those markets. Accordingly, the integrity of international markets tends to be important only to the extent that those markets impact on the local markets.<sup>367</sup> As such ASIC is less likely to pursue cross border market misconduct where the persons of interest are outside of Australia and/or where the conduct does not impact on the integrity of the Australian markets, although it does, however, take some cases where the impact is on the integrity of the foreign market.<sup>368</sup> Where ASIC does not take action because it relates to a foreign market ASIC will generally refer the conduct to foreign regulators or will take action to disrupt the conduct, for example freeze money which is in Australia, as an alternative to enforcement action. However ASIC will resource all matters (whether cross border or not and no matter where the evidence may be located) where the conduct has a significant (or is likely to have a significant) impact on the integrity of Australia's financial markets.<sup>369</sup>

Similarly the types of cases selected for investigation by the FCA in the UK largely depends upon its resources and enforcement priorities. However, if a particular form of market abuse is within the parameters of these enforcement priorities it will resource the matter even if there is an international aspect to the investigation.<sup>370</sup>

In Germany, s.4 of the *Securities Trading Act* requires that BaFin must refer to prosecutors all cases where there is a suspicion of a criminal offence.<sup>371</sup> Market manipulation is a criminal offence if the manipulation influenced the price. However, this does not mean that BaFin refers every possible instance of market abuse that is detected - it is only required to refer cases where it has evidence which meets the threshold that there is a 'suspicion' of market abuse. Forming such a suspicion usually depends upon the initial assessment of the

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<sup>367</sup> Interview with ASIC.

<sup>368</sup> See for example ASIC Media Release "10-199AD Oswyn de Silva pleads guilty to insider trading charge involving 'front running'", 22 September 2010, online: <<http://www.asic.gov.au/asic/asic.nsf/byheadline/10-199AD+Oswyn+de+Silva+pleads+guilty+to+insider+trading+charge+involving+%E2%80%98front+running%E2%80%99?openDocument>>.

<sup>369</sup> Interview with ASIC. See also ASIC Information Sheet, *supra* note 321.

<sup>370</sup> Interview with FCA.

<sup>371</sup> *Securities Trading Act*, *supra* note 36.

investigation. BaFin, like other regulators, also considers the prospects of success of a prosecution before considering whether to commit resources to the investigation. If BaFin detects possible cross border market abuse and most of the activity, for example both the trading and suspects are outside of its jurisdiction, instead of investigating the matter itself, it may decide to refer the matter to the appropriate foreign regulator.<sup>372</sup>

Regulators in the US appear to take a relatively aggressive enforcement approach to market abuse, even when some of the activity or the participants are outside of the jurisdiction.<sup>373</sup>

Although jurisdictional hurdles may limit the range of enforcement action that can practically be taken, in most cases some action can be taken. For example, FINRA may be able to take action against the 'gatekeeper', that is, the broker, if their actions or negligence enabled a client outside of the jurisdiction to engage in market abuse. The SEC may be able to seek a court order to freeze the funds suspected to be profits of market abuse or may try to liquidate the assets of perpetrators in the US to satisfy outstanding judgments. Furthermore, even if the perpetrators are not in the US the SEC may seek and obtain arrest warrants for those engaged in market abuse and then place these individuals on a watch list at US borders. This would result in the arrest of the perpetrators if they seek entry into the US. For example in 2008 Nicos Stephanou was arrested at Newark Liberty International Airport by the FBI on insider trading charges. Mr. Stephanou resided in London and was a citizen of Cyprus. He flew from Mexico to London but when the plane made a stopover at Newark he was arrested. According to newspaper reports he later became a co-operator with the FBI and assisted in obtaining convictions of others for market abuse.<sup>374</sup>

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<sup>372</sup> Interview with BaFin.

<sup>373</sup> See for example the priority of the SEC on prosecuting insider trading which SEC Chairman Christopher Cox has stated in 2007 in testimony before the US Congress as one of the three major risks to US capital markets, as quoted in PU Ali and N Gregoriou *Insider Trading Global Development and Analysis* (2009 CRC Press, Boca Raton, FL) at xi.

<sup>374</sup> See D Glovin "Hedge Fund Insider Trading Prosecutions Rely on Suspects Turned Informant", Bloomberg News, Jan 12, 2011, online: <<http://www.bloomberg.com/news/2011-01-12/insider-trading-cooperators-at-heart-of-government-prosecutions.html>>. Also see generally Coffee *supra* note 96 at 289 where he reviews some of the recent cases taken by the SEC against foreign defendants and speculates that the SEC seems to allocate disproportionately fewer resources to cases involving foreign defendants, but also states "Thus it may be true that U.S. enforcers allocate disproportionately fewer resources to cases involving foreign defendants,

**b) Gathering Information from outside of the jurisdiction**

Once an instance of suspected cross border market abuse is detected, generally information or evidence must be obtained from outside of the jurisdiction to successfully complete the investigation. Most regulators reported that it is now generally easier to obtain this material than it was in the past. This is because of two factors. First, the IOSCO MMoU and, in Europe, the Memorandum of Understanding between members of the European Securities and Markets Authority (ESMA MoU) have made obtaining information from foreign regulators quicker and more straightforward.<sup>375</sup> Second it appears that there has been a significant relaxation in the approach of some offshore financial centres to providing foreign securities regulators with information, including information as to the beneficial owners of both securities and bank accounts.

BaFin can now obtain information it requires for its investigations from most European countries within a few weeks. Most frequently, the perpetrators use a bank account outside of Germany, usually in Switzerland, and often the bank account is in the name of an offshore company. However in Switzerland offshore companies are required to name a natural person beneficiary. As such BaFin can now obtain information about Swiss bank accounts and the name of the natural person beneficiary of an account in the name of an offshore company relatively quickly. It also appears that, because it is becoming more widely known that regulators can now more easily obtain access to information in Swiss bank accounts,

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but, even if this effort is modest by U.S. standards, it may still far exceed the limited attention that securities fraud receives abroad.”

<sup>375</sup> IOSCO MMoU, *supra* note 268 and The Committee of European Securities Regulators *Multilateral Memorandum of Understanding on the Exchange of Information and Surveillance of Securities Activities* 26 January 1999, online: <[http://www.esma.europa.eu/system/files/05\\_335.pdf](http://www.esma.europa.eu/system/files/05_335.pdf)>. This organization is now called the European Securities and Markets Authority (ESMA), see <<http://www.esma.europa.eu/page/esma-short>>. See also Article 25 of Regulation (EU) No 596/2014 of the European Parliament of 16 April 2014 on market abuse (Market Abuse Regulation (MAR) is designed to facilitate cooperation between securities regulators in the EU in their investigations of market abuse. It imposes obligations on securities regulators in the EU to cooperate including that “Competent authorities shall render assistance to competent authorities of other Member States and ESMA. In particular, they shall exchange information without undue delay and cooperate in investigation, supervision and enforcement activities.”

those committing market manipulation may be starting to use accounts in other countries, for example Singapore or Dubai.<sup>376</sup>

BaFin regularly uses the IOSCO MMoU, the ESMA MoU and a few other bilateral arrangements to obtain information from other countries. This has improved BaFin's access to information over time, although there still seems to be issues in obtaining information from some jurisdictions and delays in the process of obtaining information from others. For example in one case BaFin reported that it had not been able to obtain information it required from the Dubai Free Trade Zone. It seems that part of the problem in relation to obtaining this information related to determining who was the responsible securities regulatory authority.<sup>377</sup>

The FCA most frequently uses the IOSCO MMoU to obtain information. It also uses the ESMA MoU and several bilateral treaties. Most requests it makes and receives are from the USA, France and Switzerland. In relation to criminal investigations of market abuse the FCA has also made use of Mutual Legal Assistance Treaties to obtain evidence, although this process can be slow. This is because to obtain information via a Mutual Legal Assistance Treaty, the FCA request has to go via the Home Office and then the equivalent government department in the foreign jurisdiction before it is received by the foreign securities regulator to be processed. The FCA has also received requests for information from countries that are not members of IOSCO and may answer these requests if the authority making the request performs a similar function to the FCA.<sup>378</sup>

The FCA has experienced some difficulties and delays obtaining information from some foreign regulators, including from offshore financial centres, although access to such information is improving. The difficulties can be attributed in part to different objectives and priorities of other regulators, as well as perhaps a lack of understanding of different legal systems and requirements. However, frequent communication between regulators ensures

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<sup>376</sup> Interview with BaFin.

<sup>377</sup> Interview with BaFin.

<sup>378</sup> Interview with the FCA.

that contact is made with the most appropriate person within the foreign regulator, and this can reduce these difficulties. Sometimes the delay can be because the foreign regulator has to engage the assistance of other agencies. For example, FCA may make a request to BaFin, which requires BaFin to engage the assistance of State prosecutors, who, in turn, may have to engage the assistance of local police.<sup>379</sup>

ASIC can obtain information informally from New Zealand's securities regulator, the Financial Markets Authority, and makes use of the IOSCO MMoU in obtaining information from other regulators. Sometimes it has received information requested via the MMoU very quickly. For example, in one case it used the IOSCO MMoU to obtain information from Singapore and Malaysia. In this case, the suspect was detained very early in the investigation after attempting to leave Australia. As the suspect was in custody, ASIC was required to compile the evidence within months and this included obtaining evidence from Singapore and Malaysia. The end result was a successful prosecution in which the accused pleading guilty because Singapore and Malaysia made it a priority to assist in the investigation.<sup>380</sup> However ASIC still experiences delays in obtaining information from some other regulators, particularly smaller regulators, and sometimes requests can take up to 12 months for a reply. Often the tardiness of the reply is a reflection of the resources of the other regulator and/or the priority it assigns to complying with the request verses its own internal demands. ASIC has also experienced delays in obtaining information from offshore financial centres. However, it seems these delays may be partly due to the fact these countries are often small and because small regulators tend to have very limited resources.<sup>381</sup>

The OSC also frequently uses the IOSCO MMoU, and this has allowed it to obtain information it requires, such as trading and client information. In its experience, foreign

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<sup>379</sup> Interview with the FCA.

<sup>380</sup> Interview with ASIC. See also ASIC Media Release, *supra* note 368 and ASIC Media Release "11-69AD Former fund manager imprisoned for insider trading involving front running", 31 March 2011, online: <<http://asic.gov.au/about-asic/media-centre/find-a-media-release/2011-releases/11-69ad-former-fund-manager-imprisoned-for-insider-trading-involving-front-running/>>

<sup>381</sup> Interview with ASIC.

regulators respond relatively quickly and there are now very few countries where perpetrators can hide. The OSC now also can obtain information from most offshore financial centres relatively quickly. For example, in one case the OSC obtained information from the British Virgin Islands in four days.<sup>382</sup>

In the US, although those committing market abuse do sometimes use companies located in offshore financial centres, FINRA is now better able to get that information to continue its investigation. For example, FINRA can now more easily obtain information from the Cayman Islands. FINRA is not a party to the IOSCO MMoU so it currently cannot directly use this MMoU to obtain information. To obtain information using the IOSCO MMoU, FINRA has to make a request to the SEC which will in turn then make a request to the foreign regulator. The information has to then be transferred from the foreign regulator back to FINRA via the SEC. This multi-stage process can add to the delay in conducting an investigation. FINRA does recognise the value of the IOSCO MMoU, and has requested that IOSCO consider creating a new category of membership for self-regulatory bodies who do not have a trade affiliation such as FINRA. It is hoped that this new category will enable FINRA to also become a party to the IOSCO MMoU and therefore be able to obtain information via the IOSCO MMoU directly.<sup>383</sup>

IIROC and FINRA are members of the Intermarket Surveillance Group (ISG). As discussed in Chapter 2, only self-regulatory organizations and non-governmental associations that provide regulation services to markets are eligible to become members of this organization.<sup>384</sup> IIROC and FINRA frequently use the ISG to share information such as price, trading and client data. Another important function of the ISG is the sharing of intelligence between members. This could cover issues such as what is happening in each of their markets, new types of market abuse, the activities of market participants and particularly the activities of market participants who have a presence in more than one market. As such a

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<sup>382</sup> Interview with the OSC.

<sup>383</sup> Interview with FINRA.

<sup>384</sup> ISG, *supra* note 273.

few times a year ISG members meet and, inter alia, discuss what is happening in their markets and consider case studies of possible market abuse that have been detected.<sup>385</sup>

One issue for some regulators appears to be that requesting information from a foreign regulator may result in the person under investigation becoming aware that they are under investigation.<sup>386</sup> For example in one case BaFin reported that the Liechtenstein securities regulator informed the person under investigation that it had received a request for information. Such disclosure can cause significant problems for an investigation because if a search warrant is later executed on the suspect it may not uncover anything as the suspect has had the time to destroy incriminating evidence.<sup>387</sup>

### **c) Obtaining Data**

Communications data can provide key evidence of the transfer of inside information between an insider and a trader. Obtaining evidence of this transfer of information is often the most difficult part of an insider trading investigation. In relation to market manipulation, communications data can provide evidence of, for example, trading and trading instructions and dissemination of information designed to pump the market in a pump and dump scheme.<sup>388</sup>

Accordingly in cases of cross border market abuse frequently information that has to be obtained via a request to a foreign regulator consists of data from information service providers and cell phone providers in other countries. Obtaining such information can be

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<sup>385</sup> Interviews with FINRA and IIROC. See also U.S. Commodity Futures Trading Commission “Intermarket Surveillance Group”, online: <<http://www.cftc.gov/IndustryOversight/ContractsProducts/SecurityFuturesProduct/sfpisgsummary>>, which states that the ISG “provides a forum for discussing common regulatory concerns.”

<sup>386</sup> Interview with BaFin .

<sup>387</sup> Interview with BaFin.

<sup>388</sup> In contrast in some jurisdictions it may be relatively easy to obtain evidence of who was the insider. For example, BaFin can relatively easily obtain access to a list of persons who had access to inside information because Section 15(b) of the *Securities Trading Act* requires that issuers maintain lists of persons working for them who have access to inside information. This provision also requires that these lists must be provided to BaFin upon request and without delay. This provision is in accordance with Article 6(3) of MAD I, which requires Member States to require issuers to draw up lists of insiders and transmit it to the competent authority upon request. The requirement to maintain lists of insiders will be strengthened as a result of Article 13 of MAD II, which contains requirements that are even more specific as to the content of these lists and the information about the persons on these lists.

complicated by the fact that data storage is increasingly moving from being stored on individuals and businesses' hard drives to data being maintained on virtual servers commonly known as 'clouds'. The actual location of the server that maintains these clouds may be situated anywhere in the world. This complicates data collection in that the regulator may have to deal with two parties, the business who created and understands the data and the cloud service provider which is the repository of the data.

Accordingly in cases where data is critical evidence in an investigation regulators first have to determine where the data is situated, which may itself add delay to the investigation, and then, if it is located abroad, request that data via a foreign securities regulator. ASIC reported that there can be challenges locating where the data is stored and inconsistencies in regulations between countries as to how long this data has to be stored. Sometimes data is only stored for six months, which may not be enough time for the regulator to detect the offence, locate the information service provider and request the information via a foreign regulator.<sup>389</sup> In one investigation, ASIC tried to obtain PIN messaging between two BlackBerrys and discovered that at the time of the communications the data was not stored at all by the cell phone provider.<sup>390</sup>

BaFin also reported difficulties retrieving data from information service providers, even within Germany. In some matters it must obtain a data provider order via the prosecutors and this process can take up to six months.<sup>391</sup>

#### **Part 4 Success and Failure**

Each of the regulators was asked about what, in their view, led to enforcement success or failure in relation to cross border market abuse cases. The responses varied but there were some common themes.

A frequent response was that enforcement success is often related to taking action against

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<sup>389</sup> Interview with ASIC.

<sup>390</sup> Interview with ASIC.

<sup>391</sup> Interview with BaFin.



the detected abuse quickly and that enforcement failure is often linked to delay. In relation to cross border market abuse a number of regulators commented that enforcement success was related to how quickly information was received from a foreign regulator after it was requested. Instances where a request is given high priority by a foreign regulator and information is thereby obtained quickly can significantly contribute to the success of the enforcement action. By way of contrast, delays in obtaining information from abroad can cause problems for investigations. For example, a delay in an investigation can allow perpetrators to move assets beyond the jurisdiction, thereby frustrating a regulator's capacity to collect any fines that are eventually imposed. In this respect it seems that any changes that can be made to accelerate the system of requesting and receiving information could lead to more successful outcomes for investigations. This could include making the system in relation to the exchange of information less formal and bureaucratic.

Connected with this theme of the imperative to an investigation to obtain information quickly, some regulators stressed that fostering cooperation and maintaining good and open lines of communication with foreign regulators was important to ensure that the information was not just timely but also accurately responded to what was requested. Such cooperation can also foster an understanding of different legal systems, regulatory and market frameworks, and enforcement priorities, as well as the constraints under which foreign regulators operate.

### **Part 5 The securities regulators' response**

The responses from securities regulators indicate that they are acutely aware that the rapid increase in the complexity of the markets has made their jobs more challenging. In particular they do seem to be detecting more instances of cross border market abuse, particularly cross border market manipulation, which seems to increase the difficulties in their ability to investigate and take effective enforcement action. It seems that this may sometimes mean that the ultimate perpetrator of the manipulation ultimately escapes liability with the regulator only taking action against the gatekeeper, that is the broker, in an effort to deter brokers from allowing their systems to be used for such activities.

## Detection

In terms of detection, although more cross border market abuse is being detected, it is unclear whether current detection mechanisms are sufficient in their ability to detect, and thereby deter, cross market and cross border market abuse. Certainly it is perhaps of some concern that market surveillance in Europe remains with the surveillance units of individual trading venues, limiting the ability to conduct cross market surveillance. For example, although regulators such as BaFin have access to consolidated trading data, and could use this to conduct cross market surveillance it is not clear that they do in fact conduct this surveillance. Furthermore order data remains with the individual trading venues which must limit the ability to detect manipulation of orders across markets. Perhaps the absence of cross market surveillance is why the European regulators, the FCA and BaFin, are more frequently detecting market abuse via suspicious transaction reports.

By way of contrast the SEC, Canada and Australia conduct cross market surveillance which seems to enhance their ability to detect market abuse. Furthermore after the consolidated audit trail is implemented the SEC will have the most sophisticated detection capabilities across its markets. In particular the ability to see individual client trading across markets should result in quicker detection, investigations and prosecutions. Although this consolidated audit trail will be very expensive and complex to implement, it seems that the SEC has taken the view that it is necessary to maintain the integrity of its markets. This raises the issue of whether other countries should follow suit, notwithstanding the costs and complexity in developing such a system.

In terms of cross border surveillance there seems to be little in the way of cross border surveillance systems. It seems that if a surveillance matter has a cross border aspect regulators must rely on the ISG as a mechanism to obtain the information that is needed. As highlighted in Chapter 2 the ISG may not be the ideal organization to be charged with the responsibility to exchange such information.

It seems also that all regulators use systems of voluntary reporting of market abuse which enhance their ability to detect market abuse. It also appears that some regulators are augmenting the way in which they to detect market abuse via voluntary reporting by investing in systems to mine such data. In relation to such voluntary reporting the SEC stands alone in offering payment for such voluntary reports.

### **Investigations**

It is clear that the increasing complexity of the markets presents new challenges to enforcement staff. Investigations of market manipulation cases which involve high frequency trading seem to be particularly complex and resource intensive. Given that the investigative resources of securities regulators are finite, one issue for regulators may be whether, on a cost benefit analysis, should it dedicate a large part of its resources to investigating such matters when the victims of such manipulation seem primarily to be other high frequency traders, not institutional and individual investors? Alternatively should regulators develop fee scales based upon the number of orders or trades to take into account the cost of such investigations as IRROC has done?

Issues in obtaining data, particularly in relation to the fact that a lot of data is being moved to 'cloud' databases also increase the complexity of investigations and seems can add to delays in completing investigations. Given the enforcement success seems to correspond to reducing the time that an investigation takes, perhaps more needs to be done to ensure that such information is stored for a sufficient period and to facilitate the ability of investigators to obtain information from such cloud databases. It also seems that such action will not be effective if it is limited to enacting laws facilitating such storage and access within a country. Given the international nature of data storage it seems that an international approach needs to be taken to this problem.

An international response may also be necessary to encourage regulators to take action even when the integrity of their own markets is not threatened or to at least make sure that all matters that are referred to foreign regulators are pursued. Again, due to finite resources

or perhaps a lack of political will, regulators seem to focus upon matters which impact upon the integrity of their own markets. However in the longer term this may cause difficulties for securities regulators. This is because of such policies may emboldened perpetrators allowing them to continue to attack markets wherever they are situated.

In terms of the success of investigations, it seems that there is general agreement that success is often linked to the speed of the investigation and that in relation to cross border market abuse this is impacted by how quickly information needed for an investigation is exchanged between regulators. It appears some progress has been made to facilitate this exchange of information in that the IOSCO MMoU seems to be regularly used. However given the importance of the exchange of information to the success of investigations, perhaps more could be done in developing this MMoU, or perhaps similar mechanisms, to assist investigators to progress investigations quickly.

## **Conclusion**

This Chapter has demonstrated that as markets have become more global and trading increasingly takes place across borders, securities regulators appear to be increasingly detecting and taking action against cross border market abuse. However the increasing complexity of markets and new market participants poses new challenges in relation to methods of detection and investigation. Securities regulators have had to adapt to these new challenges by, for example, upgrading their systems of market surveillance.

The following chapter continues to explore these issues including considering the trends and types of cases that are being detected. In addition it continues to analyse what enforcement policy frameworks may assist securities regulators in their cooperative endeavours to prosecute cross border market abuse.

## CHAPTER 4

### ISSUES OF DETECTION, INVESTIGATION AND ENFORCEMENT OF CROSS BORDER MARKET ABUSE – REPORTS FROM SECURITIES REGULATORS

The cases of market manipulation pursued by the German supervisory authority are becoming more and more international. For example, in the case of a stock promoter from Canada who was sentenced to six years in jail by a US court for market manipulation, BaFin worked with the Federal Bureau of Investigation (FBI) and the New York District Attorney via a state bureau of investigation in Germany. In another investigation, BaFin had submitted an enquiry abroad and obtained information on additional incidents of manipulation by the suspect. It transpired that the perpetrator had already commissioned other stock recommendations and benefited significantly from them via foreign securities accounts. Armed with this information, the US authorities were able to establish the perpetrator's true financial position, which he had previously misled them about.

BaFin Annual Report 2010<sup>392</sup>

In accordance with their mandate to work towards preserving market integrity, securities regulators are required to take action against market abuse. As detailed in the preceding chapter, securities regulators have increasingly prosecuted cross border market abuse when it has impacted the markets that they supervise, and also occasionally when it did not. It also seems that the cases of cross border market abuse that have been detected have become more complex and that securities regulators have been increasingly compelled to work cooperatively with their foreign counterparts in order to investigate these matters.

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<sup>392</sup> BaFin Annual Report 2010, online: BaFin  
<[http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl\\_annualreport\\_2010.html?nn=2821414](http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2010.html?nn=2821414)> at  
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This chapter seeks to expand upon the preliminary conclusions outlined in the preceding chapter. It examines how the increase in the sophistication of the markets has impacted upon methods of detection, investigation and prosecution of cross border market abuse as well as classifying the types of cases which have been detected and prosecuted. From this and the results of the analysis contained in chapters 2 and 3 some recommendations are made in relation to possible ways to improve the ability of securities regulators to address cross border market abuse.

### **Surveying material publically released by Securities Regulators**

The research for this chapter consisted of reviewing publically available information published by the principal securities regulators from Canada, the USA, Australia, the UK and Germany for the ten years from 1 January 2004 until 31 December 2013.<sup>393</sup> Documents reviewed were all of the Annual Reports published by securities regulators as well as enforcement reports where available.<sup>394</sup> In particular, information was collected pertaining to changes in their respective enforcement activities and methods over these ten years, as well information in relation to specific cross border investigations and enforcement actions. Furthermore, these reports were analysed in regard to what securities regulators observed in relation to changes in patterns of detected market abuse and, in particular, cross border market abuse.

In addition, descriptions of cases of cross border market abuse investigated by these securities regulators were extracted from these reports and, where available, from other published data bases such as media releases. These individual instances of cross border market abuse were collated to ascertain whether they revealed a particular pattern or problem area. These specific instances of cross border market abuse were further examined in relation to whether they disclosed the use of particular detection, investigation and

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<sup>393</sup> Two regulators did not report on an annual basis, namely ASIC in Australia and the FCA (formally the FSA) in the UK. ASIC's annual reports are for the year 1 July to 30 June and the FCA's are from 1 April to 31 March. As such in these cases the 2013/14 Annual Reports were also reviewed.

<sup>394</sup> In relation to Canada only reports of the Ontario Securities Commission, the British Columbia Securities Commission, the Alberta Securities Commission, the Securities Commission of Quebec (Autorité des marchés financiers (AMF)) and the Canadian Securities Administrators Enforcement Reports were reviewed.

enforcement methods.

### **Limitations to Methodology**

Although this process did reveal some trends and patterns, this analysis and the resulting conclusions must be considered within the context and intrinsic limitations of the information collected. For example, cases were only extracted in which cross border insider trading or cross border market manipulation were specifically alleged. There may be cases in which market abuse was suspected but could not be proven. In such cases action may have been taken but, if it was based upon the breach of another rule or law such as failure of a broker's compliance system, this data may not have been captured. In addition, cases of market abuse which are pursued are generally within the discretion of the regulator and so may not reflect all cases that are detected. This is because cases which are pursued could depend upon factors such as identified priorities, the resources allocated to enforcement, the ease of pursuing particular cases and the skills of those involved in enforcement.

Furthermore, there is usually no legal requirement for regulators to publically report specific information about their enforcement activities. As such information which is reported is generally made available at the discretion of the management of the particular securities regulator. As a result statements made and information released could be influenced by the then prevailing concerns of each regulator and these concerns could shift over time. Indeed for the years 2004 to 2013, some regulators did not always disclose the same data each year and the form and information released sometimes changed based upon what appeared to be shifting priorities set by the regulator. It could also be reasonably surmised that information provided in relation to reports of individual cases that were not successfully investigated or prosecuted may be limited to protect the privacy of the individuals involved. Perhaps also matters which are not successful are not reported as this may attract public criticism of the work of the regulator. In addition, even though in some cases information disclosed was not determined by the regulator but was dictated by various performance indicators imposed upon the regulator by government, these can also shift over the years.

Additionally, regulators do not publish information in relation to their enforcement activities in a consistent form with the consequence that direct comparisons could not be made between regulators from different countries. As such, the analysis set out below is divided by country and where observations are made in relation to correlations between different countries these correlations are, by necessity, limited because of the variations in the data and information released.

## **Chapter Structure**

Give the limitations of the data, the information for each country is analysed separately in Parts 1 through to Part 5. Part 6 then seeks to build on the material from the previous chapter, identify common themes as well as possible patterns arising out of the analysis of each country. It also considers the evolving challenges faced by securities regulators in their efforts to address cross border market abuse. Part 7 then proposes a number of potential strategies that may enhance the effectiveness of securities regulators in their efforts to take action against cross border market abuse.

### **Part 1 Germany**

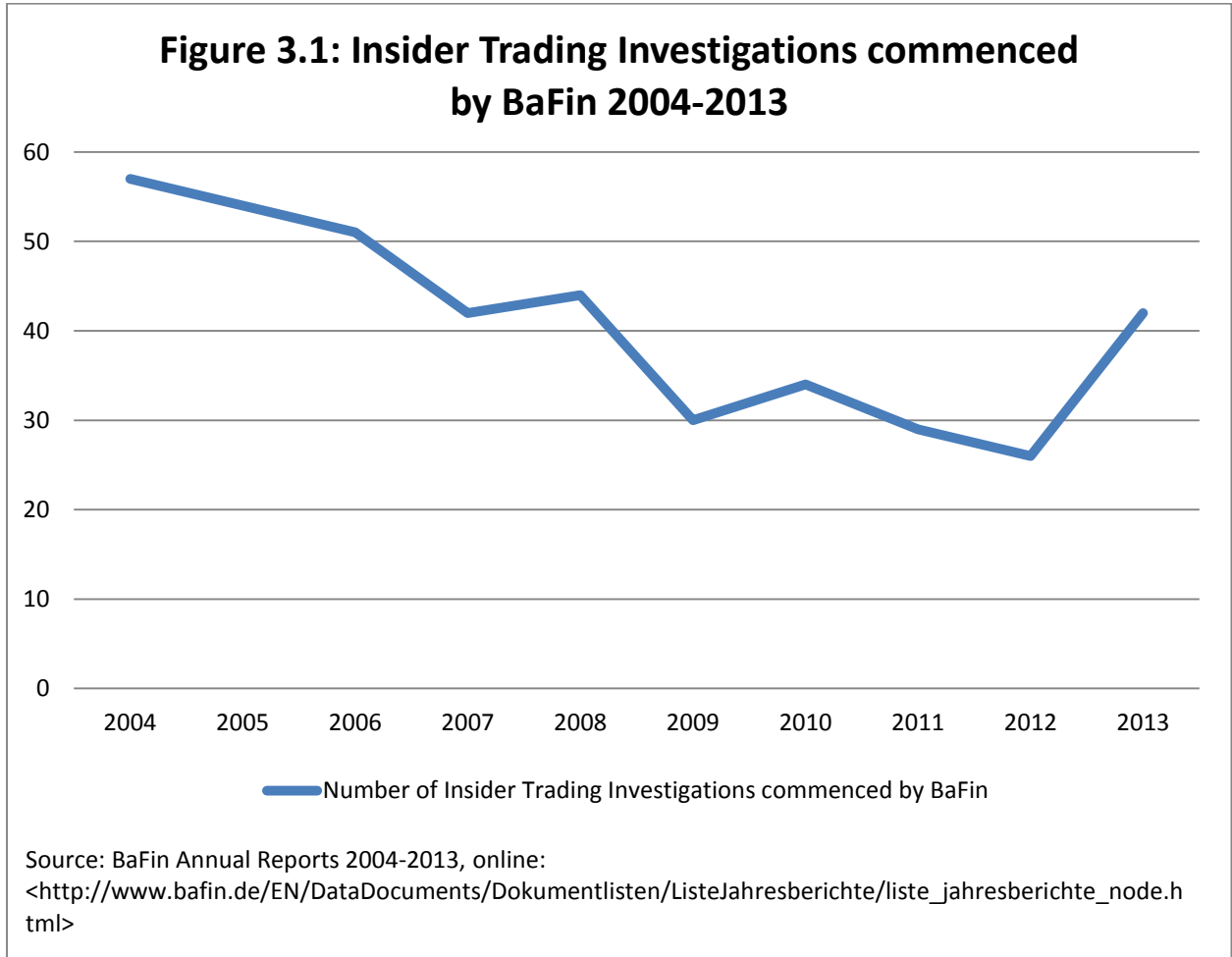
BaFin does not report specifically identify the number of market abuse matters that it investigates that have a cross border aspect. It does, however, report the overall numbers of investigations it commences in relation to insider trading and market manipulation. Figure 3.1 shows that investigations of suspected insider trading fell over the ten year period such that by 2012 BaFin investigated approximately half the number of insider trading cases it investigated in 2004. However the number rose again in 2013. BaFin states that this is due to a new approach it adopted in 2013 whereby “selected ad hoc disclosures are pre-analysed systematically and in a highly standardised manner in order to pinpoint relevant disclosures with greater accuracy than before.”<sup>395</sup>

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<sup>395</sup> BaFin Annual Report 2013, online: BaFin <[http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl\\_annualreport\\_2013.html?nn=2821414](http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2013.html?nn=2821414)> at 163.



In relation to market manipulation, Figure 3.2 shows that those investigations increased over the decade and by 2012 BaFin was investigating approximately five times as many cases as in 2004. However the number fell slightly from 2012 to 2013.



**Figure 3.2: Market Manipulation Investigations commenced by BaFin 2004-2013**



Source: BaFin Annual Reports 2004-2013, online:

<[http://www.bafin.de/EN/DataDocuments/Dokumentlisten/ListeJahresberichte/liste\\_jahresberichte\\_node.html](http://www.bafin.de/EN/DataDocuments/Dokumentlisten/ListeJahresberichte/liste_jahresberichte_node.html)>

### **Cross Border Market Manipulation**

This disparity between the number of market manipulation matters investigated and the number of insider trading matters investigated could mean that BaFin was detecting more cases of market manipulation, or was simply resourcing more market manipulation investigations.

#### **a) Manipulation in the lightly regulated 'penny stock' markets**

From statements made in its Annual Reports, it seems that the reason for the increase in market manipulation investigations over the ten year period is that a high level of manipulation was detected in the 'Open Market'. The Open Market can be characterised as a 'lightly regulated market' as the listing rules which must be complied with in order to list securities on this market are not onerous compared to the listing rules of larger exchanges.

The characteristics of the Open Market were described in BaFin's 2011 Annual Report as follows:

In addition to the regulated market, Deutsche Börse AG operates a regulated unofficial market called the Open Market. Although the trading rules are largely the same as those on the regulated market, this segment is not an exchange, but a special form of multilateral trading facility. The Open Market is organised into the Entry Standard and the First and Second Quotation Boards. Compared with the regulated market, the Open Market has significantly fewer (transparency) requirements and post admission requirements. These requirements are the least stringent for the First Quotation Board. The segment includes shares that have not yet been admitted at any other trading venue recognised by Deutsche Börse AG. Admission to the First Quotation Board is granted on application by an entity authorised for trading on the Open Market, normally a securities trading bank. The issuer is not required to be involved in this process. For admission, it is sufficient if an auditor has confirmed that the entity has equity of at least €500,000 and each share has a par value of at least €0.10.<sup>396</sup>

In response to this increase in manipulation detected in the Open Market, over the ten year period BaFin increasingly focused more resources on this manipulation in an effort to tackle this particular problem and shifted resources away from focusing on insider trading.<sup>397</sup> Over the same period BaFin also reported that manipulation in this market became increasingly international in scope with perpetrators, companies and victims often situated outside of Germany, but that Germany's lightly regulated Open Market was the market where the trading took place.

This change in approach and the recognition of the international nature of market manipulation detected is apparent by statements made in BaFin's Annual Reports. In 2005

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<sup>396</sup> BaFin Annual Report 2011, online: <[http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl\\_annualreport\\_2011.html?nn=2821414](http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2011.html?nn=2821414)> at 194.

<sup>397</sup> For example in 2009 BaFin reported that "There has been a marked shift in the focus of BaFin's report analysis activities towards market manipulation. Sham actions, such as matched trades, were the focal point of these activities in 2009 (28; 2008: 16). The shift from insider trading to more market manipulation analyses is likely to be due to the fact that the current market environment makes it more difficult for potential insiders to exploit their insider information to their advantage.", see BaFin Annual Report 2009, online: [http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl\\_annualreport\\_2009.pdf?\\_\\_blob=publicationFile](http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2009.pdf?__blob=publicationFile) at 171.

BaFin reported that 50% of manipulation investigations related to sham trading. These were transactions which are referred to as 'matched orders', being prearranged transactions between two entities, or were 'wash sales', being trades but there is no change in the beneficial ownership of the securities. Another quarter of manipulation investigations related to informational offences, that is, misleading or incorrect information or the concealing of information. It also reported that the transactions mainly impacted on "illiquid equities or 'penny stocks' traded on the OTC market".<sup>398</sup>

By 2007 BaFin reported that this trend of manipulation in the lightly regulated OTC markets had continued:

Just under two thirds of the positive manipulation analyses concerned shares that are traded exclusively over the counter... This represents the continuation of a long-running trend: manipulation takes place mainly in shares with limited liquidity traded on the OTC market.<sup>399</sup>

This report also noted that frequently the problem was "so-called pump-and-dump method using spam e-mails and market letters." It also reported on the involvement of foreign companies in such schemes, noting that this "occurs when shares, mostly of foreign companies in the commodity sector, are included in the OTC trade at German stock exchanges."<sup>400</sup> Pump and dump schemes typically involve individuals acquiring a large quantity of illiquid securities and then working to 'pump' the price by spreading false and misleading information, or conducting transactions such wash sales or matched orders. The perpetrator then sells or 'dumps' the securities when the price has increased by virtue of these artificial mechanisms.

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<sup>398</sup> BaFin Annual Report 2005, online:

<[http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl\\_annualreport\\_2005.pdf?\\_\\_blob=publicationFile](http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2005.pdf?__blob=publicationFile)> at 158. See also in 2006 in which BaFin reported that reports by investors in relation to market manipulation doubled and "related primarily to low-liquidity financial markets traded in the OTC market. BaFin Annual Report 2006, online:

<[http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl\\_annualreport\\_2006.pdf?\\_\\_blob=publicationFile](http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2006.pdf?__blob=publicationFile)> at 163

<sup>399</sup> BaFin Annual Report 2007 online:

<[http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl\\_annualreport\\_2007.pdf?\\_\\_blob=publicationFile](http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2007.pdf?__blob=publicationFile)> at 174.

<sup>400</sup> *Ibid* at 173.

By 2008 BaFin reported that “the significance of OTC trading for market manipulation remained consistently high”<sup>401</sup> and that it was identifying “increasing levels of cross border manipulation in the German market.”<sup>402</sup> In 2009 it reported:

BaFin also picked up on cases of attempted market manipulation involving regulated unofficial market instruments as a result of securities orders placed without authorisation in the year under review. These mainly related to illiquid foreign equities, primarily from the US and Switzerland, which are traded on the regulated unofficial market. Presumably with the aim of influencing prices, individuals pretended to be clients on the phone and instructed the bank to buy selected financial instruments via the corresponding client securities account.<sup>403</sup>

In 2010 BaFin again reported that its focus was ‘scalping’, also known as ‘pump and dump’ offences, in the regulated unofficial market. It found that 90% of identified market manipulation related to this market.<sup>404</sup> In the same year BaFin commented that these offences were highly complex and difficult to investigate and had the greatest potential to inflict damage.<sup>405</sup> They often also involved extensive cross border activity:

The companies whose shares are marketed in this way often come from abroad; recently, there have been a growing number from Switzerland and the United Kingdom. In all cases, they are listed on the regulated unofficial markets of German stock exchanges.<sup>406</sup>

In its 2012 Annual Report BaFin reported that this focus on market manipulation in the Open Market was continuing.<sup>407</sup> The 2012 Annual Report also contains the following description of a ‘pump and dump’ manipulation matter where two of the perpetrators were not residing in

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<sup>401</sup> BaFin Annual Report 2008, online:

<[http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl\\_annualreport\\_2008.pdf?\\_\\_blob=publicationFile](http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2008.pdf?__blob=publicationFile)> at 156.

<sup>402</sup> *Ibid* at 162.

<sup>403</sup> BaFin Annual Report 2009, *supra* note 397 at 172.

<sup>404</sup> See BaFin Annual Report 2010, *supra* note 392 at 188 and at 194 which states:

“As in the past, scalping was a key focus of BaFin’s activities in 2010. In many cases, this type of market manipulation is performed by networks in which the various entities play different roles. Ostensibly independent market letters collude to plug securities, giving investors the false impression that they are an attractive investment opportunity. In reality, though, the manipulators exploit the investors’ interest to unload their own holdings at inflated prices”.

<sup>405</sup> *Ibid* at 187.

<sup>406</sup> *Ibid* at 189.

<sup>407</sup> BaFin Annual Report 2012, online:

<[http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl\\_annualreport\\_2012.html?nn=2821414](http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2012.html?nn=2821414)>.

Germany and some of the information driving the increase in the share price was not published in Germany.<sup>408</sup> The matter involved a corporation named De Beria Goldfields Inc. whose shares were listed on the lightly regulated Open Market of Deutsche Börse AG. De Beria Goldfields was incorporated in the US and based in Vancouver. Its shares were also listed on the OTC Bulletin Board in the US. The media also reported that those involved in this scheme had previously been involved in investment fraud in Canada and Australia.<sup>409</sup> BaFin described the case as follows:

In February 2006, the shares of De Beira Goldfields Inc. were admitted to the Open Market of Deutsche Börse AG. There was hardly any turnover at first. In May and June 2006, the price was manipulated significantly upwards in a very short period of time. In a total of 62 publications – including market letters, a weekly news magazine as well as advertisements in major national dailies in Germany and abroad – the shares were recommended for purchase on a massive scale. The perpetrators of this concerted push campaign did not disclose that they themselves held considerable amounts of the shares. These publications demonstrably influenced the share price, which climbed from an initial price of €1.90 in the middle of May 2006 to a high of €18.50 in the middle of June 2006. At the same time, the trading volume increased significantly. From the middle of 2006 onwards, both turnover and share price declined again, until the shares were left without any significant trading volume and the share price trended towards zero. The manipulation generated gross proceeds totaling approximately €38.4 million.

BaFin examined the case, made comprehensive requests for assistance to foreign supervisory authorities and uncovered the perpetrators' positions and sales, which had been concealed across various companies....

On 12 October 2012, the Regional Court in Stuttgart sentenced a Canadian national to a jail term of three years and two months, a market letter publisher with a similar previous conviction to a

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<sup>408</sup> News reports have stated that the other two perpetrators were German and that the Canadian was in custody in Germany. See K Matussek, "Four Charged in De Beria Goldfields Stock-Manipulation Case", *Bloomberg* (21 May 2012), online: Bloomberg <<http://www.bloomberg.com/news/2012-05-21/four-charged-in-de-beira-goldfields-stock-manipulation-case.html>>.

<sup>409</sup> "Soaring Mining firm grounded by BCSC", *Vancouver Sun* (24 June 2006), online: Canada.com <<http://www.canada.com/vancouvernews/business/story.html?id=cfe9b907-010c-435b-bee3-4b73e95eedaf>>.

suspended jail term of one year and ten months and the former editor of a news magazine to a suspended jail term of one year and nine months for collusive market manipulation. In addition, the market letter publisher and the former editor have to pay €350,000 and €200,000 respectively to charitable organisations as conditions of their probation. Another suspected principal perpetrator, who is an Austrian resident, had also been charged. However, since market manipulation is not considered a criminal offence in Austria, the accused was not extradited to Germany and could not be tried. The judgement is not yet final.<sup>410</sup>

#### **b) A solution to the problem – the First Quotation Board of the Open market is closed**

The full extent of the problem of manipulation in the lightly regulated markets became apparent by 2008.<sup>411</sup> In the same year, in addition to taking action against such manipulation, BaFin issued warnings in relation to the risks of trading OTC securities, particularly those from the USA, Canada and Switzerland.<sup>412</sup>

One issue for BaFin is that it has no power to approve the listing rules set by a securities market. However from about 2009 Deutsche Börse, which is responsible for setting the listing rules for the Open Market, clearly became aware of the problem of manipulation on this market and gradually tightened the listing requirements. In 2009 Deutsche Börse increased the requirements that had to be satisfied before it would list a corporation's securities, including a precondition that the securities were either already traded on another

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<sup>410</sup> BaFin Annual Report 2012, *supra* note 407 at 179. The Canadian National implicated in this scheme, Aly Babu Mawji, was arrested in Vienna. See "Vancouver stock promoter arrested in Vienna for alleged market manipulation", *Vancouver Sun* (20 May 2011), online: Canada.com <<http://www.canada.com/story.html?id=ec57e249-7b1f-4aa9-980c-c2734864a4d1>>.

<sup>411</sup> In its 2008 Annual Report BaFin stated:

"Most of the market manipulation investigations in the year under review concerned what is known as "scalping", during which the suspect first purchases a share or another financial instrument and then makes a recommendation without making adequate reference to his existing conflict of interests. Joint-stock companies, most of which were incorporated or renamed only very recently, are frequently floated for this purpose. Due to the comparatively low transparency requirements, the perpetrators consciously choose the OTC market so as to make it difficult for investors to obtain further information about the company. The companies are then given massive buy recommendations via market letters, calls, or spam e-mails. Prices and turnover increase considerably as a result of the recommendations, which is exploited by the perpetrators to sell the previously acquired shares at a profit. If the shares do not receive further recommendations, in most cases the prices collapse within a very short time. BaFin has investigated many such scenarios and referred eight cases of suspected market manipulation to the public prosecutors. During one investigation the public prosecutor, the Federal Criminal Police Office (Bundeskriminalamt), several regional criminal police services and BaFin searched more than 20 business premises and private residences and seized extensive evidence." See BaFin Annual Report 2008, *supra* note 401 at 162.

<sup>412</sup> *Ibid.*

exchange, the corporation had share capital of at least €250,000, or a prescribed form containing detailed information on the securities and the issuer was submitted.<sup>413</sup>

Despite these changes, the 2010 Annual Report of BaFin was critical of the listing requirements of the Open Market:

The regulated unofficial market is run by the stock exchanges, but does not count as exchange trading. It is used primarily to trade small and in some cases highly illiquid stocks that are frequently of foreign origin. The conditions to be met for companies to be included are extremely lax compared with the regulated market. There is no serious examination of the issuers, nor must the companies comply with any reporting obligations. Even companies in respect of which it is completely unclear whether they have, or are planning, operational business activities can be included in trading extremely easily and used for manipulative purposes. Although Deutsche Börse AG introduced stricter inclusion requirements in 2009, this has yet to have any noticeable effect.<sup>414</sup>

In 2011 Deutsche Börse threatened to delist entities that did not meet its new tighter listing requirements, and initially suspended trading in the shares of 174 entities on the First Quotation Board. Prompted by new incidents of suspected market manipulation, it then decided in December 2011 not to admit any new entities to the First Quotation Board. Finally, in February 2012, Deutsche Börse announced that the First Quotation Board would be closed and it was closed on 15 December 2012.<sup>415</sup>

In 2013 BaFin reported that, although the First Quotation Board was closed down in December 2012, the number of manipulation investigations has not yet decreased significantly. This was because of matters were still pending from previous years. BaFin did however report that instances of scalping had decreased since the First Quotation Board was closed.<sup>416</sup>

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<sup>413</sup> BaFin Annual Report 2009, *supra* note 397 at 173.

<sup>414</sup> BaFin Annual Report 2010, *supra* note 392 at 188.

<sup>415</sup> BaFin Annual Report 2011, *supra* note 396 at 194; BaFin Annual Report 2012, *supra* note 407 at 168.

<sup>416</sup> BaFin Annual Report 2013, *supra* 395 at 163-164 .



### c) Other instances of Cross Border Market Manipulation

In addition to multiple instances of cross border market manipulation through pump and dump schemes, over the ten year period from 2004 until 2013 BaFin in its annual reports set out details of a number of other, perhaps significant, instances of cross border market manipulation. These were:

- In 2004 an instance of cross border manipulation by traders based in London of Bund and Bobl futures with a view to influencing the price of government bonds.<sup>417</sup>
- In 2007 BaFin prosecuted two private investors, one of whom was German and the other Polish, in relation to trading a very illiquid option on the Stuttgart EUWAX exchange by co-ordinating buy and sell orders to create an artificially high price.<sup>418</sup>
- In 2008 BaFin took action in a matter in which two members of the board of directors of a Swiss company placed orders for call warrants on Pfitzer Inc. shares on the Stuttgart stock exchange.<sup>419</sup>

BaFin also reported one instance of assisting a regulator outside of the European Union in relation to a market manipulation matter. In 2005 BaFin reported on a matter in which false information in relation to a company was published over the internet in relation to a corporation whose shares were listed on both German and Australian exchanges. BaFin assisted ASIC taking action against the accused and a BaFin employee gave expert evidence in Australia.<sup>420</sup>

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<sup>417</sup> BaFin Annual Report 2004, online:

<[http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl\\_annualreport\\_2004.pdf?\\_\\_blob=publicationFile](http://www.bafin.de/SharedDocs/Downloads/EN/Jahresbericht/dl_annualreport_2004.pdf?__blob=publicationFile)> at 166. BaFin reported that it worked closely with other European supervisory authorities in this matter, and, in particular, the FSA in the UK, the Italian securities regulator, the Commissione Nazionale per le Società e la Borsa (CONSOB) as well as the Eurex Trading Surveillance Office. BaFin reported that ultimately this case did not proceed to a criminal prosecution because the criminal law at the time did not cover this form of manipulation. However, it also reported that the law had been changed so that if the same activity occurred in the future it would constitute a criminal offence.

<sup>418</sup> BaFin Annual Report 2005, *supra* note 398 at 182-183.

<sup>419</sup> BaFin Annual Report 2008, *supra* note 204. The directors coordinated the timing and volume of these orders such that they were executed against each other and resulted in 56 artificially generated stock prices. In so doing one of the defendants used the Swiss company's safekeeping account while the other used his personal account. The personal account thus made a profit while the corporate account incurred a loss.

<sup>420</sup> *Ibid* at 159.

In the period 2004 to 2013 in its annual reports BaFin reported on two unsuccessful investigations of suspected cross border market manipulation. First, in 2007 BaFin reported that a market manipulation investigation was not successful because the author of an internet publication which published false information could not be identified. This was because the internet provider did not, and was not required to, maintain records to identify the owner of the IP address.<sup>421</sup> Second, in 2010 BaFin reported on an investigation concerning possible market manipulation which did not result in a prosecution because BaFin was not able to get the information it required. The trader was a resident in Dubai and the company that undertook the trading was resident in a free trade zone in Dubai. BaFin was not able to get the information it required because the free trade zone was not covered by agreements BaFin had with the Emirates Securities and Commodities Authority (ESCA) and the Dubai Financial Services Authority (DFSA).<sup>422</sup>

### **Cross Border Insider Trading**

BaFin does not report the details of all instances of cross border insider trading. However in its annual reports from 2004 to 2013 BaFin reported three cases of cross border insider trading as follows:

- In 2007 BaFin took action in relation to the purchase of call options in Switzerland of Henkel KGaA by a person resident in Germany who purchased these options with inside information prior to the public announcement of the information.<sup>423</sup>
- In the same year BaFin took action in relation to share purchases made by a director of a German consulting company with inside information, the company being the subject of a takeover offer by a Dutch company. The shares were acquired by a foundation registered in Liechtenstein and a bank in Luxembourg. BaFin reported that while the investigation was ongoing the defendant turned himself in to the prosecutor's office and confessed to part of the share dealings transacted via

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<sup>421</sup> BaFin Annual Report 2007, *supra* note 399 at 184.

<sup>422</sup> BaFin Annual Report 2010, *supra* note 392 at 197.

<sup>423</sup> BaFin Annual Report 2007, *supra* note 399 at 177-178.

Liechtenstein. He had been informed of the BaFin enquiry by the Liechtenstein supervisory authority (the FMA). This was because the FMA gives customers of locally registered banks the opportunity to respond before it reveals their identity to BaFin.<sup>424</sup>

- In 2009 BaFin prosecuted an investor relations manager at Deutsche Telekom AG who passed inside information on to a friend. Before this information was made public the friend purchased call and put options using both his own accounts, and accounts of close relatives held in Germany, Luxembourg and Switzerland. Profits made were more than €2.4 million and the Telekom employee received a cut of around €70,000 in cash via a bank safe in Luxembourg. In March 2009, in what was described in as the most severe case of insider trading to be brought to court to date, the Telekom employee was sentenced to a suspended prison sentence of 15 months and 50 hours of community service and the friend was sentenced to three years in prison for insider trading on 34 counts.<sup>425</sup>

### **Detection methods**

Over the decade 2004 to 2013 BaFin's Annual reports provide some information on the various detection methods it used in relation to market abuse, although it did not report on how individual cases were detected.

Not unsurprisingly, market surveillance was an important detection mechanism for market abuse and remains so. In 2012 BaFin reported that in relation to market manipulation more "than half of the formal investigations launched – 148 – were based on referrals by the trading surveillance units at the German exchanges."<sup>426</sup> BaFin also receives transaction data which is very important for pursuing market abuse. In 2013, BaFin reported that it received:

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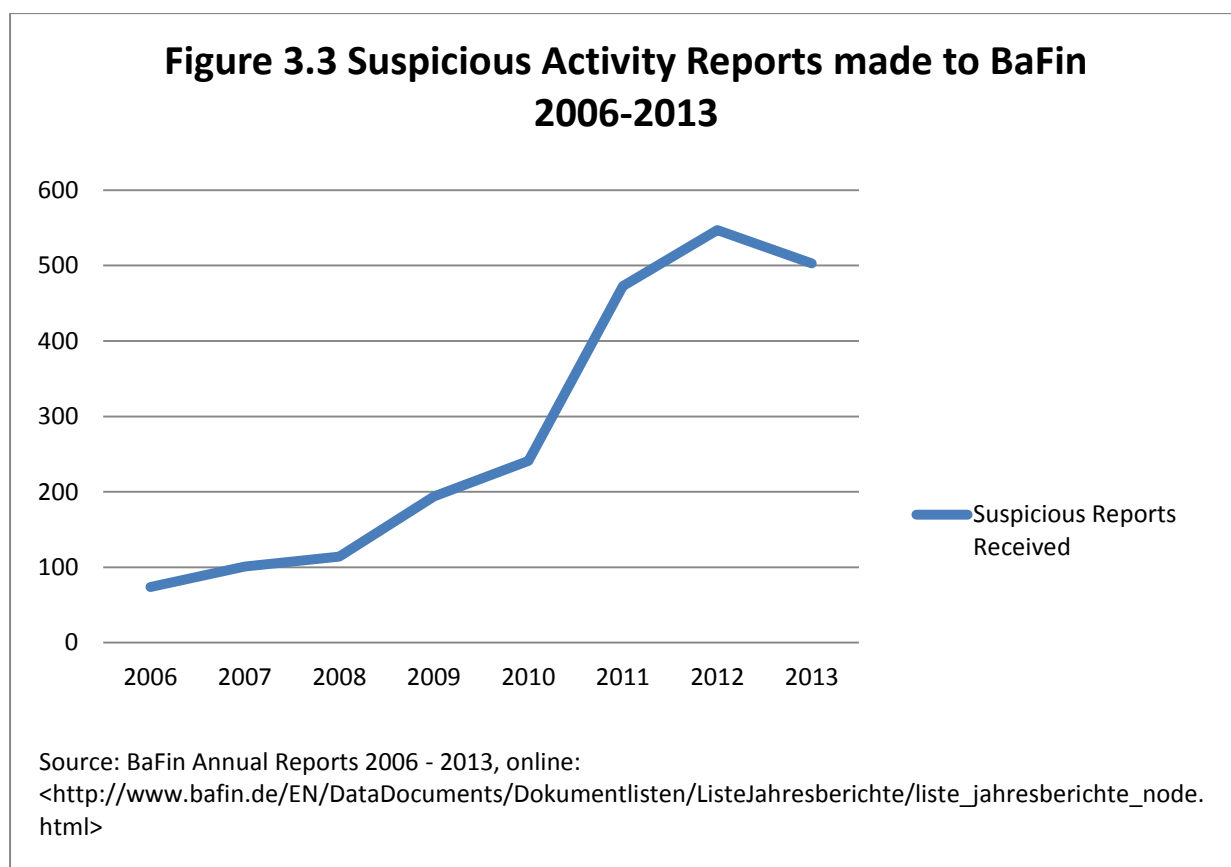
<sup>424</sup> *Ibid* at 178.

<sup>425</sup> BaFin Annual Report 2009, *supra* note 397 at 175.

<sup>426</sup> BaFin Annual Report 2012, *supra* note 407 at 174.

approximately 772 million transaction data records via the German reporting system (previous year: 698 million) and a further 714 million reports via the pan-European platform (previous year: 606 million).<sup>427</sup>

Despite the importance of market surveillance, over the decade suspicious transaction reports of market abuse became an increasingly important source of detection of market abuse particularly in relation to market manipulation. BaFin first reported the receipt of suspicious transaction reports from securities service companies, credit companies, brokers, operators of OTC markets and foreign authorities in 2006.<sup>428</sup> Figure 3.3 shows a dramatic increase in the number of these reports over the next few years.



From 2006 to 2010 BaFin also reported the number of suspicious transaction reports which were passed on to it from foreign supervisory authorities. The number of such reports

<sup>427</sup> BaFin Annual Report 2013, *supra* note 395 at 163.

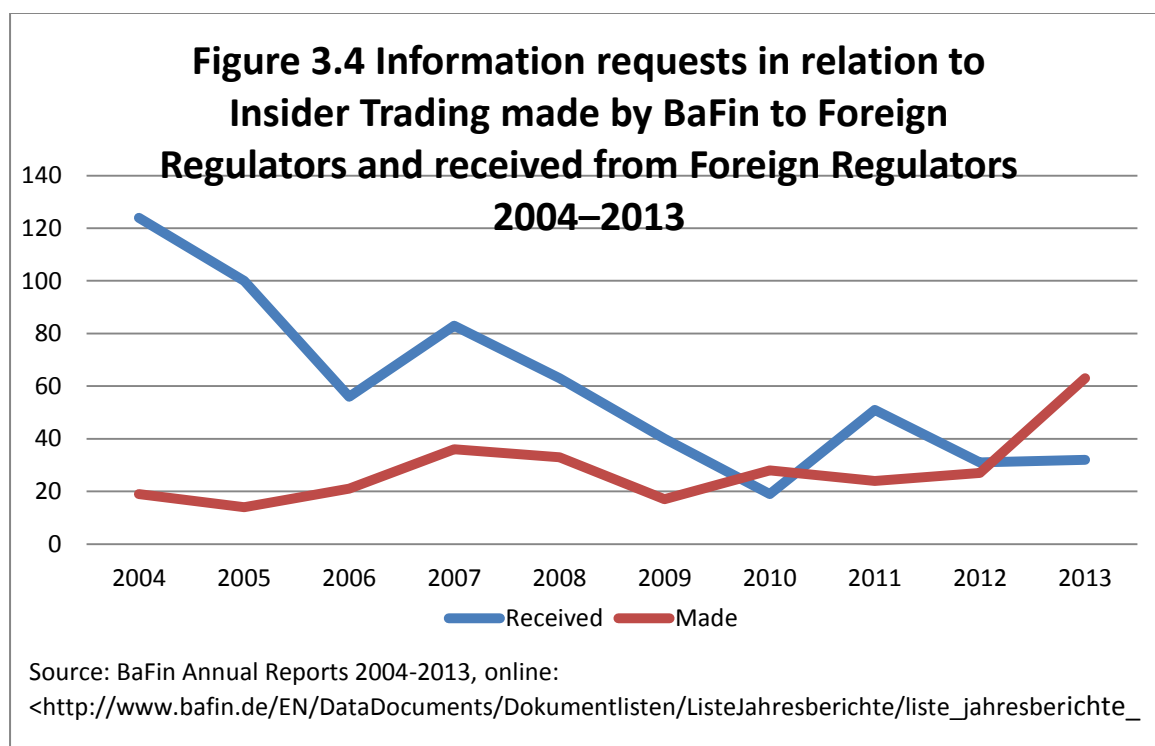
<sup>428</sup> BaFin Annual Report 2006, *supra* note 398 at 165. See also Chapter 3 in relation to EU Market Abuse Directives in relation to suspicious transaction reports.

gradually climbed from one in 2006 to 25 in 2010. In 2013 BaFin also reported that broken down by offence, the majority of the reports related to suspected market manipulation.<sup>429</sup>

Another source BaFin used to detect market abuse were tips and voluntary reports from investors. For example in 2009 BaFin received 750 tips.<sup>430</sup> Over the ten year period it appears that most of these were in relation to market manipulation and originated from investors who purchased shares as a result of false or misleading information.<sup>431</sup>

### International Cooperation with Foreign Regulators

During the ten year period, requests made by BaFin to foreign authorities in relation to insider trading matters remained relatively steady (Figure 3.4) until 2013. In 2013 these increased with BaFin reporting that “the number of cross-border insider trading investigations increased sharply.”<sup>432</sup> Over the same period the number of requests received by BaFin in relation to insider trading gradually fell.



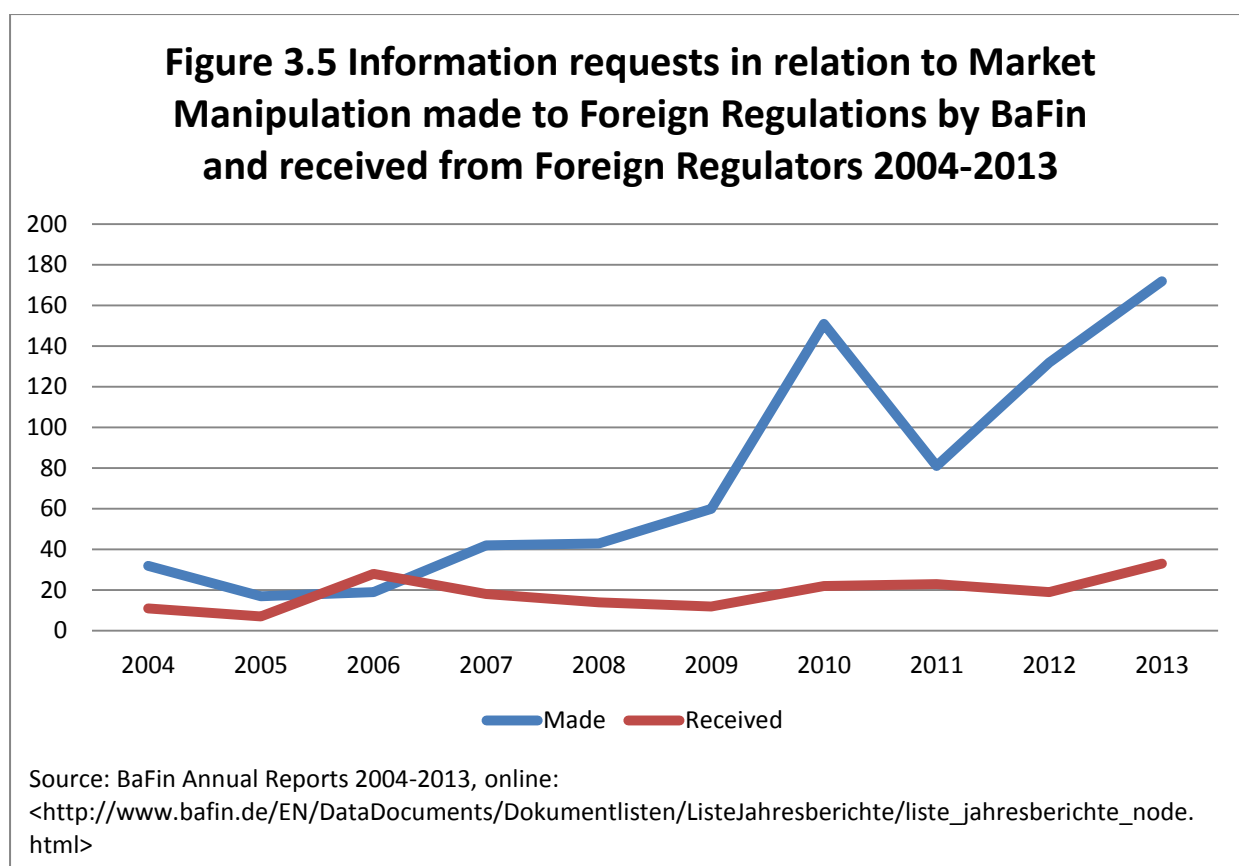
<sup>429</sup> BaFin Annual Report 2013, *supra* note 395 at 163.

<sup>430</sup> BaFin Annual Report 2009, *supra* note 397 at 171.

<sup>431</sup> See BaFin Annual Report 2006, *supra* note 398 at 163; BaFin Annual Report 2007, *supra* note 399 at 172; BaFin Annual Report 2012, *supra* note 407 at 174.

<sup>432</sup> BaFin Annual Report 2013, *supra* note 395 at 167.

The reported increase in cases of cross border market manipulation (Figure 3.5) over the ten year period is consistent with a corresponding increase in BaFin's requests for information from foreign regulators in relation to market manipulation and this also seems consistent with statements made by BaFin in its Annual Reports that it was increasingly focusing more of its resources on this issue. In contrast, requests received by BaFin from foreign authorities in relation to market manipulation remained relatively steady.



In 2013 BaFin reported that most of its requests for information to foreign regulators related to data concerning customers who had engaged in suspicious trading activities on a German exchange via a foreign institution.<sup>433</sup>

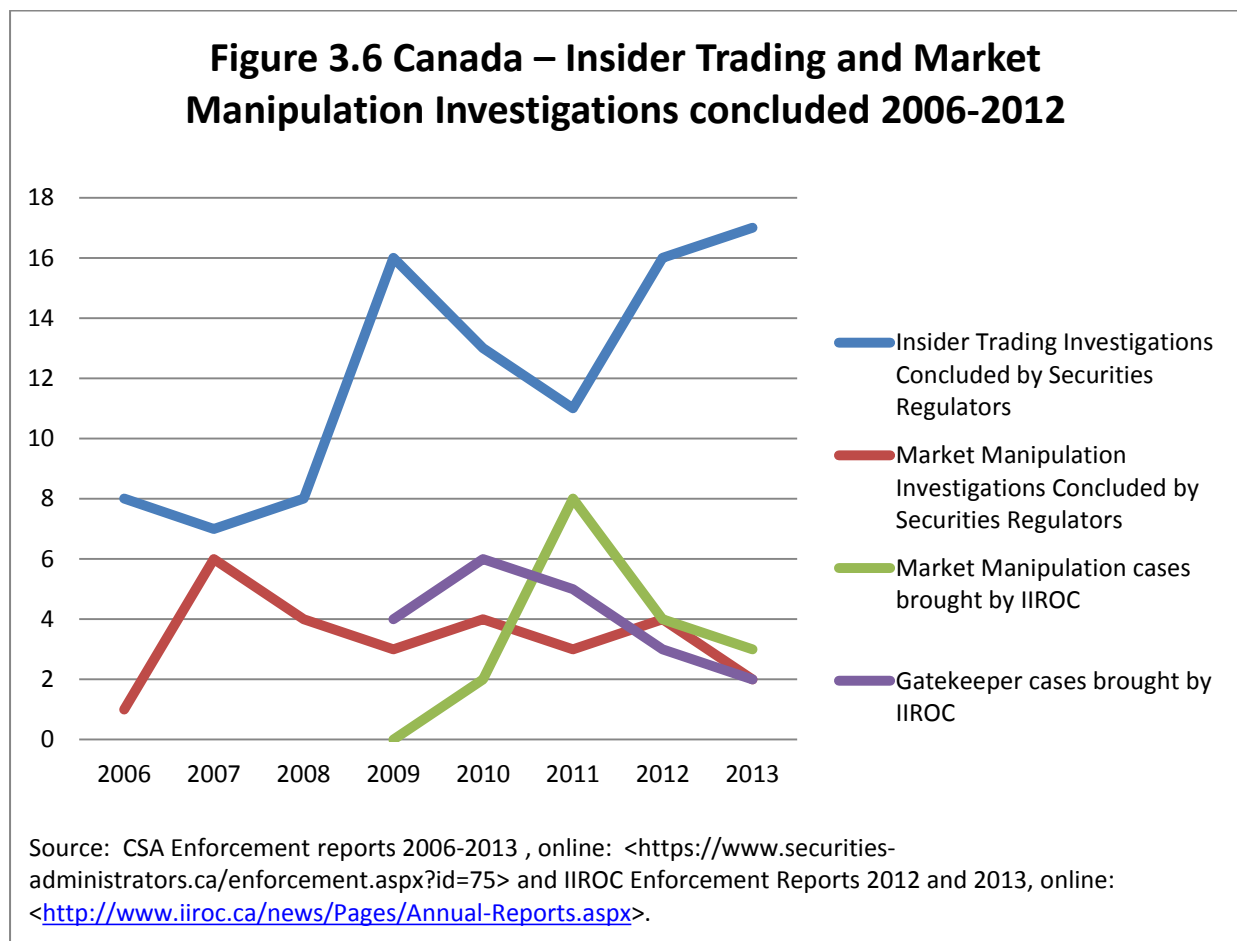
## Part 2 Canada

Although Canada does not have a national securities regulator, since 2006 the Canadian Securities Administrators (CSA), the umbrella organisation of Canada's provincial and

<sup>433</sup> BaFin Annual Report 2013, *supra* note 395 at 164.

territorial securities regulators, has reported the number of investigations into insider trading and market manipulation successfully concluded each year across Canada (Figure 3.6). The number of investigations in relation to market manipulation has remained fairly consistent. The number of investigations into insider trading has gradually trended upwards. These figures do not distinguish between instances where the activity took place wholly within the jurisdiction or was cross border market abuse.

In addition, since 2009, IIROC has published figures annually on the number of matters in which it took action against its members for market manipulation. It has also published the number of 'gatekeeper' cases it has prosecuted. These are prosecutions of members who have allowed their clients to engage in unlawful behaviour, which could include insider trading (Figure 3.6).



## Cross Border Market Manipulation

Figure 3.6 shows that relatively few investigations were conducted across Canada each year into market manipulation. Although there are no figures as to the number of these matters that had a cross border dimension, a review of published material produced by the main provincial securities regulators in Canada revealed that they did sometimes take action in relation to instances of cross border market manipulation.

From 2004 until 2013 the largest provincial securities regulators reported eleven cases of cross border market manipulation. Most of these cases were instances of ‘pump and dump’ schemes where the trading took place on the US OTC markets. In all of these cases the architects of the schemes, or the brokers that were used, were located in Canada. For example, one such case is described in CSA enforcement report in 2011 as follows:

Sulja Bros. Building Supplies, Ltd., another corporation and six individuals were involved in a fraudulent scheme wherein Sulja shares were issued and subsequently traded in a market that was inflated by overwhelmingly positive but false press releases about Sulja’s prospects. The respondents sought to conceal the extent of their involvement by trading through nominee accounts, creating a misleading appearance of trading activity in Sulja securities and obtaining trading profits of US\$5.6 million. The Ontario Securities Commission (OSC) levelled sanctions against the respondents totalling more than \$7 million.<sup>434</sup>

In addition to those eleven matters in 2011 the OSC reported an investigation into a similar matter that could not be proven.<sup>435</sup>

In three of these cases accounts or corporations situated in countries commonly known as offshore financial centres were used. Offshore financial centres are nation states that have laws, or are commonly thought to have laws, which protect financial secrecy thereby

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<sup>434</sup> CSA, Enforcement Report 2011, online: CSA <<http://er-ral.csa-acvm.ca/report-archive/2011-en/2011-case-highlights/categories-of-offence/market-manipulation/>>.

<sup>435</sup> *Re MRS Securities Inc.*, 2011 CarswellOnt 594 (OSC). The OSC found that the evidence suggested of a pattern of manipulative trading, but it was not satisfied, on a balance of probabilities, that the defendants knew or ought to have known that their conduct would result in or contribute to a misleading appearance of trading volume or an artificial price. This was partly due to the fact that investigators who testified relied on incomplete data and lacked the knowledge and the detail of the Pink Sheets market and the trading.



preventing the disclosure of the beneficial ownership of corporate entities and bank accounts. Presumably accounts or corporations situated in these offshore financial centres were used in an attempt to conceal the trading from securities and/or taxation regulators.<sup>436</sup> In fact in one of these cases the perpetrator admitted that this was indeed the case. The decision of the BCSC notes that the main perpetrator stated in his sentencing hearing in the US in relation to related criminal charges that:

In each of these schemes, I conspired with officers of these companies as well as other people including people from [Commonwealth], the firm in which I worked, which is located in Manhattan. We made false filings with the Securities and Exchange Commission, issued misleading press releases, placed stock in brokerage accounts opened under other people's names and conducted stock trades to manipulate the price involving those stocks. When the price and volume rose sufficiently, we bought and sold stock to manipulate the market to our benefit.

To disguise the nature of these profits and to hide our activities from US law enforcement, we funneled these monies through accounts in other countries. . . . To carry out our schemes, we made use of national exchanges and stock trading systems, the US mails and telephone calls and wires across state lines and between the US and foreign countries.<sup>437</sup>

In another of these matters involving the use of accounts in an offshore financial centre the BCSC failed to determine the identity of the perpetrators of the scheme because of the

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<sup>436</sup> See *Re Firestar Capital Management Corp et al* (2011), 34 OSCB 6123; *Re Sulja Bros Building Supplies Ltd*, 2011 CarswellOnt 3915; *Re Kunekt Corporation and Mark Bruk*, 2011 BCSECCOM 225; *Downshire Capital Inc* as reported in CSA Activity Report 2010, online: CSA <<http://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA2010EnforcementReportEng.pdf>> at 19; *AMF c McKeown*, online: Lautorite <[http://www.lautorite.qc.ca/files/pdf/bulletin/2011/vol8no39/vol8no39\\_2-2.pdf](http://www.lautorite.qc.ca/files/pdf/bulletin/2011/vol8no39/vol8no39_2-2.pdf)>; *Re Hypo Alpe-Adria-Bank (Liechtenstein) AG*, 2008 BCSECCOM 257. This case involved the use of accounts at a bank in Liechtenstein. IIROC took proceedings against the Canadian brokers, see IIROC, News Release, "IIROC announces settlement with John Anastasious Collias and Karen Marie Young" (17 June 2010), online: IIROC <<http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=9106B99AB86F485CB50B18ED6982F1B0&Language=en>>; *Re Watson*, 2008 CarswellOnt 124; *Ontario (Securities Commission) v 1367682 Ontario Ltd*, 2008 CarswellOnt 2920. This matter involved the use of accounts in Belize; *Investment Dealers Assn. of Canada v Boulieris*, 2004 CarswellOnt 385. In this matter a US resident conducted a scheme using a Canadian broker; *Re Nano World Projects Corporation and Robert Papalia*, 2005 BCSECCOM 648; *Re Edward Andrew Durante*, 2004 BCSECCOM 634. This matter involved the use of offshore corporations in Nauru, St. Kitts & Nevis. The perpetrator was from the US but used a Canadian broker; *Investment Dealers Assn of Canada v Kasman*, 2009 CarswellOnt 4083. This matter involved the use of offshore corporations in Belize and Bermuda. The perpetrators were from the US but used Canadian brokers; *Re Exotics.com Inc, Firoz Jinnah and Ingo W Mueller*, 2006 BCSECCOM 709.

<sup>437</sup> *Durante*, *supra* note 436 at 12.

banking secrecy laws in Liechtenstein. It did however note that the laws in Liechtenstein were due to be amended which would permit such disclosure in the future.<sup>438</sup>

During the ten year period between 2004 and 2013 there was only one reported case of cross border manipulation where the trading took place on a Canadian exchange. In 2004 the BCSC reported the settlement of a matter which involved manipulation on the Vancouver exchange (now the TSX venture exchange). This manipulation consisted of a series of wash sales by a director in which he utilized an account in Channel Island of Jersey in the name of a trust that he controlled, presumably in an attempt to disguise his involvement with the trading.<sup>439</sup>

### **Cross Border Insider Trading**

A review of case reports of insider trading cases investigated by the principal securities regulators in Canada revealed only four identified instances of cross border insider trading over the ten year period.

Three involved the use of accounts in offshore financial centres apparently in an attempt to conceal the offences. There were:

- In 2005 the OSC brought proceedings against a director of a company who purchased shares in the company using a nominee account in Bermuda before

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<sup>438</sup> See *Re Hypo Alpe-Adria-Bank (Liechtenstein) AG*, *supra* note 436 at 9-11:

“In the course of investigating this trading activity, Commission staff has sought from Hypo and the Liechtenstein financial regulator the information necessary to identify the beneficial owners of the shares being traded in Hypo’s accounts. Their inquiries started in July 2007 but they have been unsuccessful. Hypo says it has been constrained in providing information as a result of Liechtenstein’s banking secrecy laws.

Although there is a procedure under that regime for disclosure to foreign regulators, it is lengthy and cumbersome and, in any event, does not appear to allow disclosure in these circumstances. In November 2007 the Liechtenstein regulator ordered Hypo to give commission staff the information it seeks but Hypo appealed that order because, it says, commission staff’s request was too broad, and complying with the order would have had adverse implications for its other clients. The court granted the appeal and suspended the regulator’s order, finding that the empowering legislation limits the regulator’s authority to order disclosure to cases where the securities have been traded on a regulated market in Europe (which would not include the OTC BB or the Pink Sheets). The court remanded the matter to the regulator for “a possible extension of the proceedings and a new ruling.

Apparently the legislation in question is to be amended to address this issue.”

<sup>439</sup> *Re Douglas Laurence Mason*, 2004 BCSECCOM 508.

information in relation to the company's participation in a private placement was made public.<sup>440</sup>

- In 2009 criminal insider trading proceedings were brought by the OSC against two individuals, Gil Cornblum and Stanko Grmovsek, for an insider trading scheme. The SEC also brought proceedings in the same case and IIROC brought proceedings against their financial adviser. This scheme operated over a 14 year period from 1994 to 2008 and the individuals netted over \$10 million trading Canadian and US securities. The scheme was uncovered by FINRA and referred to the OSC. The purchases were made using accounts set up in the Bahamas and the Cayman Islands.<sup>441</sup>
- In 2013 the OSC prosecuted Richard Bruce Moore, a managing director of investment banking at CIBC World Markets and later at UBS Securities Canada Ltd. He used inside information to purchase securities on the LSE and on the TSX via an account in Jersey, Channel Islands. The OSC notes that the SEC also was taking action in relation to purchases made in the US.<sup>442</sup>

In 2007 the SEC commenced proceedings against two Canadians for insider trading on securities listed on NASDAQ.<sup>443</sup> Following the finalization of these proceedings, the OSC also brought proceedings against these two individuals.<sup>444</sup>

### **International Cooperation with Foreign Regulators**

Given the fractured system of regulation across Canada, there are no consolidated reported

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<sup>440</sup> *Re Hryniw*, 2005 CarswellOnt 2612.

<sup>441</sup> *Re Grmovsek*, 2009 CarswellOnt 6520; *SEC v Stanko J Grmovsek*, SEC Litigation Release, online: SEC <<http://www.sec.gov/litigation/litreleases/2009/lr21263.htm>>; IIROC, News Release, "In the Matter of Sandy Joseph Bortolin- Discipline decision – Liability and Penalty" (13 April 2012), online: IIROC <[http://www.iiroc.ca/Documents/2012/10c1a654-1fdf-43eb-874a-dcf0a3539af4\\_en.pdf](http://www.iiroc.ca/Documents/2012/10c1a654-1fdf-43eb-874a-dcf0a3539af4_en.pdf)>. See also J Greenwood, "Gromovsek gets 39 months for Insider Trading", *Financial Post* (7 January 2010), online: *Financial Post* <<http://www.financialpost.com/news-sectors/financials/story.html?id=2415865>>.

<sup>442</sup> *In the matter of Richard Bruce Moore*, OSC Settlement Agreement, online: <[https://www.osc.gov.on.ca/documents/en/Proceedings-SET/set\\_20130408\\_moorerb.pdf](https://www.osc.gov.on.ca/documents/en/Proceedings-SET/set_20130408_moorerb.pdf)>.

<sup>443</sup> *SEC v Suman & Rahman*, SEC Complaint, online: SEC <<https://www.sec.gov/litigation/complaints/2007/comp20203.pdf>>.

<sup>444</sup> *Re Suman*, 2012 CarswellOnt 15350.

figures of requests received by Canadian securities regulators to foreign authorities or made by them to foreign authorities.

However, since it's 2008/09 Annual Report the BCSC has reported on an annual basis some data in relation to requests it made and received (Figure 3.7).

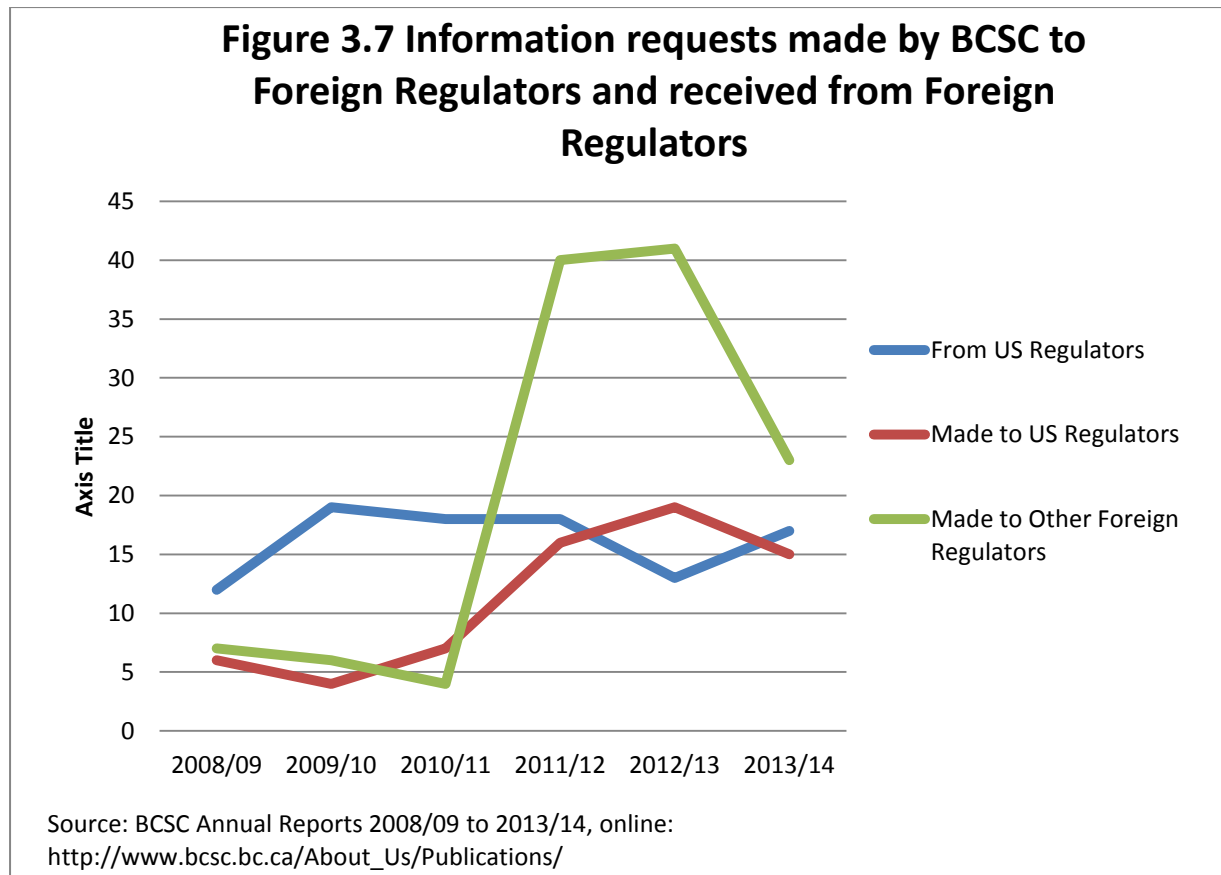


Figure 3.7 shows that up until about 2010 most of the requests made by the BCSC were to US authorities. However, since that time the number of requests it is making to other foreign authorities has increased and in its 2013/14 Annual Report it reported that these included requests to the Swiss Financial Market Supervisory Authority, the FCA and the Panama Superintendencia del Mercado de Valores.<sup>445</sup>

The Ontario Securities Commission reported in its 2010 Annual Report that it acted on 36 requests for assistance from foreign securities regulators under the IOSCO MMoU. By 2013

<sup>445</sup> BCSC, Annual Report 2013/2014, online: BCSC <[http://www.bcsc.bc.ca/uploadedFiles/About\\_Us/Annual%20Report%202013-14%20bw.pdf?t=1432659929716](http://www.bcsc.bc.ca/uploadedFiles/About_Us/Annual%20Report%202013-14%20bw.pdf?t=1432659929716)> at 66.

this had risen to 54 requests (37 coming from US authorities). In 2012 it made 39 requests, with 20 of those made to US authorities.<sup>446</sup> In 2012 it stated:

The largest number of requests for assistance from the OSC come from U.S. regulators, specifically the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC), but an increasing number of requests are made between the OSC and regulators in Asia and Europe, such as Hong Kong and Germany.....

Requests to the OSC often involve assistance with access to broker and banking records for investigations, locating people of interest to investigators and compelling testimony from individuals in interviews. Assistance requests can alert OSC Enforcement staff to possible misconduct in Ontario which requires prompt action to protect investors and markets here. The rising level of assistance is being driven by the effectiveness and timeliness of the OSC's co-operation and the significant increase in the number of non-U.S. regulators who are compliant with the International Organization of Securities Commissions' (IOSCO) Multilateral Memorandum of Understanding for information sharing.<sup>447</sup>

These disclosures from the BCSC and the OTC suggest that there is a relatively frequent exchange of information to and from Canadian and US regulators. It also seems that the level of exchange of information with other foreign regulators is increasing, largely because of increased use of the IOSCO MMoU.

### **Part 3 United Kingdom**

Although the mandate of the FCA is to protect the UK markets, particularly given its position within the EU, it has stated that it will take action even if the perpetrator is outside of the UK:

Our market abuse regime applies to anyone whose activity relates to the UK exchange-based markets, including those overseas. It is based on the Market Abuse Directive that aims to fight cross-border market abuse by establishing a common approach among EU member states.<sup>448</sup>

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<sup>446</sup> OSC, Enforcement Activity 2013, online: OSC <[https://www.osc.gov.on.ca/en/NewsEvents\\_nr\\_20140321\\_osc-results-2013-enf.htm](https://www.osc.gov.on.ca/en/NewsEvents_nr_20140321_osc-results-2013-enf.htm)>.

<sup>447</sup> OSC, Enforcement Activity 2012, online: OSC <[https://www.osc.gov.on.ca/en/NewsEvents\\_nr\\_20130228\\_osc-2012-enf-rpt.htm](https://www.osc.gov.on.ca/en/NewsEvents_nr_20130228_osc-2012-enf-rpt.htm)>.

<sup>448</sup> FSA Annual Report 2010/11, online: <[http://www.fsa.gov.uk/library/corporate/annual/ar10\\_11.shtml](http://www.fsa.gov.uk/library/corporate/annual/ar10_11.shtml)> at 59.

The FCA does not separately report instances of cross border market abuse but does give overall numbers of investigations of market abuse each year. As shown in Figure 3.8, over the ten year period the number of market abuse investigations conducted by the FSA remained relatively consistent.<sup>449</sup> This seems to be a reflection of the fact that the FSA was selective in the types of cases that were chosen for investigation. For example in 2005 the FSA stated that it did not investigate every apparent breach of the market abuse regime and rather it adopted a risk-based approach.<sup>450</sup> In 2007 the FSA stated that it was its priority to focus on high-impact cases of market abuse.<sup>451</sup> This approach to case selection was further explained in its 2011/12 Enforcement Report:

The Executive believes we are using the enforcement tool strategically to deliver our credible deterrence philosophy. We are selective in the cases we investigate. Our considerations include whether:

- the misconduct poses a significant risk to our objectives;
- the misconduct is serious in nature;
- there is actual or potential consumer loss or detriment;
- there is evidence or risk of financial crime or market abuse; and
- it is an FSA priority to raise standards in that sector in respect of that issue.<sup>452</sup>

Despite the fact that the number of market abuse investigations remained relatively stable, the FSA did note that cases were becoming more complex.<sup>453</sup>

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<sup>449</sup> In its 2013/2014 Annual report the FCA did not report the same data. Market abuse investigations at the end of 2013/2014 year were listed as 60 but the FCA noted “The number of cases in progress were restated early in the year to count both firms and individuals. Cases were also re-categorised using new FCA Issue codes as above. It is not possible to restate previously reported case numbers on the new basis.” See FCA Annual Report 2013/2014, online: FCA < <http://www.fca.org.uk/news/corporate/annual-report-13-14> > at Appendix 2.

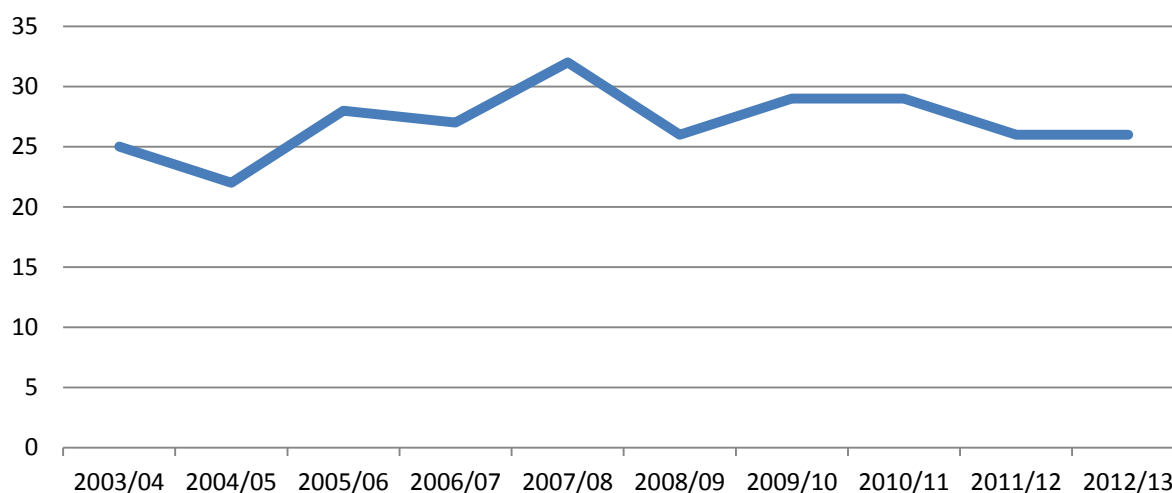
<sup>450</sup> FSA Annual Report 2004/05, online: FSA < [http://www.fsa.gov.uk/library/corporate/annual/ar04\\_05.shtml](http://www.fsa.gov.uk/library/corporate/annual/ar04_05.shtml) > at 21.

<sup>451</sup> FSA Annual Report 2006/07, online: FSA < [http://www.fsa.gov.uk/library/corporate/annual/ar06\\_07.shtml](http://www.fsa.gov.uk/library/corporate/annual/ar06_07.shtml) > at 17.

<sup>452</sup> FSA Enforcement Annual Performance Account 2011/12, online: FSA < <http://www.fsa.gov.uk/static/pubs/annual/ar11-12/enforcement-report.pdf> >, at 5.

<sup>453</sup> FSA Annual Report 2012/13, online: FSA < <http://www.fca.org.uk/news/firms/fsa-annual-report-2012-13> > at 39.

**Figure 3.8 FCA Market Abuse cases outstanding at year end 2003-2012**



Source: FSA Annual Reports 2003/04 to 2012/13, online:  
<http://www.fsa.gov.uk/pages/library/corporate/annual/index.shtml>

One change that occurred over the ten years is a shift in emphasis by the FSA, and then the FCA, towards seeking criminal sanctions for perpetrators of market abuse and away from administrative or disciplinary actions.<sup>454</sup> In 2009 the FSA brought its first criminal insider trading case and in 2010 the FSA noted that:

In the last 12 months, we have seen the visible returns on a long-term programme to put criminal prosecutions at the heart of our credible deterrence strategy in relation to market misconduct.<sup>455</sup>

<sup>454</sup> As referred to in Chapter 2, there has been criticism in the literature of the FSA in failing to bring sufficient prosecutions to deter insider trading in markets it supervised. See also Barnes, *supra* note 9 at 155, in which Barnes analysed criminal cases brought by the FSA and commented “It has always been believed that ‘City professionals’ such as merchant bankers, accountants and lawyers, who are privy to price-sensitive information, have continued to use offshore companies and nominees in this manner since the 1950s. By means of nominee holdings and intricate networks, the tracing of organized dealing rings, the swapping of information, is simply not possible. The only successful prosecutions of insider dealing of City professional ‘rings’ are the Asif Butt and others and the Gray, Rowlands, Liggins and Riding cases. Perhaps the largest case is that of Spearman, Smith and Payne although they are business people from outside London and not City folk. Most of the remaining cases are, in the words of the FSA, ‘small fry’.”

<sup>455</sup> FSA Annual Report 2009/10, online: [http://www.fsa.gov.uk/library/corporate/annual/ar09\\_10.shtml](http://www.fsa.gov.uk/library/corporate/annual/ar09_10.shtml) at 38.

## Cross Border Insider Trading

An analysis of Notices and Releases from 2004 to 2013 revealed that the FSA, then the FCA, took action in nine cases of cross border insider trading. Of these three involved finance professionals who used the information they had received to trade for the benefit of their firms or their clients. For example in 2006 the FSA fined a London based broker employed by Credit Suisse First Boston who received an email from an analyst about a US company and passed the information on to clients, including hedge funds, which sold or shorted the stock.<sup>456</sup> Two cases related to persons who gained insider information whilst within the UK who tipped relatives or friends abroad or traded in those friends or family members' names. For example, in 2009, the FSA prosecuted a senior investment banker, his wife and a friend in Singapore for insider trading. The three made profits in excess of £590,000 on trading of over £2m. As part of this enforcement action the friend was arrested in Mayotte, a French overseas territory in the Comoros Islands, and extradited to the UK.<sup>457</sup> A further four cases related to persons outside of the UK who became aware of insider information about entities whose securities were traded on UK exchanges and who traded on this information or tipped off others who traded on this information. For example, in 2010, the FSA fined three Turkish oil company executives for purchasing shares of UK listed Heritage Oil Plc., prior to the announcement of a major oil discovery in Turkey.<sup>458</sup>

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<sup>456</sup>See also FSA, Final Notice, *Re Seau Pignatelli* (20 November 2006), online: FSA <<http://www.fsa.gov.uk/pubs/final/Pignatelli.pdf>> . In 2006 the FSA fined the head of European Cash Trading at Deutsche Bank in London £350,000 and Deutsche Bank £6.363M for instructing Deutsche Bank to purchase shares in a Swedish company, Scania AB, while Deutsche Bank was selling shares in Scania to its clients as a result of a parcel it had acquired from AB Volvo. See FSA, Final Notice, *Re Deutsche Bank* (10 April 2006), online: FSA <<http://www.fsa.gov.uk/pubs/final/deutsche.pdf>>. See also FSA, Final Notice, *Re Nicholas James Kyprios* (13 March 2012), online: FSA <<http://www.fsa.gov.uk/static/pubs/final/nicholas-kyprios.pdf>>.

<sup>457</sup> FSA, Final Notice, *Re Christian Littlewood* (31 May 2012), online: FSA <<http://www.fsa.gov.uk/static/pubs/final/christian-littlewood.pdf>>. See also FSA, News Release, "Investment banker sentenced for insider dealing" (13 December 2012), online: FSA <<http://www.fsa.gov.uk/library/communication/pr/2012/113.shtml>>.

<sup>458</sup> FSA, News Release, "Three Turkish oil company executives fined £1.16m for market abuse" (16 February 2010), online: FSA <<http://www.fsa.gov.uk/library/communication/pr/2010/028.shtml>>. See also FSA, Final Notice, *Re Jeffery Burley* (19 July 2010), online: FSA <[http://www.fsa.gov.uk/pubs/final/jeremy\\_burley.pdf](http://www.fsa.gov.uk/pubs/final/jeremy_burley.pdf)>. FSA, Final Notice, *Re David Einhorn* (12 January 2012), online: FSA <<http://www.fsa.gov.uk/static/pubs/decisions/dn-einhorn-greenlight.pdf>>



In one case in 2012 the FSA prosecuted two UK based brokers who traded contracts for difference in US securities and tipped other clients of their firm. The brokers received inside information from a relative who was married to a senior partner in a large US accounting firm. The total profits generated by the brokers were approximately £1.9 million, while the total profits generated by their clients were approximately £10.2 million. The FSA noted that the case was significant as it involved a successful parallel investigation with the SEC, the US Department of Justice and the FBI.<sup>459</sup>

### **Cross Border Market Manipulation**

An analysis of Releases and Notices for the period 2004 to 2013 revealed that the FSA prosecuted five cases of cross border market manipulation over this period.

#### ***a) Layering and High Frequency Trading***

During the period the FSA and then FCA brought two cases in relation to the manipulative technique known as layering. Both involved the use by unauthorised persons of direct market access.

In 2011 the FSA fined the Canadian corporation, Swift Trade Inc., £8m for manipulation. Swift Trade was controlled by Peter Beck, a Canadian, and operated a network of over 50 customers based in over 150 trading locations worldwide who, in turn, engaged over 3000 traders. None were based in the UK. Swift Trade was granted direct market access by licensed London Stock Exchange (LSE) brokers. Between 1 January 2007 and 4 January 2008 Swift Trades' traders engaged in layering by causing a succession of small price movements in a wide range of individual securities on the LSE. The trading was widespread and repeated on many occasions involving tens of thousands of orders by many individual

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<sup>459</sup> FSA, News Release, "Three guilty of insider dealing" (28 May 2012), online: FSA <<http://www.fsa.gov.uk/library/communication/pr/2012/060.shtml>>. In its enforcement report of that year, the FSA commented on this case and stated: "[O]ne case was the result of parallel investigations in the UK and USA by the FSA, the US Securities and Exchange Commission and the US Department of Justice resulting in convictions and fines in both the UK and the USA. Each such investigation or prosecution we bring increases our ability to bring further cases and strengthens the ties we have with our international regulatory colleagues tackling similar matters around the world". See FSA Enforcement Annual Performance Account 2011/12, online: <<http://www.fsa.gov.uk/static/pubs/annual/ar11-12/enforcement-report.pdf>> at 9.

traders who sometimes acted in concert with each other across many locations worldwide. It was not possible to quantify Swift Trade's profits precisely but they and were in excess of £1.75 million. In March 2007, when Swift Trade became aware that the LSE had raised concerns about its trading activity, Swift Trade told its direct market access provider that it would impose effective controls. However, in fact, the manipulation continued when Swift Trade changed its direct market access provider.<sup>460</sup>

In 2013 took enforcement action against a high frequency trader, Michael Coscia, for layering. Between 6 September 2011 and 18 October 2011 Coscia used an algorithmic program he designed to place thousands of false orders for Brent Crude, Gas Oil and Western Texas Intermediate futures on the ICE Futures Europe exchange in the UK. He traded from the US through a direct market access provider. As a result of the price movements generated by his layering strategy, Coscia made a profit of US \$279,920 over the 6 week period of trading at the expense of other market participant, primarily other high frequency traders. Coscia received a 30% discount on the fine by agreeing settlement under the FCA's executive settlement procedures and was fined USD 903,176 (approximately £597,993). The FCA noted that Coscia was also fined by the US Commodities and Futures Trading Commission and the Chicago Mercantile Exchange (CME) also imposed fines for similar market manipulation by Coscia on US markets.<sup>461</sup>

**b) Other cases of cross border manipulation**

Other cases of cross border manipulation brought by the FSA over the period were:

- In 2004 the FSA fined a US hedge fund and the hedge fund manager who made misleading statements in relation to a corporation listed on the LSE while trading

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<sup>460</sup> FSA, Decision Notice, *Re Swift Trade Inc* (6 May 2011), online: FSA <[http://www.fsa.gov.uk/static/pubs/decisions/swift\\_trade.pdf](http://www.fsa.gov.uk/static/pubs/decisions/swift_trade.pdf)>.

<sup>461</sup> FCA News Release, "FCA fines US based oil trader US \$903K for market manipulation", 22 July 2013, online: <<https://www.fca.org.uk/news/fca-fines-us-based-oil-trader>> and FCA Final Notice, online <<https://www.fca.org.uk/static/documents/final-notices/coscia.pdf>> .

contracts for difference.<sup>462</sup>

- In 2005 the FSA fined Citigroup Global Markets Limited for manipulation of European government bonds<sup>463</sup>; and
- In 2011 the FSA fined an Indian businessman living in Dubai for manipulating the closing price of an instrument traded on the LSE to influence the payout he was due to receive on a structured product. The brokers who facilitated this manipulation were also fined.<sup>464</sup>

### Detection Methods

It appears that the main method of detection of market abuse used by the FSA between 2004 and 2013 was market surveillance. In 2007 and 2008 FSA reported that market surveillance activities were central to its efforts to combat market abuse and that it was enhancing its surveillance systems. In 2012, it also reported that it acquired software to enhance its technological intelligence based detection of market risks and abuse.<sup>465</sup>

Over the ten year period, like BaFin, it appears that suspicious transaction reports increasingly became an important detection method of market abuse for the FSA. In 2007 and 2008, the FSA reported that it was improving its system of collecting suspicious transaction reports by standardizing the form of reports as well as its capacity to exchange these reports with other European securities regulators.<sup>466</sup> Subsequently there was a steady increase in suspicious transaction reports in relation to both insider trading and market manipulation (Figure 3.9).

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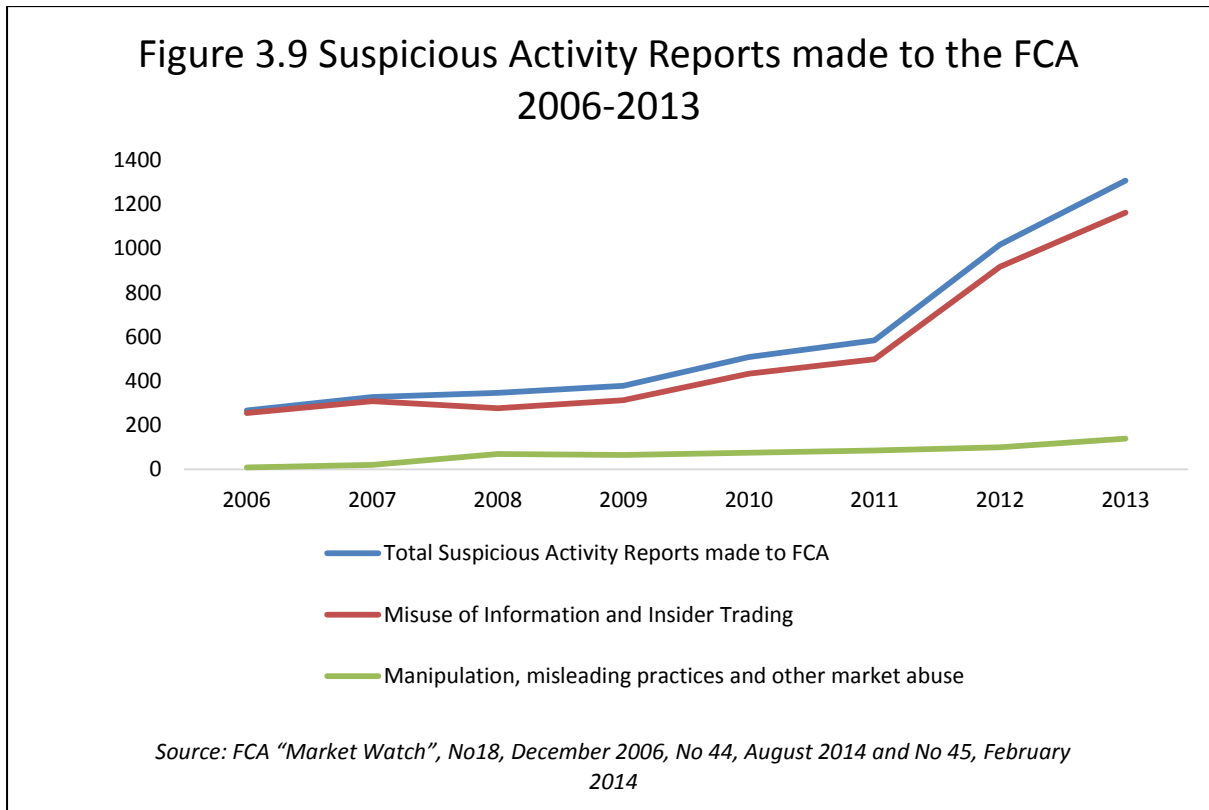
<sup>462</sup> FSA News Release, “FSA fines Robert Bonnier £290,000 and Indigo Capital £65,000 for Market Abuse” (21 December 2004), online: FSA <<http://www.fsa.gov.uk/pages/library/communication/pr/2004/110.shtml>>.

<sup>463</sup> FSA, News Release, “FSA fines Citigroup £13.9 million (\$20.9m) for Eurobond Trades” (28 June 2005), online: FSA <<http://www.fsa.gov.uk/library/communication/pr/2005/072.shtml>>.

<sup>464</sup> FSA, Final Notice, *Re Rameshkumar Goenka* (17 October 2011), online: <[http://www.fsa.gov.uk/pubs/final/rameshkumar\\_goenka.pdf](http://www.fsa.gov.uk/pubs/final/rameshkumar_goenka.pdf)>. FSA Final Notice *Re Tariq Carrimjee* (23 March 2013), online: <<https://www.fca.org.uk/static/decision-notice/tariq-carrimjee.pdf>>.

<sup>465</sup> FSA Annual Report 2012/13, *supra* note 453 at 40.

<sup>466</sup> FSA Annual Report 2006/07, *supra* note 451 at 18; FSA Annual Report 2007/08, online: <[http://www.fsa.gov.uk/library/corporate/annual/ar07\\_08.shtml](http://www.fsa.gov.uk/library/corporate/annual/ar07_08.shtml)> at 23.

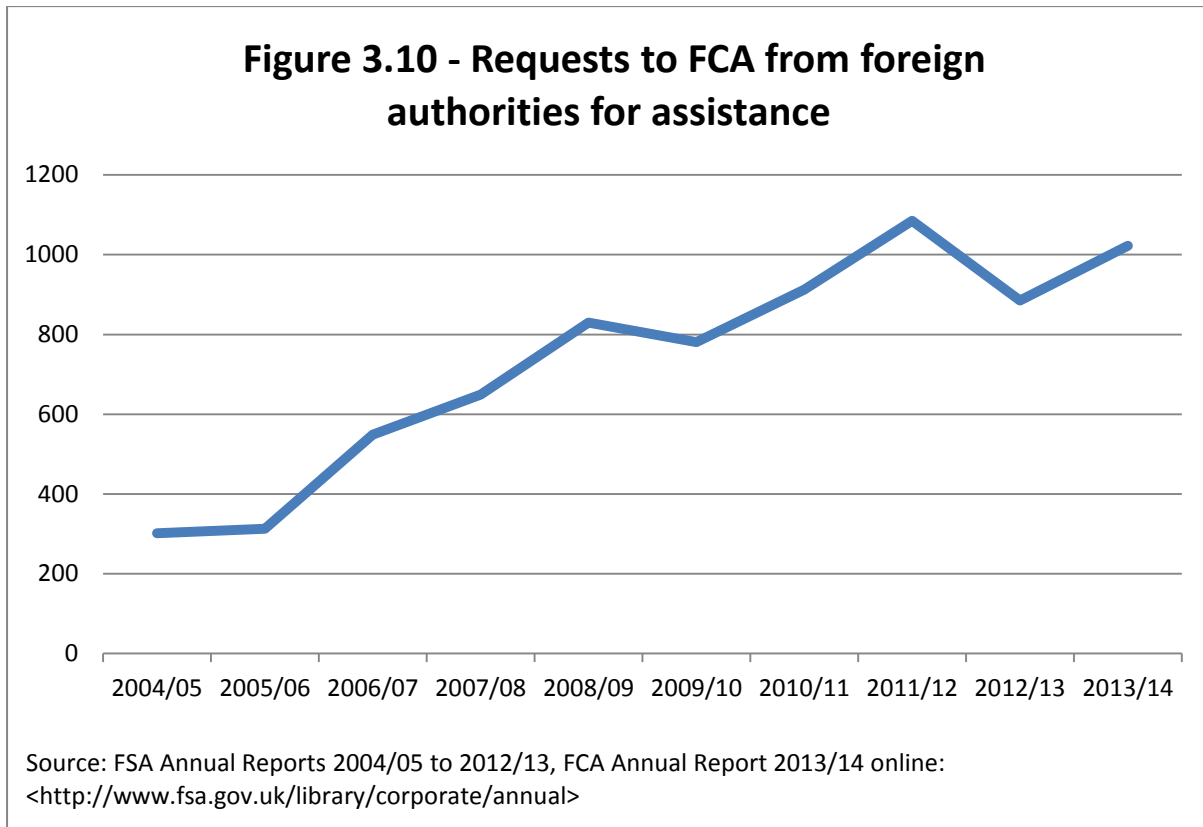


In addition the FCA also has a whistleblower program. In 2013 it reported that it received 6674 reports from whistleblowers. Out of these it opened cases in relation 1,040 reports.<sup>467</sup>

### **International Cooperation with Foreign Regulators**

Over the ten year period there was also an increase in requests by foreign regulators for assistance from the FSA although it is not clear how much of this was related to investigations in relation to cross border market abuse (Figure 3.10).

<sup>467</sup> FCA Annual Report 2013/14 *supra*, 227 at 38-41.



Answering these requests from foreign authorities seemed to absorb a significant amount of resources as in 2013/14 the FCA stated:

Over the last few years we have seen a steady increase in the number and complexity of international requests for assistance in enforcement-related matters, and we are expecting this trend to continue. In 2013/14, we received 1022 formal requests for assistance from our overseas counterparts in relation to their investigations. Increasingly these require more intensive assistance, e.g. through interviews as well as the more routine gathering of information and documents. We also dealt with many more requests though the criminal mutual legal assistance route.

We have also asked our counterparts overseas for assistance. This commonly involves locating and interviewing subjects of investigations, or possible witnesses, who may be residing outside the UK, and using the powers of overseas regulators to obtain documentation or information located abroad. Effective relationships with our overseas counterparts are vital in enabling us to deliver case outcomes and to meet our international obligations. Those day-to-day working relationships are enhanced through our participation in global committees such as the

International Organisation of Securities Commissions (IOSCO) and in the European Supervisory Authorities, notably the European Securities and Markets Agency (ESMA).<sup>468</sup>

There also seems to be a large imbalance in the number of requests the FSA received and the FCA receives far more requests than it makes.<sup>469</sup>

It also seems that the FCA is now more frequently engaged in parallel investigations. In its 2013/14 Enforcement Report it stated:

We have seen a steady increase in the number of cases we conduct in parallel with overseas regulatory authorities over the last few years as misconduct across borders becomes increasingly common. We have worked with the international regulatory community to build on existing relationships and expertise to work together to tackle misconduct that often crosses borders.<sup>470</sup>

#### Part 4 USA

The SEC takes a relatively large number of market abuse every year compared to other securities regulators. In 2004 the SEC initiated 42 insider trading matters involving a total of 95 individuals and respondents.<sup>471</sup> In 2013 this had increased to 58 insider trading matters.<sup>472</sup>

The SEC also does not separately report the number of cases that it investigates that involve cross border market abuse.<sup>473</sup> However, it has reported that there were more instances of investigations that required evidence to be obtained from outside of the US and that these investigations have increasingly become more complex over time. For example, in the 2004 Annual Report the SEC stated:

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<sup>468</sup> FCA Enforcement Report Account Performance Report 2013/2013, online: FCA <<https://www.fca.org.uk/static/documents/corporate/enforcement-annual-performance-account-13-14.pdf>> at 11.

<sup>469</sup> Section 169 of the *Financial Services and Markets Act 2000* sets out the obligations of the FCA to assist overseas regulators.

<sup>470</sup> FCA Enforcement Report 2013/14, online: FCA <<https://www.fca.org.uk/your-fca/documents/corporate/enforcement-annual-performance-account-13-14>> at 11.

<sup>471</sup> SEC Annual Report 2004, Appendix C, online <<http://www.sec.gov/about/secpar.shtml>>.

<sup>472</sup> SEC Annual Report 2013, Appendix B, online <<http://www.sec.gov/about/secpar/secpar2013.pdf#appendix>>.

<sup>473</sup> For a discussion on the extraterritorial reach of the Securities Exchange Act see Daniel E Herz-Roiphe, "Innocent abroad? Morrison, Vilar, and the extraterritorial application of the Exchange Act" (2014) 123(6) Yale LJ 1626.

The increasingly global nature of the capital markets has resulted in an increase in SEC cases with international elements, and has heightened the complexity of many SEC cases. Many SEC cases on which the Office of International Affairs assisted the Division of Enforcement involved complex factual scenarios, such as those presented by fraudulent boiler rooms operating across a range of international jurisdictions. Other cases posed challenging issues related to conflicts of law such as cross-border asset freezes or the production of foreign audit workpapers.<sup>474</sup>

Perhaps in partial response to this increasing complexity, the SEC in 2004 reported a large increase in funding for its activities and an increase in the number of employees. The SEC also made additional changes to the structure of its Division of Enforcement in 2007 and 2010 to target specific enforcement areas. In 2007 it set up a hedge fund unit to target insider trading by hedge funds. The work of this unit led to a number of insider trading charges involving hedge funds.<sup>475</sup> In addition, since 2010, the SEC has five specialized investigative units dedicated to high-priority areas of enforcement. One of these is a market abuse unit targeting high-volume and computer-driven trading strategies, large-scale insider trading by market professionals and others and market manipulation schemes.<sup>476</sup>

### **Cross Border Insider Trading**

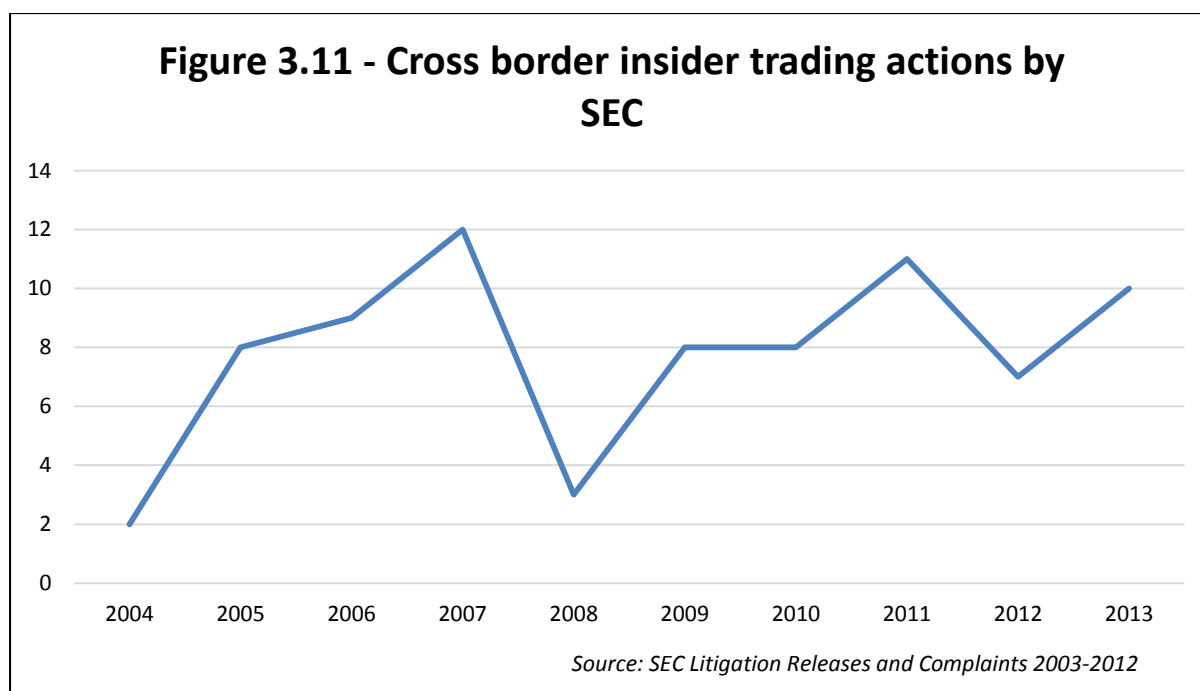
A review of SEC Complaints and Litigation Releases from 2004 to 2013 reveals no particular pattern in relation to the number of cross border insider trading enforcement actions that the SEC brings each year (Figure 3.11). It averaged 8 per year and varied from a low of two in 2004 to a high of 12 in 2007.

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<sup>474</sup> SEC Annual Report 2004, online: SEC <<http://www.sec.gov/about/secpar.shtml>> at 58.

<sup>475</sup> SEC Annual Report 2007, online: SEC <<http://www.sec.gov/about/secpar2007.shtml>> at 8.

<sup>476</sup> SEC Annual Report 2011, online: SEC <<http://www.sec.gov/about/secpar2011.shtml>> at 189.



#### a) Trading abroad or tipping of friends or relatives abroad

A large percentage of the cases of cross border insider trading over the period between 2004 and 2013 involved persons who obtained inside information whilst living within the US and either tipped relatives and/or friends abroad or traded in the names of these family or friends names in another country.<sup>477</sup> One of these is a case described in the 2011 Annual Report as follows:

<sup>477</sup> In 2005, see SEC, Litigation Release, *SEC v Zomax Inc et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/lr19262.htm>>; SEC, Complaint, *SEC v Loomans & Loomans*, online: SEC <<http://www.sec.gov/litigation/complaints/comp19075.pdf>>; SEC, Complaint, *SEC v Sudol et al*, online: SEC <<http://www.sec.gov/litigation/complaints/comp19162.pdf>>. In 2006, see SEC, Complaint, *SEC v Anticevic et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2006/comp19775.pdf>>, a case in which the trades came from persons located in Australia, China and Belgium; SEC, Complaint, *SEC v Obus et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2006/comp19667.pdf>>, a case in which some of the securities were distributed to a hedge fund in the Cayman Islands. In 2007, see SEC, Complaint, *SEC v Jennifer Wang et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20112.pdf>>. In 2008, see SEC, Complaint, *SEC v Kan King Wong et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2008/comp20447.pdf>>. In 2009, see SEC, Litigation Complaint, *SEC v Tang*, online: SEC <<http://www.sec.gov/litigation/complaints/2009/comp21271.pdf>>; SEC, Complaint, *SEC v Naseem*, online: SEC <<http://www.sec.gov/litigation/admin/2009/34-59367.pdf>>. In 2010, see SEC, Litigation Release, *SEC v Arnold McClellan and Annabel McClellan*, online: SEC <<http://www.sec.gov/litigation/litreleases/2010/lr21758.htm>>; SEC, Litigation Release, *SEC v Poteroba et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2010/lr21460.htm>>; SEC, Complaint, *SEC v Wyly et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2010/comp21607.pdf>>. In 2011, see SEC Complaint, *SEC v Andrew Liang et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp21987.pdf>>; SEC, Complaint, *SEC v George Holley et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp-2011-9.pdf>>; SEC, Litigation Release, *SEC v Cheng Yi Liang*, online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp21987.pdf>>; SEC Complaint, *SEC v Zizhong Fan et al*,



The Commission brought an action against Annabel McClellan, the wife of a former Deloitte Tax LLP partner, for repeatedly leaking confidential merger and acquisition information to family members in the UK. These family members traded in advance of seven deals worked on by Ms. McClellan's husband, netting nearly \$3 million for themselves (and approximately \$20 million for friends and clients). Ms. McClellan subsequently settled the Commission's action by agreeing to pay a \$1 million penalty, and, in a related criminal case, she pleaded guilty to obstruction of justice during the Commission's investigation. In a case of international cooperation, the UK Financial Services Authority filed charges against Ms. McClellan's family members for their role in the scheme. That case is pending.<sup>478</sup>

It seems that this was the same matter which was described in the 2012 FSA Annual Report as a successful case of a parallel investigation by the FSA, the SEC and the DOJ.<sup>479</sup>

#### **b) Individual outside US trading or tipping others to trade on US exchanges**

Another substantial category of matters were those in which an individual residing outside of the US became aware of inside information about corporations whose securities are traded on US exchanges and traded on this information or tipped others to trade on this information.<sup>480</sup> Typically these persons obtained inside information when a corporation with

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online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp21820.pdf>>. In 2012, see SEC, Litigation Complaint, *SEC v Timothy McGee et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2012/comp22288.pdf>>. In 2013 See SEC Litigation Release, 25 July 2013, "SEC Charges Former Portfolio Manager At S.A.C. Capital with Insider Trading", online: <<http://www.sec.gov/litigation/litreleases/2013/lr22761.htm>>.

<sup>478</sup> SEC Annual Report 2011, *supra* note 476 at 200.

<sup>479</sup> See FSA News Release, *supra* note 459.

<sup>480</sup> In 2004, see SEC, Litigation Release, *SEC v Levy et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/lr19217.htm>>; SEC, Litigation Release, *SEC v Kryzda* (on file), in which purchases were made from Panama and Mexico. In 2005, see SEC, Complaint, *SEC v Liang*, online: SEC <<http://www.sec.gov/litigation/complaints/comp19049.pdf>>. In 2006, see SEC, Complaint, *SEC v Cavallero et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2006/comp19731.pdf>>; SEC, Litigation Release, *SEC v Jeong*, online: SEC <<http://www.sec.gov/litigation/litreleases/lr19531.htm>>. In 2007, see SEC, Complaint, *SEC v Euro Security Fund et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20211.pdf>>; SEC, Litigation Release, *SEC v Suman et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2010/lr21419.htm>>; SEC, Complaint, *SEC v Shane Bashie Suman and Monie Rahman*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20203.pdf>>; SEC, Complaint, *SEC v Roman Filho*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20157.pdf>>; SEC, Complaint, *SEC v Azevedo*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20013apda.pdf>>; SEC, Litigation Release, *SEC v Suterwalla*, online: SEC <<http://www.sec.gov/litigation/litreleases/2008/lr20718.htm>>; SEC, Complaint, *SEC v Petco et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20224.pdf>>; SEC, Complaint, *SEC v Luiz Junior*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20013lmgj.pdf>>; SEC, Litigation Release, *SEC v Jones*

which they were involved made a takeover offer for a US corporation. For example, in its 2010 Annual Report, the SEC reported on the following matter:

In an expedited investigation spearheaded by the Division of Enforcement's Market Abuse Unit, the Commission swiftly charged two residents of Madrid, Spain with insider trading and obtained an emergency asset freeze. The residents made nearly \$1.1 million by trading while in the possession of material non-public information in advance of a public announcement of a multi-billion dollar tender offer by BHP Billiton Plc. to acquire Potash Corp. of Saskatchewan Inc. One of the defendants is the head of a research arm at Banco Santander, S.A., a Spanish banking

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and *Godden*, online: SEC <<http://www.sec.gov/litigation/litreleases/2007/lr20129.htm>>; SEC, Complaint, *SEC v Wagner*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20392.pdf>>. Three of these cases were of nationals of Brazil and related to the same takeover transaction. In 2008, see SEC, Complaint, *SEC v De Colli*, online: SEC <<http://www.sec.gov/litigation/complaints/2008/comp20581.pdf>>. In 2009, see SEC, Complaint, *SEC v Grmovsek*, online: SEC <<http://www.sec.gov/litigation/complaints/2009/comp21263.pdf>>; SEC, Complaint, *SEC v Kohler et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2009/comp21075.pdf>>; SEC, Complaint, *SEC v Benoit et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2009/comp21347.pdf>>; SEC, Complaint, *SEC v Stephanou et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2009/comp20884.pdf>>; SEC, Complaint, *SEC v MacDonald et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2009/comp21079.pdf>>; SEC, Complaint, *SEC v Al Hashemi*, online: SEC <<http://www.sec.gov/litigation/complaints/2009/comp21154.pdf>>. In 2010, see SEC, Litigation Release, *SEC v Di Nardo et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2011/lr21935.htm>>; SEC, Complaint, *SEC v Gianluca Di Nardo*, online: SEC <<http://www.sec.gov/litigation/complaints/2010/comp21687.pdf>>; SEC, Complaint, *SEC v Garcia and Sanchez*, online: SEC <<http://www.sec.gov/litigation/complaints/2010/comp-pr2010-153.pdf>>; SEC, Complaint, *SEC v Levinburg*, online: SEC <<http://www.sec.gov/litigation/complaints/2010/comp21405.pdf>>; SEC, Complaint, *SEC v Richard Verdiramo et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2010/comp21447.pdf>>. In 2011, see SEC, Litigation Release, *SEC v Re All Know Holdings Ltd et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2012/lr22508.htm>>; SEC, Complaint, *SEC v All Know Holdings Ltd et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp22194.pdf>>; SEC, Litigation Release, *SEC v Abatamarco*, online: SEC <<http://www.sec.gov/litigation/litreleases/2011/lr21980.htm>>; SEC, Litigation Release, *SEC v Phillip MacDonald et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2011/lr21807.htm>>; SEC, Litigation Release, *SEC v Kohler et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2011/lr21860.htm>>. In 2012, see SEC, Litigation Release, *SEC v Well Advantage Ltd et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2012/lr22428.htm>>; SEC, Litigation Release, *SEC v Guth*, online: SEC <<http://www.sec.gov/litigation/litreleases/2012/lr22374.htm>>; SEC, Litigation Release, *SEC v Siming Yang et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2012/lr22320.htm>>; SEC, Litigation Release, *SEC v Quorne Limited and Sarkesian*, online: SEC <<http://www.sec.gov/litigation/litreleases/2012/lr22312.htm>>; SEC, Complaint, *SEC v Peter Siris et al*, online: <<http://www.sec.gov/litigation/complaints/2012/comp-pr2012-146-2.pdf>>. In 2013 see SEC Press Release, *SEC v. Badin Rungruangnavarat*, September 5, 2013, online: <[www.sec.gov/News/PressRelease/Detail/PressRelease/1370539798614#Uj-NxoYjLmg](http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539798614#Uj-NxoYjLmg)>, SEC Complaint, *SEC v Chan Tze Ngo et al*, online: <<http://www.sec.gov/litigation/complaints/2013/comp-pr2013-200.pdf>>, SEC Complaint *SEC v David Marchant*, online: <<http://www.sec.gov/litigation/complaints/2013/comp22899.pdf>>, SEC Complaint, *SEC v Richard Bruce Moore*, online: <<http://www.sec.gov/litigation/complaints/2013/comp22674.pdf>>.

group advising BHP on its bid. In addition to the emergency relief, the Commission is seeking permanent injunctions, disgorgement and penalties. The SEC's investigation is continuing.<sup>481</sup>

In 2013 the SEC reported that it had criminally charged Cedric Cañas Maillard, who served as an executive advisor to Banco Santander's CEO, and a former judge in Spain with insider trading. It alleges that Maillard purchased Potash Corp. contracts-for-difference (CFDs), which were not traded in the U.S. but based on the price of U.S. exchange-listed Potash stock.<sup>482</sup> Interestingly the SEC is continuing to pursue these charges even though both were charged and cleared of insider trading arising out of the same events in Spain and neither is resident in the US.<sup>483</sup>

### **c) Insider Trading Schemes**

The majority of cross border insider trading cases did not involve a systematic scheme of insider trading with a large network of people but rather were more akin to opportunistic insider trading, whereby a person obtained inside information as a result of their position within a corporation or professional firm and, as a consequence, traded or tipped others. One exception was a matter in 2006 where the SEC took action against what it described as was a:

widespread and brazen international scheme of serial insider trading orchestrated by Plotkin, a former Associate in the Fixed Income Research division at Goldman Sachs Group ("Goldman Sachs"), and Pajcin, a former analyst at Goldman Sachs, resulting in at least \$6.8 million of illicit gains.<sup>484</sup>

Plotkin and Pajcin actively recruited individuals into the scheme who had access to price sensitive information that had not been made public. For example, one was an employee of

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<sup>481</sup> SEC Annual Report 2010, online: <<http://www.sec.gov/about/secpar2010.shtml>> at 159.

<sup>482</sup> SEC Litigation Release, 1 August 2013 "Sec Charges Two Traders in Spain with Insider Trading Ahead of BHP Acquisition Bid", online: <<http://www.sec.gov/litigation/litreleases/2013/lr22768.htm>>.

<sup>483</sup> C Penty "Ex-Santander Aide Cleared of Insider Trading by Spanish Court", 22 January 2014, Bloomberg Business, online: <<http://www.bloomberg.com/news/articles/2014-01-22/ex-santander-aide-cleared-of-insider-trading-by-spanish-court>> and C Brownell "Former Banco Santander executive indicted in U.S. for Potash Corp insider trading", National Post, 3 February 2015 online: <http://business.financialpost.com/news/fp-street/former-banco-santander-executive-indicted-in-u-s-for-potash-corp-insider-trading> .

<sup>484</sup> *SEC v Anticevic*, *supra* note 364.

a printing plant that printed a business newsletter. The scheme members tipped a number of individuals in a number of European countries, who received the tips in exchange for a percentage of the profits they made from trading based on this information.<sup>485</sup>

#### d) Purchase of Call Options

Another common category of cases were instances where there was a suspicious purchase of securities, often call options, made by an unidentified foreign entity immediately before a takeover offer. These purchases were made through brokers located in Europe, most commonly Switzerland.<sup>486</sup> For example, in 2008, the SEC sought the profits and a civil penalty against an unknown defendant who purchased call option contracts in DRS Technologies Inc. immediately prior to the announcement of a takeover offer for this corporation. In 2006 this same entity had also purchased call option contracts in another corporation traded on US exchanges, American Power Conversion Corp, again immediately prior to the announcement of a takeover offer for this corporation. Both purchases were made through an account at UBS in Zurich, Switzerland and resulted in a combined profit of \$3.3M.<sup>487</sup> In the case of some of these suspicious purchases of call options by unidentified

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<sup>485</sup> *Ibid.*

<sup>486</sup> In 2005, see SEC, Litigation Release, *SEC v Unknown purchasers of call options of Placer Dome Inc*, online: SEC <<http://www.sec.gov/litigation/litreleases/lr19457a.htm>>; SEC, Litigation Release, *SEC v Unknown purchasers of Invision Technologies Inc.*, online: SEC <<http://www.sec.gov/litigation/litreleases/lr18657.htm>>. In 2006, see SEC, Litigation Release, *SEC v Unknown call options in Petco Animal Supplies*, online: SEC <<http://www.sec.gov/litigation/litreleases/2006/lr19778.htm>>; SEC, Litigation Release, *SEC v Unknown call options of CNS*, online: SEC <<http://www.sec.gov/litigation/litreleases/2006/lr19867.htm>>; SEC, Litigation Release, *SEC v Unknown traders options of Ralston Purina Co*, online: SEC <<http://www.sec.gov/litigation/litreleases/2006/lr19594a.htm>>. In 2007, see SEC, Complaint, *SEC v One or More Unknown purchasers of call options for the common stock of TXU Corp et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20113.pdf>>. In 2008, see SEC, Complaint, *SEC v One or more unknown purchasers of Call options for the common stock of DRS Technologies*, online: SEC <<http://www.sec.gov/litigation/complaints/2008/comp20654.pdf>>. In 2010, see SEC, Litigation Release, *R v One or more unknown purchasers of Securities of Wimm-Bill-Dann Foods OJSC*, online: SEC <<http://www.sec.gov/litigation/litreleases/2010/lr21766.htm>>. In 2011, see SEC, Complaint, *Unknown Purchases of Securities of Global Industries, Ltd*, online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp22099.pdf>>; SEC, Litigation Release, *SEC v Compania International Financiera SA et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2011/lr22055.htm>>. In 2012 see SEC Complaint *SEC v Michel Terpins*, online: <<http://www.sec.gov/litigation/complaints/2013/comp-pr2013-219.pdf>>, SEC Complaint *SEC v One or More Unknown Traders in the securities of Onyx Pharmaceuticals, Inc* online: <<http://www.sec.gov/litigation/complaints/2013/comp-pr2013-123.pdf>>, SEC Complaint *SEC v Certain Unknown Traders in the Securities of H.J. Heinz Company* <<http://www.sec.gov/litigation/complaints/2013/comp-pr2013-24.pdf>>.

<sup>487</sup> *SEC v One or more unknown purchasers of Call options for the common stock of DRS Technologies*, *supra* note 486.

foreign entities, it appears that the SEC did pursue the name of the beneficial owners from the authorities in the jurisdictions where the call options were purchased and then took enforcement action against these persons.<sup>488</sup> For example, in the DRS and American Power Conversion case, the SEC later discovered from the Swiss authorities that the purchasers were three Italian citizens. These individuals subsequently agreed to disgorge the profits from their trading and pay a civil penalty to the SEC.<sup>489</sup>

#### e) Computer Hacking

During the ten year period, the SEC also took enforcement action in several cases that involved trading on information that was stolen through computer hacking.<sup>490</sup> For example, in one case an Estonian national hacked into a news wire service that distributed press releases in relation to listed corporations and on multiple occasions traded in the securities of the corporations before these press releases were made public.<sup>491</sup>

#### f) Use of Offshore Financial Centres

The use of accounts in offshore financial centres was common in many of the detected cases of cross border insider trading actioned by the SEC over the ten year period. Again these jurisdictions were probably used in an attempt to conceal the activity from the authorities. In addition to the purchase of call option contracts through Switzerland, frequently perpetrators used corporations incorporated in the British Virgin Islands.<sup>492</sup>

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<sup>488</sup> See e.g. *SEC v Unknown call options in Petco Animal Supplies*, *supra* note 480, and then later case of *SEC v Taher Suterwalla*, SEC, Litigation Release, online: SEC <<http://www.sec.gov/litigation/litreleases/2008/lr20718.htm>>; SEC, Complaint, *SEC v One or more unknown purchasers for the common stock of Petco Animal Supplies Inc and Taher Suterwalla*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20224.pdf>>.

<sup>489</sup> See *SEC v Gianluca Di Nardo*, *supra* note 480.

<sup>490</sup> See SEC, Complaint, *SEC v Blue Bottle Limited and Stokes*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20018.pdf>>; SEC, Litigation Release, *SEC v Oleksandr Dorozhko*, online: SEC <<http://www.sec.gov/litigation/litreleases/2010/lr21465.htm>>; SEC, Complaint, *SEC v Olexsandr Dorozhko*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20349.pdf>>.

<sup>491</sup> SEC, Litigation Release, *SEC v Lohmus Haavel & Viisemann, et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2007/lr20134.htm>>; SEC, Litigation Release, *SEC v Lohmus Haavel & Viisemann, et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2006/lr19810.htm>>; SEC, Complaint, *SEC v Lohmus Haavel & Viisemann, et al*, online: SEC <<http://www.sec.gov/litigation/complaints/comp19450.pdf>>.

<sup>492</sup> For example, in 2011, two insider trading cases involved the use of British Virgin Islands companies *SEC v Re All Know Holdings Ltd et al*, *supra* note 480; SEC, Litigation Release, *SEC v Onele Trading & Finance Ltd*,

A striking example of the use of offshore financial centres in an attempt to disguise insider trading is the case of *SEC v Samuel Wylly et al.* In that case two directors of a number of public companies listed on the New York Stock Exchange traded whilst in possession of inside information and used what the SEC described in its complaint as follows:

The apparatus of the fraud was an elaborate sham system of trusts and subsidiary companies located in the Isle of Man and the Cayman Islands (collectively hereinafter the “Offshore System”) created by and at the direction of the Wyllys. The Offshore System enabled the Wyllys to hide their ownership and control of the Issuers’ securities (hereinafter “Issuers Securities”) through trust agreements that purported to vest complete discretion and control in the offshore trustees. In actual fact and practice, the Wyllys never relinquished their control over the Issuer Securities and continued throughout the relevant time period to vote and trade these securities at their sole discretion.<sup>493</sup>

#### **g) Protecting the Integrity of non-US markets**

Almost universally the cases of cross border insider trading in which the SEC took action were ones in which the activity somehow threatened the integrity of the US markets, either directly because it involved trading on US markets, or because it indirectly impacted the integrity of US markets, if, for example, the underlying economic interest was US securities. One exception was a case in 2012 in which the SEC took action against a US based hedge fund manager who manipulated the price of two Chinese bank stocks listed on the Hong Kong stock exchange. In this case the activities of the hedge fund manager seemed to have no impact on US markets but threatened the integrity of the Hong Kong stock market.<sup>494</sup>

#### **Cross Border Market Manipulation**

A review of SEC Litigation Releases and complaints revealed that there were no cases of

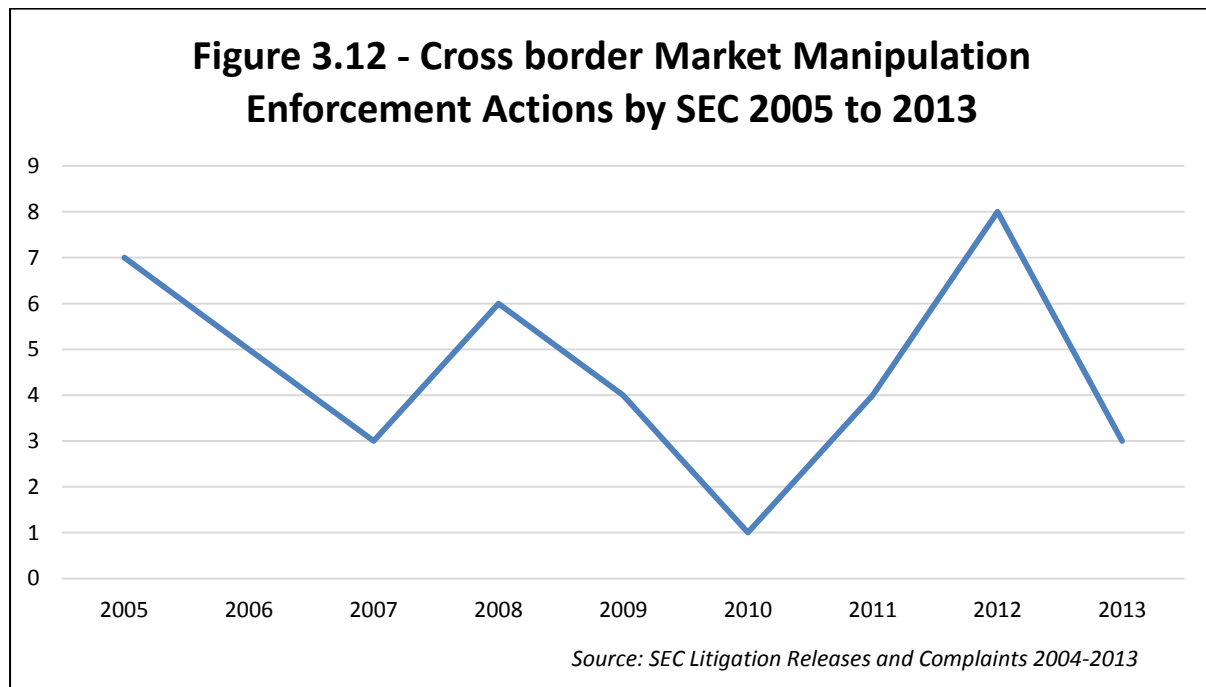
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online: SEC <<http://www.sec.gov/litigation/litreleases/2011/lr22055.htm>>. In 2012 the SEC took action in another two cases which involved use of British Virgin Islands companies See *SEC v Siming Yang, et al, supra* note 480; *SEC v Quorme Limited and Michael Sarkesian, supra* note 480. In 2013 see SEC Complaint, *SEC v Jing Wang & Gary Yin*, online: <<http://www.sec.gov/litigation/complaints/2012/comp22807.pdf>>.

<sup>493</sup> *SEC v Wylly, supra* note 477.

<sup>494</sup> SEC, Litigation Release, *SEC v Tiger Asia Management Llc et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2012/lr22569.htm>>.

cross border manipulation taken by the SEC in 2004. From that time the number of cases averaged 5 with a high of 8 cases in 2012 and a low of one case in 2010 (Figure 3.12).



### a) Pump & Dump Schemes in Penny Stock Markets

Throughout the years from 2005 to 2013 the vast majority of cases of cross border market manipulation were ‘pump and dump’ schemes of illiquid securities quoted on the lightly regulated markets or ‘penny stock’ markets, in particular the OTC Bulletin Board (OTCBB) and the Pink Sheets.<sup>495</sup> It was also not uncommon for the perpetrators of these schemes to

<sup>495</sup> In 2005, see SEC, Litigation Release, *SEC v Exotics.com Inc et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2006/lr19699.htm>>; SEC, Complaint, *SEC v Exotics.com Inc et al*, online: SEC <<http://www.sec.gov/litigation/complaints/comp19207.pdf>>; SEC, Litigation Release, *SEC v Zinn et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/dec19498.pdf>>; SEC, Litigation Complaint, *SEC v Jessop et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/lr19481.htm>>; SEC, Litigation Release, *SEC v Save the World Air, Inc et al*, online : SEC <<http://www.sec.gov/litigation/litreleases/lr17283.htm>>; SEC, Litigation Complaint, *SEC v Concorde America Inc et al*, online: SEC <<http://www.sec.gov/litigation/complaints/comp19085.pdf>>; SEC, Litigation Release, *SEC v Wolfson et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/lr19201.htm>>; SEC, Litigation Release, *SEC v Healy et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/lr16952.htm>>. In 2006, see SEC, Complaint, *SEC v Fisse and Dohertyl*, online: SEC <<http://www.sec.gov/litigation/complaints/2006/comp19902.pdf>>; SEC, Litigation Release, *SEC v Bauer*, online: SEC <<http://www.sec.gov/litigation/litreleases/lr19563.htm>>; SEC, Litigation Release, *SEC v Garcia*, online: SEC <<http://www.sec.gov/litigation/admin/2006/34-54116.pdf>>; SEC, Litigation Release, *SEC v Sheptycki*, online: <<http://www.sec.gov/litigation/litreleases/lr19575.htm>>. In 2007 see SEC Complaint, *SEC v Brian N Lines et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20407-lines.pdf>>; SEC, Litigation Release, *SEC v Brian*

use accounts or corporations located in offshore financial centres, such as the British Virgin Islands, Anguilla, the Bahamas and Turks and Caicos presumably in an endeavour to avoid detection by US regulators.<sup>496</sup>

These 'pump and dump' schemes took a variety of forms but typically followed the pattern of a person taking a large stake in the target company and then 'pumping' the securities by way of promoting the corporation in internet postings and/or igniting interest via wash sales and matched orders. For example, in the case of *SEC v Jessop et. al* the SEC took action in relation to the unlawful manipulation of the common stock of Cameron International, Inc. ("Cameron"), a small and thinly-traded purported marketing firm quoted on the OTCBB. The manipulation drove the share price from pennies to \$90 per share in a two month period, even though there was no significant news concerning the company. Cameron was described in the SEC's complaint as being a tiny company with virtually no assets or business operations. Its last quarterly accounts before the complaint was filed showed that

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*N Lines et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2007/lr20407.htm>>. In 2008, see SEC, Complaint, *SEC v Homeland Safety International et al*, online : SEC <<http://www.sec.gov/litigation/litreleases/2008/lr20645.htm>>; SEC, Complaint, *SEC v Simmons et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2008/lr20572.htm>>; SEC, Complaint, *SEC v Absolute Future et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2008/lr20560.htm>>; SEC, Complaint, *SEC v Grossman et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2008/lr20776.htm>>. In 2009, see SEC, Litigation Complaint, *SEC v Georgiou*, online: SEC <<http://www.sec.gov/litigation/complaints/2009/comp20899.pdf>>; SEC, Complaint, *East Delta Resources Corp et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2010/comp21395.pdf>>; SEC, Litigation Release, *East Delta Resources Corp et al*, online : SEC <<http://www.sec.gov/litigation/litreleases/2012/lr22561.htm>>. In 2011, see SEC, Complaint, *SEC v. Ficeto et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp21865.pdf>>; SEC, Complaint, *SEC v Curshen et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp21862.pdf>>; SEC, Complaint, *SEC v Baldassarre et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp22182.pdf>>; SEC, Complaint, *SEC v Metcalf et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp21824.pdf>>; SEC, Complaint, *SEC v Narwal et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2011/comp21861.pdf>>. In 2012, see SEC, Litigation Release, *SEC v Coldicutt et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2012/comp22445.pdf>>; SEC Litigation Release, *SEC v Geranio et al*, online: SEC <<http://www.sec.gov/litigation/complaints/2012/comp-pr2012-93.pdf>>, SEC Complaint, *SEC v Axius et al*, online : <<http://www.sec.gov/litigation/complaints/2012/comp22410.pdf>> , SEC Complaint *SEC v Thomas Edward Hunter et al*, online: <<http://www.sec.gov/litigation/complaints/2012/comp-pr2012-72.pdf>> . In 2013 see SEC Complaint *SEC v Randy A Hamdan et al*, online: <<http://www.sec.gov/litigation/complaints/2013/comp22892.pdf>>, SEC Complaint *SEC v Carrillo Huettel LLP*, online: <<http://www.sec.gov/litigation/complaints/2013/comp-pr2013-39.pdf>> and SEC Complaint, *SEC v Colin McCabe*, online: <<http://www.sec.gov/litigation/complaints/2013/comp22632.pdf>>.

<sup>496</sup> See e.g. *SEC v Jessop et al*, *supra*, note 495; SEC, Litigation Release, *SEC v The Rockies Funds Inc, et al*, online: SEC <[http://www.sec.gov/litigation/opinions/34-48590\\_appeal.pdf](http://www.sec.gov/litigation/opinions/34-48590_appeal.pdf)>; *SEC v Garcia*, *supra* note 380; SEC, Litigation Release, *SEC v AutoChina International Limited et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2012/lr22326.htm>>.



the company reported assets of \$1,395 and had incurred losses of \$2,396 for the previous six month period.<sup>497</sup>

The manipulation was described in the SEC's complaint as follows:

From August 29, 2005 through November 3, 2005, the Defendants, whose trading comprised the majority (and on many days all) of the retail trades in Cameron, effected the manipulation of Cameron's stock price through a series of wash sales and matched orders designed to create a false or misleading appearance of an active and rising market in Cameron and induce others to purchase or sell Cameron shares. As a result of their manipulative trading, Defendants collectively realized net proceeds totaling more than \$1.5 million.<sup>498</sup>

The defendants in this matter were Peter Jessop who was a Canadian citizen residing in Geneva, Switzerland, Steven Wright, an accountant residing in California and Shawn Cassius who also resided in California. This was also not the first time the SEC had taken action against Steven Wright, the SEC noting in its complaint that "in 2003, Wright was sued by the Commission in connection with a similar "shell factory" manipulation scheme".<sup>499</sup> The corporations used to effect the wash sales and matched orders included an entity incorporated in the British Virgin Islands and operating out of Geneva, Switzerland, an entity located in Geneva, Switzerland, a Belize corporation operating out of Nassau, Bahamas and a Belize corporation operating out of Dubai.<sup>500</sup>

Although typically in such pump and dump schemes misleading information is published on the internet via company websites, blogs and other websites which publish stock market information, the SEC reported that in one case fraudulent information was touted by a Canadian couple through the use of Facebook and Twitter.<sup>501</sup>

It appears that over the ten year period between 2004 and 2013 these pump and dump manipulation schemes detected and prosecuted by the SEC gradually became more

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<sup>497</sup> *SEC v Jessop et al*, *supra* note 495.

<sup>498</sup> *Ibid.*

<sup>499</sup> *Ibid*

<sup>500</sup> *Ibid.*

<sup>501</sup> SEC Annual Report 2010, *supra* note 481 at 160.

complex and increasingly sophisticated. For example, in 2011 the SEC took enforcement action against Jonathan Curshen who ran a Costa Rican asset protection company called Red Sea Management Limited ('Red Sea'). The SEC complaint described Curshen as "a recidivist securities law violator". In the same action, the SEC also brought proceedings against two co-accused, David Ricci and Ronny Salazar. Ricci is a Canadian citizen who resided in Costa Rica and was the head trader for Sentry Global Securities Ltd ('Sentry Global'), a broker-dealer licensed by St. Kitts and Nevis and affiliated with Red Sea. Salazar is a dual US and Costa Rican citizen who also resided in Costa Rica and shared trading responsibilities with Ricci at Sentry Global.

The complaint alleged that:

On behalf of its clients, Red Sea incorporated shell corporations, established virtual offices for the shell corporations, and opened bank accounts for the shell corporations in countries such as the Republic of Seychelles, Cyprus, Panama and Tanzania. Another service that the firm provided was to effect pump-and-dump schemes for its clients using a Byzantine trading and money-laundering structure designed to avoid detection by criminal and regulatory authorities. This structure included a labyrinth of nominee brokerage, custodial and foreign bank accounts.

To perpetrate the pump-and-dump schemes, Red Sea required its clients to obtain control over all the free-trading stock of their issuers and to deposit it in the Red Sea nominee brokerage accounts. Controlling the float of the stock enabled Red Sea, in the persons of Ricci and Salazar, to dominate the market and manipulate the stock's price. By using the names of nominees in opening its brokerage accounts, Red Sea concealed from the broker dealers its beneficial ownership of the accounts. And by trading through numerous nominee accounts, Red Sea created the false impression that unrelated parties were buying and selling the stock and that the market was deeper than it actually was.

In October 2006, Red Sea operated approximately 54 brokerage accounts in the names of 20 nominee shell corporations with 26 brokerage firms in the U.S. and Canada. Curshen supervised the formation of the nominees and the opening of the accounts. He changed the brokerage

account structure as needed to hide the link between the accounts that he believed were known to government authorities and new accounts that Red Sea had opened to carry on the business.

...

In August 2006, Curshen ordered a Red Sea employee named Joseph Francis, Jr. to open a bank account in the name of Sentry Global at HSBC Bank in Vancouver, British Columbia. Francis represented to HSBC that the money that would be flowing in and out of the account would be personal trading proceeds. In reality, Red Sea used the HSBC account to wire proceeds from the sales of client's stocks to locations outside of the United States.....

From November 2, 2006 through September 28, 2007, Red Sea wired \$90.8 million into the HSBC account and \$91.5 million out to accounts around the world in the names of different individuals and entities... Of the \$90.8 million that was wired into the account, more than \$76.8 million originated from trading in Red Sea nominee brokerage accounts... On information and belief, most of this money consisted of trading proceeds from pump and dump schemes perpetrated by Red Sea on behalf of its clients.

The actual subject of the complaint was a pump and dump scheme in relation to a corporation, CO2 Tech, which was quoted on Pink Sheets. The scheme was conducted on behalf of two clients, one of whom was a resident of Israel. CO2 supposedly had its headquarters in London, while its operations were purportedly based in Israel. Material false and misleading information about the corporation was disseminated in press releases and on its website. Ricci and Salazar then executed matched orders with Red Sea's nominee brokerage accounts in order to 'jump-start' the market and increase the price of the stock. Given the international nature of the scheme the SEC noted that it had been assisted in its investigation by the Costa Rican Police, the BCSC, the Israel Securities Authority, the FSA and The City of London Police.<sup>502</sup>

Also in 2011 the SEC took enforcement action in another complex cross border pump and dump manipulation scheme. In *SEC v Ficeto et. al*, the SEC prosecuted Todd Ficeto, Florian Homm and Colin Heatherington for a sophisticated multi-year pump and dump manipulation

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<sup>502</sup> *SEC v Curshen et al, supra*, note 495.

scheme involving wash sales, matched orders and marking the close on multiple corporations quoted on OTCBB and Pink Sheets. The manipulation was undertaken to overstate the performance and net asset value of a number of hedge funds managed by Absolute Capital Management Holdings (ACMH), a London based hedge fund management company organised under the laws of the Cayman Islands. Ficeto was based in the US. Homm was a resident of Majorica, Spain and at the time of the SEC's complaint his whereabouts were unknown. Homm had previously been fined by BaFin for publishing false statements about a company and failing to declare self interest in research reports. Heatherington was a resident of Victoria, BC, Canada and was a trader for ACMH. He also controlled a British Virgin Islands entity which made a number of the trades.

Ficeto and Homm were co-owners of a registered broker-dealer located in Beverly Hills, California. Homm was the co-founder and a chief investment adviser for ACMH which managed eight equity hedge funds, all domiciled in the Cayman Islands that purportedly had \$2.1 billion in assets under management. The scheme used clients' funds to conduct the manipulative trading and caused the defendants to make at least \$63.7 million in illicit proceeds. The majority of the proceeds made from the scheme were transferred to Swiss and Canadian bank accounts. The defendants also used a secret instant message system that allowed the traders to freely talk without fear that their scheme would be discovered by the SEC or FINRA. It appears that the scheme was not uncovered until 2007 when Homms resigned from ACMH and it was discovered that ACMH investors held between \$440 and \$520 million in illiquid positions in US penny stocks. Because of the involvement of Canadian individuals, the SEC worked with the BCSC in this matter.<sup>503</sup>

#### **b) Pump & Dump and Computer Hackers**

Computer hackers also featured in relation to some of the cross border market manipulation matters brought by the SEC in the ten year period from 2004 to 2013. From 2008 to 2012 the SEC prosecuted a number of cases where the perpetrator had hacked into online

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<sup>503</sup> *SEC v Ficeto et al, supra*, note 495.

brokerage accounts, sold off existing securities and used the funds to conduct a pump and dump scheme usually in illiquid securities. After the scheme was complete the online account was left holding only illiquid securities of almost no value. The perpetrators of these schemes were located in India, China, Russia and Latvia.<sup>504</sup> In one case, prosecuted in 2012, in addition to hacking into online accounts, the defendant also used direct market access to trade securities. This case was described in the SEC 2012 Annual Report as follows:

In late January, the SEC charged a trader in Latvia for conducting a widespread online account intrusion scheme in which he manipulated the prices of more than 100 NYSE and Nasdaq securities and caused more than \$2 million in harm to customers of U.S. brokerage firms. The SEC also instituted related administrative proceedings against four electronic trading firms and eight executives charged with enabling the trader's scheme by allowing him anonymous and unfiltered access to the U.S. markets. According to the SEC's complaint, Igors Nagaicevs broke into online brokerage accounts of customers at large U.S. broker-dealers and drove stock prices up or down by making unauthorized purchases or sales in the hijacked accounts. This occurred on more than 150 occasions over the course of 14 months. Nagaicevs – using the direct, anonymous market access provided to him by various unregistered firms – traded those same securities at artificial prices and reaped more than \$850,000 in illegal profits.<sup>505</sup>

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<sup>504</sup> See SEC, Litigation Release, *SEC v One or More Unknown Traders in the Common Stock of Certain Issuers, Defendants, and JSC Parex Bank, Relief Defendant*, online: SEC <<http://www.sec.gov/litigation/litreleases/2007/lr20030.htm>>; SEC, Complaint, *SEC v One or More Unknown Traders in the Common Stock of Certain Issuers, Defendants, and JSC Parex Bank, Relief Defendant*, online: SEC <<http://www.sec.gov/litigation/complaints/2007/comp20030.pdf>>; SEC, Complaint, *SEC v Marimuthu et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2007/lr20037.htm>>; SEC, Complaint, *SEC v Butko*, online: SEC <<http://www.sec.gov/litigation/litreleases/2008/lr20675.htm>>; SEC, Complaint, *SEC v Pointer Worldwide Ltd et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2009/lr21122.htm>>; SEC, Complaint, *SEC v BroCo Investments Inc and Maltsev*, online: SEC <<http://www.sec.gov/litigation/complaints/2010/comp21452.pdf>>.

<sup>505</sup> SEC Annual Report 2012, online: SEC <<https://www.sec.gov/about/secsafr2012.shtml>> at 129. See also SEC, Complaint, *SEC v Nagaicevs et al*, online: SEC <<http://www.sec.gov/litigation/admin/2012/34-66248.pdf>>; SEC, Complaint, *SEC v Nagaicevs*, online: SEC <<http://www.sec.gov/litigation/complaints/2012/comp22238.pdf>>; SEC, Litigation Release, Administrative Proceedings File No 3-14720, online: SEC <<http://www.sec.gov/litigation/admin/2012/34-66249.pdf>>; SEC, Litigation Release, Administrative Proceedings File No 3-14718, online: SEC <<http://www.sec.gov/litigation/admin/2012/34-66247.pdf>>; SEC, Litigation Release, Administrative Proceedings File No 3-14719, online: SEC <<http://www.sec.gov/litigation/admin/2012/34-66248.pdf>>.

The Latvian trader was granted direct market access through a US entity called Mercury Capital (“Mercury”). Whilst Mercury was not registered, it had been given direct market access by registered brokers. Mercury also maintained an independent contractor agreement with a Canadian entity that solicited day traders from around the world through its website and referred traders to Mercury who then gave them direct market access. The SEC complaint in the matter stated that approximately 100 traders who had been referred by the Canadian entity were given direct market access by Mercury, and traded through its account.<sup>506</sup>

### **c) Manipulation in larger US Markets**

Detection of cross border market manipulation of larger US markets was less common but in two cases the SEC did take enforcement action in relation to cross border manipulation of securities listed on NASDAQ. In 2006 the SEC took action in relation to a stock manipulation scheme whereby shares in a company called China Energy Technology Inc. were gifted to a large number of entities to enable it to have the required number of shareholders to obtain a NASDAQ listing. The defendants then engaged in a pump and dump scheme in relation to the stock and issued false press releases and engaged in artificial transactions to increase its share price. The majority shareholder was New Solomon Consultants, a corporation formed under the laws of the British Virgin Islands but operating out of Hong Kong. After the share price rose New Solomon proceeded to sell its shares, which generated a profit of US\$17 million. New Solomon Consultants was controlled by a number of individuals who were resident in Hong Kong or the People’s Republic of China. A number of other individuals, all of whom were also resident in Hong Kong or the People’s Republic of China, also participated in the scheme.<sup>507</sup>

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<sup>506</sup> *Ibid.*

<sup>507</sup> SEC, Complaint, *SEC v China Energy Savings Technology Inc et al*, online: SEC <<https://www.sec.gov/litigation/complaints/2006/comp19933.pdf>>; SEC, Litigation Release, *SEC v China Energy Savings Technology Inc et al*, online: SEC <<http://www.sec.gov/litigation/litreleases/2006/lr19933.htm>>.

Another matter, which involved the manipulation of securities listed on NASDAQ, was a case in 2012 in which the SEC took action in relation to the manipulation of a company called AutoChina International Ltd. In this matter a director of the company manipulated the price of the stock because the corporation had been refused a loan secured by stock because of low trading volumes. The defendant and all of the other major participants in the scheme were based in the People's Republic of China. The defendants utilized accounts in their own names and in the names of British Virgin Island companies that they controlled to conduct wash trades and matched orders between accounts on E\*Trade and accounts held at a broker in Hong Kong.<sup>508</sup>

#### **d) Layering & High Frequency Trading**

Towards the end of the ten year period, the SEC brought two cases involving the manipulation of markets utilizing the practice of spoofing, layering and quote stuffing by foreign traders who had direct market access. In the matter of *SEC v Biremis Corp et al* the SEC took action against Biremis Corp a registered US broker and its principals, Peter Beck and Charles Kim. Peter Beck is the same individual who was associated with Swift Trade, the corporation which the FSA fined for market manipulation.

Biremis Corp was originally formed as a US corporation but became a Canadian corporation in 2011 and then an Anguillan corporation in 2012. It listed its principal place of business as an address in Boston, but that address was a commercial business service which received and forwarded Biremis Corp's mail to its actual place of business in Toronto. Biremis Corp had no employees, operations, books or records in the United States. Biremis Corp allowed entities to open and operate trading floors with access to securities markets worldwide, including direct market access into the US markets. To open a trading floor, the operator entered into a market access agreement with Opal Stone Financial Services, S.A., a corporation incorporated in Uruguay and domiciled in Costa Rica. The SEC complaint stated that at various times, the Biremis business had as many as 200 different trading floors in

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<sup>508</sup> *SEC v AutoChina International Limited et al, supra*, note 496.

over 30 nations, including Canada, Russia, Bangladesh, Nigeria, Venezuela, and Uzbekistan, with the majority located in China. None of these trading floors were located in the United States. Some of the individuals who owned or managed these trading floors recruited overseas traders who traded on the trading floors. The SEC complaint alleged that hundreds of the overseas traders, on at least ten different trading floors associated with Biremis, engaged repeatedly in layering manipulations on U.S. securities markets. These orders sent false signals to the market regarding the supply and demand for such securities.<sup>509</sup>

In similar case the SEC took action against another US registered broker dealer, Hold Brothers Online Investment Services LLC. Hold Brothers allowed overseas traders, principally from China, direct access into U.S. markets. These overseas traders engaged in manipulative trading, typically layering or spoofing, in US listed and over the counter stocks. Furthermore, the principals of Hold Brothers created and founded two foreign companies: Alpha, which was incorporated in Nevis; and Demostrate, which was incorporated in the British Virgin Islands. Principals of Hold Brothers shared in the trading profits of these companies. The SEC's complaint alleged that during the period the subject of the complaint, overseas traders trading for Demostrate engaged in layering by entering into more than 325,000 layered transactions, which corresponded to the entry of more than 8 million layered orders. The two Demostrate trading groups that engaged in the most layering were also the most profitable, cumulatively making the owners of Demostrate approximately US\$1.8 million in trading revenue.<sup>510</sup>

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<sup>509</sup> SEC, Complaint, *SEC v Biremis Corp et al*, online: SEC <<http://www.sec.gov/litigation/admin/2012/34-68456.pdf>>. The SEC Complaint also notes that in 2011, the United Kingdom Financial Services Authority found Biremis affiliate Swift Trade, Inc. to have committed market abuse through layering on the London Stock Exchange and fined it GBP 8 million. In 2012, the Ontario Securities Commission ("OSC") found Biremis, Swift Trade, Inc. and four other securities businesses affiliated with Biremis, Beck or Beck's family trust jointly and severally liable for financial management deficiencies, trade review deficiencies, books and records violations, and non-compliance with dealer registration requirements under the Ontario Securities Act. The OSC also barred Biremis and Swift Trade from trading or acquiring securities in Ontario for six years. See also *In the matter of Peter Beck et al*, online: <[https://www.osc.gov.on.ca/documents/en/Proceedings-SET/set\\_20120620\\_beckp.pdf](https://www.osc.gov.on.ca/documents/en/Proceedings-SET/set_20120620_beckp.pdf)>.

<sup>510</sup> SEC, Litigation Release, *SEC v Hold Brothers On-Line Investment Services, LLC et al*, online: SEC <<http://www.sec.gov/litigation/admin/2012/34-67924.pdf>>.



## Detection and Investigation Methods

It seems that Market surveillance remained the principal method of detection of cross border market abuse throughout the ten year period. However, towards the end of the period it appears that more resources were committed to collecting and analysing voluntary reports of suspicious transactions, including suspected market abuse. In 2010, the SEC established a separate Office of Market Intelligence to serve as a central office for handling tips, complaints, and referrals. This office was designed to deal with what was described as a “huge volume of potential leads the agency receives every day”.<sup>511</sup> This Office was also designed to house the new whistleblower office created by the *Dodd-Frank Wall Street Reform and Consumer Protection Act*.<sup>512</sup>

In 2012, the first full year of this paid whistleblower program, the SEC received 3001 tips.<sup>513</sup> In 2013 it received 3238 tips.<sup>514</sup> The 2012 SEC annual report stated that “Enforcement is receiving many excellent tips through the Whistleblower Program, resulting in significant savings in investigative resources and time”<sup>515</sup> In 2013 525 tips were in relation to manipulation and 196 were in relation to insider trading. Also in 2013 404 tips were received from foreign countries. Of the 55 foreign countries which were the source of tips, the majority were from the UK, Canada, Russia and China.<sup>516</sup>

In terms of investigation methods a novel investigation technique used by the SEC in relation to cross border market manipulation was that the SEC worked with the FBI to use co-operators, that is others accused of criminal behaviour, to go undercover to gather direct evidence of the manipulation. One such case was the case of *SEC v Georgiou*. Georgiou was a Canadian national who, from 2004 through September 2008, controlled the publicly-

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<sup>511</sup> SEC Annual Report 2010, *supra* note 481 at 11.

<sup>512</sup> See *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub L No 11-203 § 922(a), 121 Stat 1894 (2010), which inserted a new § 21F into the *Securities Exchange Act*.

<sup>513</sup> See SEC, “Annual Report on the Dodd-Frank Whistleblower Program Fiscal Year 2012” (November 2012), online: SEC <<http://www.sec.gov/whistleblower/reportspubs/annual-reports/annual-report-2012.pdf>>

<sup>514</sup> See SEC, “Annual Report on the Dodd-Frank Whistleblower Program Fiscal Year 2013” online: SEC <<https://www.sec.gov/about/offices/owb/annual-report-2013.pdf>>.

<sup>515</sup> SEC Annual Report 2012, *supra* note 505 at 25.

<sup>516</sup> SEC Report *supra* note 514.

traded stock of a number of companies quoted on the OTCBB and Pink Sheets. Georgiou manipulated the market for the purpose of artificially inflating each company's stock price, creating the false appearance of an active and liquid market. In order to do so, Georgiou used many nominee accounts at offshore broker-dealers in Canada, the Bahamas, Turks and Caicos, and other locations. He also used a variety of manipulative techniques, including controlling the trading volume through promises of profits to nominees, executing or directing matched orders, wash sales, or other prearranged trades, marking-the-close, and paying illegal kickbacks in exchange for purchases. Georgiou realized at least \$20.9 million in ill-gotten gains from his manipulation schemes.

The SEC was able to gather direct evidence against Georgiou in relation to manipulation of a corporation called Northern Ethanol. Georgiou offered the payment of an illegal kickback to a person Georgiou believed was a corrupt registered representative who was in reality an undercover FBI agent.<sup>517</sup>

Similarly, in 2008 the SEC took enforcement action against a number of individuals who manipulated the price of Guyana Gold Corp, a corporation quoted on pink sheets. One of perpetrators was resident in Canada. In this case the SEC also used an FBI agent who purported to have the discretion to trade on behalf of the accounts of wealthy customers. The defendant promised to pay a 30% kickback to the agent in exchange for the purchase of stock through the customers' accounts.<sup>518</sup>

### **Tackling manipulation in 'lightly' regulated (or penny stock) markets**

As is referred to above, the majority of cross border manipulation cases undertaken by the SEC over the period were pump and dump schemes in the lightly regulated or penny stock markets. Some of the perpetrators appear to be repeat offenders who systematically engaged in such schemes.

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<sup>517</sup> *SEC v Georgiou, supra* note 495.

<sup>518</sup> *SEC v Grossman et al, supra* note 495.

In an effort to tackle these cases, the SEC in 2007 announced the creation of a new unit, the Microcap Fraud Working Group, within the Division of Enforcement to lead the SEC's efforts against what was referred to as micro-cap fraud. The SEC stated that it created the unit in response to the growing threat of fraud involving small issuers whose securities are not traded on registered exchanges. It was the intention of the SEC that the group would focus on market manipulation and offering frauds, as well as other market violations and also liaise with domestic and foreign authorities regarding micro-cap fraud issues.<sup>519</sup>

In 2012 the Microcap Fraud Working Group became proactive in suspending trading in the securities of a number of dormant companies before they could be used for pump and dump schemes. This was described as follows:

In May the SEC suspended trading in the securities of 379 dormant companies before they could be hijacked by fraudsters and used to harm investors through reverse mergers or pump-and-dump schemes. The trading suspension marks the most companies ever suspended in a single day by the Commission as it ramps up its crackdown against fraud involving microcap shell companies that are dormant and delinquent in their public disclosures. Microcap companies typically have limited assets and low-priced stock that trades in low volumes. An initiative tabbed Operation Shell-Expel by the SEC's Microcap Fraud Working Group utilized various agency resources, including the enhanced intelligence technology of the Enforcement Division's Office of Market Intelligence, to scrutinize microcap stocks in the markets nationwide and identify clearly dormant shell companies in 32 states and six foreign countries that were ripe for potential fraud.<sup>520</sup>

In 2013 the SEC continued what it states is its "crackdown on against the manipulation of microcap shell companies" and suspended 61 empty shell companies. It stated that:

the SEC used enhanced intelligence technology in the Division of Enforcement's Office of Market Intelligence and identified clearly dormant shell companies in at least 17 states and one foreign

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<sup>519</sup> SEC Annual Report 2007, *supra* note 475 at 9. In both the 2011 and 2012 Annual Reports, the SEC referred again to the market abuse unit and its activity in taking action against penny stock promoters for their roles in various schemes to manipulate the volume and price of microcap stocks and to generate stock sales through the payment of illegal kickbacks, See SEC Annual Report 2011, *supra* note 476 at 13; SEC Annual Report 2012, *supra* note 505 at 25.

<sup>520</sup> SEC Annual Report 2012, *supra* note 505 at 136.

country. By suspending trading in these companies, the SEC obligated the companies to provide updated financial information to prove that they are still operational, essentially rendering them useless to scam artists as the companies are no longer allowed to fly under the radar.<sup>521</sup>

### International Cooperation with Foreign Regulators

Over the ten year period there was a steady increase in both requests made by the SEC to foreign regulators for assistance and requests for assistance made by foreign regulators to the SEC. In 2004 the SEC made 380 requests to foreign authorities and received 372 requests from foreign authorities. By 2013 the SEC made 717 requests to foreign authorities and received 508 requests from foreign authorities. The increase in both of these types of requests is shown below in Figure 3.13.



The main reason given for the increase in the number of requests to foreign authorities was an increased need to obtain overseas documents and testimony for enforcement

<sup>521</sup> SEC Annual Report 2013, *supra* note 472 at 137.

purposes.<sup>522</sup> The SEC also noted that requests received from foreign regulators became increasingly complex.<sup>523</sup> It also seems that one of the mechanisms used to make and receive such requests was IOSCO MMoU as well as other mechanisms such as Mutual Legal Assistance Treaty procedures.<sup>524</sup>

## Part 5 Australia

### Cross Border Insider Trading and Market Manipulation

As is referred to in chapter 3, ASIC primarily prosecutes insider trading and market manipulation criminally. Over the ten year period the numbers of prosecutions for insider trading and market manipulation did increase. In 2005, ASIC obtained five criminal convictions and two civil penalty orders for market abuse offences.<sup>525</sup> For the twelve months ending on 31 December 2013 ASIC obtained thirteen criminal convictions for insider trading and one criminal conviction for market manipulation. It also brought one disciplinary action and negotiated an enforceable undertaking in relation to another manipulation matter. At year end, ASIC had eleven pending criminal insider trading matters, one pending civil insider trading matter and three pending criminal market manipulation matters.<sup>526</sup>

ASIC increasingly committed more resources to the detection, investigation and prosecution of insider trading and market manipulation over the ten year period. The 2006 report notes that:

While we have had successes in deterring insider trading and market manipulation, we intend to do more. A taskforce is being established to determine what additional actions ASIC, in cooperation with the Australian Securities Exchange (ASX), can take in the areas of continuous disclosure, market manipulation and insider trading.

<sup>522</sup> SEC Annual Report 2011, *supra* note 476 at 66; SEC Annual Report 2010, *supra* note 481 at 53.

<sup>523</sup> SEC Annual Report 2005, online: <http://www.sec.gov/about/secpar2005.shtml> at 38.

<sup>524</sup> SEC Annual Report 2007, *supra* note 475 at 28.

<sup>525</sup> ASIC Annual Report 2005, online: ASIC

<[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC\\_AR\\_05.pdf/\\$file/ASIC\\_AR\\_05.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_AR_05.pdf/$file/ASIC_AR_05.pdf)> at 14.

<sup>526</sup> ASIC Report 360 "Enforcement Outcomes, January 2013 to June 2013" online:

<<http://download.asic.gov.au/media/1344356/rep360-published-24-July-2013.pdf>> and ASIC, Report 383,

"Enforcement Outcomes: July to December 2013", online: ASIC

<<http://download.asic.gov.au/media/1344494/rep383-published-11-February-2014.pdf>>.

As a result of this taskforce, in 2007 ASIC increased resources to improve the detection, investigation and prosecution of market abuse offences.<sup>527</sup> ASIC also reported an increase in resources committed to this area again in 2010.<sup>528</sup>

Over the ten year period, ASIC brought only three cases of cross border insider trading and only one case involving cross border market manipulation. In relation to insider trading, two cases were in relation to persons outside of Australia who became aware of inside information about corporations whose securities were traded on Australian exchanges and subsequently traded using this information.<sup>529</sup> Another related to an Australian resident who was a portfolio manager for an Australian Bank. In this matter the defendant obtained inside information of the trading intentions of the Bank in relation to a number of securities and purchased contracts for difference in these securities on the Singapore Stock Exchange. ASIC obtained the assistance of the Singapore authorities in this investigation.<sup>530</sup> In relation to cross border market manipulation, ASIC also brought criminal proceedings against a director of a corporation whose securities were listed on both Australian and German exchanges for making false statements over the internet to increase the price of the securities.<sup>531</sup> This was the same case referred to by BaFin in its 2005 Annual Report where a

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<sup>527</sup> ASIC Annual Report 2007, online: ASIC

<[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC\\_Annual\\_Report\\_06-07\\_full.pdf/\\$file/ASIC\\_Annual\\_Report\\_06-07\\_full.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_Annual_Report_06-07_full.pdf/$file/ASIC_Annual_Report_06-07_full.pdf)>.

<sup>528</sup> ASIC Annual Report 2010, online: ASIC

<[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC\\_AnnualReport-2009-10.pdf/\\$file/ASIC\\_AnnualReport-2009-10.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_AnnualReport-2009-10.pdf/$file/ASIC_AnnualReport-2009-10.pdf)> at 17.

<sup>529</sup> See ASIC, Media Release, "Sydney Man Jailed for Insider Trading" (24 June 2005), online: ASIC

<[https://www.asic.gov.au/asic/asic.nsf/byheadline/05-](https://www.asic.gov.au/asic/asic.nsf/byheadline/05-179+Sydney+man+jailed+for+insider+trading?openDocument)

[179+Sydney+man+jailed+for+insider+trading?openDocument](https://www.asic.gov.au/asic/asic.nsf/byheadline/05-179+Sydney+man+jailed+for+insider+trading?openDocument)>; ASIC, Media Release, *the matter of O'Reilly*

(23 November 2009), online: <[http://www.asic.gov.au/asic/asic.nsf/byheadline/09-](http://www.asic.gov.au/asic/asic.nsf/byheadline/09-235AD+Former+director+of+Lion+Selection+pleads+guilty+to+insider+trading?openDocument)

[235AD+Former+director+of+Lion+Selection+pleads+guilty+to+insider+trading?openDocument](http://www.asic.gov.au/asic/asic.nsf/byheadline/09-235AD+Former+director+of+Lion+Selection+pleads+guilty+to+insider+trading?openDocument)>.

<sup>530</sup> See ASIC, Media Release, "Former director of Lion Selection pleads guilty to insider trading" (22 September 2010), online: ASIC <[http://www.asic.gov.au/asic/asic.nsf/byheadline/10-](http://www.asic.gov.au/asic/asic.nsf/byheadline/10-199AD+Oswyn+de+Silva+pleads+guilty+to+insider+trading+charge+involving+E2%80%98front+running%E2%80%99?openDocument)

[199AD+Oswyn+de+Silva+pleads+guilty+to+insider+trading+charge+involving+%E2%80%98front+running%](http://www.asic.gov.au/asic/asic.nsf/byheadline/10-199AD+Oswyn+de+Silva+pleads+guilty+to+insider+trading+charge+involving+E2%80%98front+running%E2%80%99?openDocument)

[E2%80%99?openDocument](http://www.asic.gov.au/asic/asic.nsf/byheadline/10-199AD+Oswyn+de+Silva+pleads+guilty+to+insider+trading+charge+involving+%E2%80%98front+running%E2%80%99?openDocument)>; ASIC, Media Release, "Former fund manager imprisoned for insider trading

involving front running" (31 March 2011), online: ASIC <[http://www.asic.gov.au/asic/asic.nsf/byheadline/11-](http://www.asic.gov.au/asic/asic.nsf/byheadline/11-69AD+Former+fund+manager+imprisoned+for+insider+trading+involving+front+running?openDocument)

[69AD+Former+fund+manager+imprisoned+for+insider+trading+involving+front+running?openDocument](http://www.asic.gov.au/asic/asic.nsf/byheadline/11-69AD+Former+fund+manager+imprisoned+for+insider+trading+involving+front+running?openDocument)>.

<sup>531</sup> See ASIC, Media release, "Former Adelong Capital director charged" (19 February 2003), online: ASIC

<[http://www.asic.gov.au/asic/asic.nsf/byheadline/03-](http://www.asic.gov.au/asic/asic.nsf/byheadline/03-062+Former+Adelong+Capital+director+charged?openDocument)

[062+Former+Adelong+Capital+director+charged?openDocument](http://www.asic.gov.au/asic/asic.nsf/byheadline/03-062+Former+Adelong+Capital+director+charged?openDocument)>.

BaFin employee gave expert evidence in Australia to assist ASIC.<sup>532</sup>

### **Detection Methods**

It appears that market surveillance is the main detection method used by ASIC to detect market abuse. Until August 2010, the ASX conducted surveillance of its own markets. From 1 August 2010 ASIC took over the supervision and surveillance of all licenced equity derivatives and futures markets and the ASX surveillance staff were transferred to ASIC. In its 2010 Annual Report ASIC noted that it believed that having only one market supervisor would streamline supervision and enforcement.<sup>533</sup> Two years later, it reported that:

ASIC's responsibility for market supervision has delivered numerous benefits from a market integrity perspective.

We bedded down processes relating to identifying and investigating possible misconduct, and how misconduct is referred to ASIC's enforcement groups. This has halved the average number of days involved from identifying misconduct to starting investigations, resulting in more timely and better outcomes. We are also refining the parameters for real-time surveillance to ensure analysts can concentrate their time on genuine market misconduct issues.<sup>534</sup>

ASIC reported that market abuse was also detected by way of complaints from the public. In 2013/14 ASIC reported that it received approximately 630 reports in relation to market integrity matters which included insider trading, continuous disclosure, misleading statements and market manipulation.<sup>535</sup>

### **International Cooperation with Foreign Regulators**

Like the other regulators ASIC also received a substantial number of requests from foreign authorities each year and also makes a significant number of requests to foreign authorities for assistance each year. In 2013/14 it reported that it had received 116 requests for

<sup>532</sup> BaFin Annual Report 2005, *supra* note 398.

<sup>533</sup> ASIC Annual report 2010, *supra* note 528 at 45.

<sup>534</sup> ASIC Annual Report 2012, online: ASIC <[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-Annual-Report--2011-12.pdf/\\$file/ASIC-Annual-Report--2011-12.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC-Annual-Report--2011-12.pdf/$file/ASIC-Annual-Report--2011-12.pdf)> at 33.

<sup>535</sup> ASIC Annual report 2013/14, online: ASIC <<https://www.asic.gov.au/about-asic/corporate-publications/asic-annual-reports/#ar14>>.

assistance from foreign authorities for assistance in enforcement related matters.<sup>536</sup> It also appears that some of these requests utilized the IOSCO MMoU.<sup>537</sup>

### **Part 6 Some common themes**

As the above analysis of the material published by securities regulators demonstrates, over the ten year period from 2004 to 2013, most of the securities regulators took enforcement action in a number of instances of cross border market abuse. The number of such investigations appears to have been influenced by such factors as the size of the markets, the resources available to undertake investigations and the priorities of the regulator. Certainly in some cases priorities appeared to shift over time. For example, BaFin spent most of the years giving preference to investigating market manipulation in its lightly regulated markets. In 2013 as the level of instances of detected manipulation in that market declined, BaFin increased insider trading investigations.

Furthermore, it does seem that over the ten year period instances of cross border market abuse that were detected and investigated by each of the regulators steadily increased in complexity. This is consistent with the comments by the regulators referred to in Chapter 3. Complexity seems to be a particular feature of market manipulation matters. This may be due to a combination of factors including fragmentation of the markets, the use of different jurisdictions by perpetrators in an effort to avoid detection and the possibility that complex matters are increasingly being detected.

#### **Changes in Detection Mechanisms**

In terms of improvements in detection mechanisms, certainly most regulators reported increasing investment in surveillance technology and other detection mechanisms over the

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<sup>536</sup> ASIC Annual Report 2013/14, *supra* note 535 at 37.

<sup>537</sup> For example in 2004 ASIC reported that, utilizing this MMoU, it had obtained documents and information from 21 jurisdictions to assist enforcement action, and that it had assisted two foreign regulators with the five requests they made ASIC Annual Report 2004, online: ASIC <[http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC\\_AR\\_04\\_complete.pdf/\\$file/ASIC\\_AR\\_04\\_complete.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ASIC_AR_04_complete.pdf/$file/ASIC_AR_04_complete.pdf)> at 31.



ten year period. There also appears to be an increase in the reporting of market abuse to regulators from tips and whistleblowers.

In the case of the two European regulators, BaFin and the FCA, the system in Europe of obtaining reports of suspicious transactions and exchanging such reports between European securities regulators seems to have become an important detection method of market abuse. By way of contrast in the US, Canada and Australia reports of transactions suspected to be market abuse is relatively less important.<sup>538</sup> This may be because in these jurisdictions there is no specific requirement that market intermediaries report suspected market abuse directly to the securities regulator. In Canada for example, brokers and banks are not required to report instances of suspected market abuse directly to the provincial securities regulators. They are, however, required to report breaches of the law to IIROC,<sup>539</sup> and report instances of suspected money laundering to the Financial Transactions and Reports Analysis Centre of Canada.<sup>540</sup> In the US broker dealers are required to have compliance systems in place and report suspicious activity to the Financial Crimes Enforcement Network (FinCEN) as a result of requirements in the *Bank Secrecy Act* and FINRA rules. A FinCEN report is required if the firm has “reason to suspect” or has knowledge of facts that suggest that the transactions are not legitimate, may be related to unlawful activity, or do not make economic sense.<sup>541</sup> This includes possible money laundering transactions as well as suspected market abuse.<sup>542</sup>

In relation to encouraging reporting by whistleblowers, the SEC stands alone in offering monetary rewards for information leading to successful prosecutions. Whilst it is probably too early to determine the success of the program, it does appear to be generating additional information about possible fraudulent conduct. In addition the fact that a significant number

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<sup>538</sup> Over the ten year period there was no mention in the reports examined in relation to Canada, the USA or Australia in relation to detecting market abuse through suspicious transaction reports. See also the comments by FINRA referred to in the previous chapter.

<sup>539</sup> IIROC Universal Market Integrity Rules, *supra* note 313 at Rule 10.1.

<sup>540</sup> *Proceeds of Crime (Money Laundering) and Terrorist Financing Act*, SC 2000, c 17.

<sup>541</sup> *Bank Secrecy Act* 31 USC § 5311 (1970) and FINRA Rules, *supra* note 319 at Rule 3100 .

<sup>542</sup> *Ibid.*

of tips are coming from foreign sources is of note, perhaps also suggesting that this might become a source of information in relation to cross border market abuse which would not have otherwise have been available.

### **Market Manipulation in the lightly regulated or 'penny stock' markets**

A significant proportion of the increase in enforcement actions in cross border market abuse over the ten year period can be attributed to pump and dump market manipulation schemes in lightly regulated or penny stock markets. The two securities regulators with responsibility for the supervision of relatively large lightly regulated markets, BaFin and the SEC, devoted significant resources to these matters and detected a disproportionately high number of instances of these schemes in their markets. Furthermore, the majority of the cross border market manipulation schemes investigated by Canadian securities regulators were matters in which Canadian individuals and entities were involved in schemes conducted on US markets. At least some of these schemes appear to be highly organised and very profitable. It also appears that some schemes operated out of several jurisdictions and utilized accounts and corporations in a number of jurisdictions, and in particular, offshore financial centres, in an attempt to conceal the schemes from securities and other enforcement agencies. It also appears that over time these schemes may be becoming more sophisticated and as a result increasingly complex to investigate.

Lightly regulated or penny stock markets exist because they benefit small to medium enterprises. This is because they facilitate the ability of such enterprises to attract funds from the issue of securities without incurring the high costs associated with listing those securities on a large exchange. However there seems to be a significant disadvantage to such markets in that they seem particularly prone to manipulation, including by individuals and entities located outside of the jurisdiction. One of the reasons seems to be that securities traded on such markets are generally illiquid and accordingly prices can be manipulated using few trades of low volumes.

Because of the large number of these types of schemes on these markets a significant

amount of investigative resources was allocated to these matters during the ten year period. As a result both BaFin and the SEC implemented changes with a view to ending these schemes. However the changes made by each regulator varied. In Germany initially Deutsche Börse increased its listing requirements and delisted entities which did not comply with these increased requirements. However this did not seem to satisfy BaFin which agitated to close the First Quotation Board of the Open Market, most lightly regulated market. BaFin succeeded and this market was closed. Incidences of detected manipulation declined as a result.

In contrast the SEC formed a designated unit, Microcap Fraud Working Group, to investigate such matters. This unit then deregistered a large number of corporations which could potentially have been high jacked for these nefarious purposes. The SEC also worked with the FBI to covertly infiltrate the schemes with a co-operator in order to gather direct evidence about the scheme and those running them.

It appears therefore that the SEC is willing to allow these lightly regulated markets to exist based, apparently, upon a cost benefit analysis. The SEC endeavours to suppress fraud in these markets rather than eliminate the market altogether as this would have the effect of limiting the ability of small enterprises to raise funds via such markets. BaFin however appears to have taken the position that the resources required to tackle the level of manipulation in very lightly regulated markets is too high compared to the benefit of allowing small enterprises to raise funds on such markets.

### **New Market Participants – Hedge Funds**

In terms of the impact of new participants in the market during the ten years, although there were some instances in the US of hedge funds participating in insider trading and market manipulation, no identifiable pattern emerged suggesting widespread systematic schemes of cross border market abuse by such funds. This is of note given that over that time the SEC formed a special unit to investigate insider trading by hedge funds. Investigations by this unit led to some highly publicised prosecutions of networks of persons involved in generating

profits for hedge funds by insider trading. However most of these prosecutions were cases in which all of the participants were within the US.<sup>543</sup>

### **Direct Market Access and High Frequency Trading**

In relation to the participation of high frequency (or algorithmic) traders in cross border market abuse, from 2011 to 2013 both the SEC and the FCA detected instances where direct market access was used as a gateway by traders in foreign jurisdictions to engage in large scale instances of layering, spoofing and quote stuffing. In particular the case of Canadian Peter Beck and companies he controlled is of note. In 2011 the FSA fined Swift Trade Inc, controlled by Beck, £8m for market manipulation by its network of traders. In 2012 the SEC made a cease and desist order against Biremis Corp, also controlled by Beck, and fined him \$250,000 for failure to properly supervise its traders who had engaged in manipulation. Also in 2012 the OSC took action against Beck, Biremis, Swift Trade and three other entities he controlled for failure to properly supervise its traders. This action was settled by an agreement to pay an administrative penalty of \$100,000, costs of \$300,000 and by Beck being prohibited from being a registrant or a director of a registrant for a period of 2 years.<sup>544</sup>

In these matters the SEC, the FSA and the OSC took action against those facilitating the traders access to the markets. As is referred to in Chapter 2, since 2010 there has also been a strengthening of compliance and supervision obligations on brokers who allow clients direct access to the markets. These two initiatives may work to dissuade those operating

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<sup>543</sup> See for example the prosecutions of those involved with the Galleon Group hedge fund and SAC Capital Advisors hedge fund. See Azam Ahmed & Guilbert Gates, *The Galleon Network*, 11 May 2011, online: The New York Times <<http://www.nytimes.com/interactive/2011/03/08/business/galleon-graphic.html?gwh=7605D65E8D26F083FB8F67B71DCE8989>> and The New York Times, *Insider Trading and a Top Hedge Fund*, 5 December, 2012, online: The New York Times <[http://www.nytimes.com/interactive/2012/12/05/business/1205-inside.html?\\_r=0&gwh=A19DA7CFB7A26EBAB5406D1623E45EAE](http://www.nytimes.com/interactive/2012/12/05/business/1205-inside.html?_r=0&gwh=A19DA7CFB7A26EBAB5406D1623E45EAE)>. See also the prosecutions in relation to the SAC Capital Advisors. In relation to these prosecutions see generally M Goldstein “Martoma, SAC Capital Ex-Trader, Gets 9 years in Prison” New York Times, 8 September 2014, online: <<http://dealbook.nytimes.com/2014/09/08/hours-before-sentencing-u-s-judge-says-cohen-trades-should-count-against-martoma/>>.

<sup>544</sup> *In the matter of Peter Beck et al, supra* note 509.

direct market access gateways from allowing these facilities to be used for manipulative purposes.

Nevertheless it is perhaps of some concern that the SEC, the OSC and the FSA did not take action against the traders themselves. Of course this would have been very difficult, if not almost impossible, given the disparate jurisdictions in which they were situated. However this does leave open the very real possibility that these traders may penetrate other markets if the opportunity presents itself. It is also possibly of concern that the penalties levied on Beck and the companies he controlled consisted only of monetary penalties and cease and desist orders. Given the suspected significant profits made from the activity and the potential profits available for others who facilitate these types of activities, these kinds of monetary penalties may simply not be sufficient to deter individuals from engaging in such misconduct in the future if they apply a simple cost benefit analysis.

It is also perhaps of note that despite the fact that comments by regulators referred to in Chapter 2 demonstrate that they are aware that high frequency traders are engaging in manipulative techniques such as spoofing and layering, there does not seem to be a significant number of manipulation cases brought by regulators, at least in relation to manipulation that crosses borders. This may be because there are only a small number of such cases. Alternatively it may be that such cases are significantly resource intensive to investigate and perhaps, given that the victims of such manipulation are usually other high frequency traders, they are simply not a top priority for investigations. Perhaps regulators are more likely to target 'pump and dump' schemes in relation to their manipulation investigations because these are less complex to investigate and also because they directly target small and usually unsophisticated investors.

Another possible reason for the lack of prosecutions of manipulation by high frequency trading may be that such manipulation has only started to be detected relatively recently and the investigations are time consuming. Furthermore there is often a significant time lag between detection and prosecution. Perhaps these cases will not be reported in significant

numbers by regulators for several years. In this respect it is relevant to note that, as referred to in Chapter 2, it was not until 2015, some five years after the 2010 'flash crash', that the SEC brought charges against a person resident in the UK whom it alleges is responsible for this event.

### **Cross Border Insider Trading**

A significant number of the cases of cross border insider trading were cases of persons who lived within the jurisdiction and tipped friends or family in another jurisdiction, or traded in their names. The cross border aspect to this insider trading may have been coincidental, in that the friends or family possibly just happened to live outside of the jurisdiction. Alternatively it may have been done intentionally in an effort to try and avoid detection or make attempts at prosecution more difficult.

Another category of cases were situations where there were suspicious purchases of call options in a foreign jurisdiction in relation to a corporation the subject of takeover. It appears therefore that securities regulators do monitor the markets for unusual call option purchases of takeover targets and views such purchases as a likely indicator of insider trading.

There were also a significant number of cases of cross border insider trading where use was made of accounts and corporations in offshore financial centres, presumably in an attempt to disguise from the authorities the connection between the insider and the trader. It is significant that in most of the reported cases the regulator was able to determine the name of the beneficial owner. This seems to signal that in the case of some of these countries financial secrecy laws are becoming weaker or enforcement authorities are more readily complying with requests from foreign regulators for information. For example, the number of such cases where use was made of corporations in the British Virgin Islands strongly suggests that the authorities in this country will disclose information to foreign securities regulators much more readily than had previously been the case.

However it is unclear from publically available reports by securities regulators if there are still some offshore financial centres which will still not provide the information required for investigations into alleged market abuse. If so this is of concern given that the reported cases frequently feature perpetrators using offshore financial centres in an attempt to hide their activities. This suggests that it is critically important that efforts be made to ensure that securities regulators are able to obtain information from *all* nations as any gap in this capacity to obtain such information can be predicted to be exploited by those involved in cross border market abuse.

### **International Cooperation with Foreign Regulators**

Most regulators also reported increasing their requests for information to foreign authorities along with a reciprocal increase in requests received from foreign authorities for information. Although clearly not all of this increase can be attributed to cross border market abuse, it can reasonably be suggested that at least some of this increase is in relation to enforcement actions taken in relation to these matters. Such increases in requests also suggest that over time closer connections are developing between securities regulators in terms of their enforcement activities and it seems that securities regulators are increasingly willing to reach out to foreign regulators to obtain the information they require. It may also indicate that the IOSCO MMoU is having a real impact in bridging the gap that regulators may have in obtaining evidence required to complete an investigation where the activity which is the subject of the investigation does not solely take place within their own jurisdiction.

In addition, perhaps also demonstrating the development of closer links between regulators, the FSA and the SEC have reported being engaged in an increased number of 'parallel investigations'. Whilst not a joint investigation, a parallel investigation is where the regulators work more closely together rather than merely sharing information. One of the advantages of such parallel investigations seems to be that all of perpetrators of the market abuse are prosecuted, as was the case in relation to the parallel insider trading investigation

undertaken by the FSA and the SEC in 2011 where the tipper was prosecuted in the US by the SEC and the DOJ and the tipper was prosecuted by the FSA in the UK.

### **Protecting Integrity of Foreign Markets?**

Most cases of cross border market abuse reported by securities regulators were related to activity which impacted on the integrity of markets situated within their own jurisdiction. This seems to indicate that securities regulators focus their enforcement activities on matters which impact upon the integrity of their own markets, rather than taking action against individuals and entities that are situated within the jurisdiction but who engage in market abuse which also impacts upon the integrity of markets in other jurisdictions. One exception to this was Canadian regulators who regularly took enforcement action in relation to activity which impacted upon the integrity of markets in the US, perhaps pointing to the close networks between securities regulators in these two countries.

Towards the end of the ten year period there appeared to be the emergence of a few matters in which regulators worked together and initiated enforcement action against perpetrators of market abuse even when the integrity of their home market was not in jeopardy. For example, the enforcement action taken by the SEC in 2012 in relation to a US hedge fund manager who had used inside information to trade on the Hong Kong Stock Exchange.

### **Part 7 Possible Strategies to improve the success of Regulators**

Over the last few years there have been significant improvements in the detection and investigation of cross border market abuse which seems to have led to more enforcement action being taken in such cases. In addition it seems regulators are increasingly instituting investigations in more and more complex cases. Nevertheless it seems that there may be additional ways in which this kind of progress could continue to evolve.



## **Suspicious transaction reports**

Market surveillance remains, and is likely to continue to remain, the key detection method in relation to market abuse, including cross border market abuse. However an important development in the detection of market abuse within Europe has been the introduction of the requirement that market intermediaries must mandatorily report any instance of suspected market abuse without delay directly to regulators via a suspicious transaction report. In addition, if the report concerns a market outside of a particular regulator's jurisdiction, the regulator is required to send the report to the authority responsible for that other market. As referred to in the preceding chapter, MAD II strengthens this requirement by extending this requirement to all OTC transactions and even suspicious unexecuted orders. It also requires that countries enact effective penalties for a failure by a market intermediary to make such a report.

Since the introduction of this requirement the number of such reports has increased and significantly it has become an important detection mechanism of market abuse and cross border market abuse for European securities regulators. The relative importance of suspicious transaction reports for European securities regulators may be due to the lack of cross market surveillance in Europe. However it is probable that this is not the only reason in that one advantage of this European system of suspicious transaction reports over that which exists in the US and Canada is that the report is filed directly with the regulator and is specifically targeted at transactions suspected to constitute market abuse. This may result in the regulators becoming aware very early of the matter enabling them to quickly instigate an investigation and take enforcement action.

Given what appears to be the success of the European system of requiring the making of suspicious transactions reports of market abuse directly to the regulator, perhaps other countries should consider adopting a similar system. Introducing such a requirement, with significant penalties attached may also increase the awareness of their legal obligations within organisations and their compliance departments. Furthermore, as in Europe, perhaps

a system could also be developed to send the report to all other regulators whose markets could be potentially impacted by the report. IOSCO is arguably the most appropriate organisation to develop such a system.

### **Case Selection**

As the primary mandate of regulators is to protect the integrity of their own markets it is understandable that regulators are inclined to focus their investigative resources on matters which potentially compromise the integrity of their home markets. However this could possibly lead to matters in which no action or only a low level of enforcement action is taken against the real perpetrators of market abuse. For example, if the trading takes place in one jurisdiction, but the perpetrators are located in another, neither regulator may decide to bring a case against the perpetrators of the market abuse. It appears that in such a matter often the only action that may be taken is that a case is brought against the broker who allowed the foreigner access to the market. Alternatively, or in addition, the matter may be referred to the foreign regulator only to result in little follow up and, in any event, little or nothing that can be done if the foreign regulator decides to take no action. The critical problem of course is that if no action is taken against a perpetrator there will be very little to deter the perpetrator from engaging in similar misconduct in the future.

Mindful perhaps of the failure of foreign regulators to take action, the SEC seems to be particularly aggressive in ensuring that at least some action is taken in all matters it has detected even when there is a foreign element. For example, as is referred to in Chapter 3, it may put a foreign perpetrator on a watch list at US airports or freeze funds in the US. Compared to other regulators, the SEC also seems to most aggressively pursue cross border market abuse and take action when their markets are only indirectly affected by the market abuse. For example it has pursued matters where contracts for difference are traded in relation to US stocks on markets outside of the US, even if there is no other connection in the activity to the US.

However despite these efforts by the SEC it seems likely that some perpetrators are still escaping prosecution because the market abuse is not confined to one jurisdiction. As such this is another area in which perhaps IOSCO could take the lead. IOSCO could encourage regulators to firstly work together to ensure that perpetrators of market abuse do not 'fall through the cracks' of enforcement and secondly by encouraging regulators to work together to ensure that all of the key perpetrators of market abuse are prosecuted.

### **Ensuring access to telecommunications data**

In relation to the investigation of market abuse, as referred to in Chapter 3, there seems to be inconsistent requirements concerning regulators' abilities to access telecommunications and other data as well as inconsistent requirements about how long such data has to be stored. This can adversely impact upon regulators own investigations as well as their ability to assist foreign regulators.

The importance of this information to the investigation of market abuse offences was recently set out in the Market Abuse Regulations of the European Parliament (MAR):

Existing recordings of telephone conversations and data traffic records from investment firms, credit institutions and financial institutions executing and documenting the execution of transactions, as well as existing telephone and data traffic records from telecommunications operators, constitute crucial, and sometimes the only, evidence to detect and prove the existence of insider dealing and market manipulation. Telephone and data traffic records may establish the identity of a person responsible for the dissemination of false or misleading information or that persons have been in contact at a certain time, and that a relationship exists between two or more people.<sup>545</sup>

As such the MAR contains provisions to strengthen the capacity of securities regulator in the EU to collect data. Under MAR, Member States are required to introduce laws which will allow authorities to require telecommunication operators and investment firms to produce

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<sup>545</sup> MAR, *supra* note 355 at paragraph (65).

data traffic records where a reasonable suspicion exists that such records may be relevant to prove market abuse.<sup>546</sup>

Given the importance of this data to securities offences, including market abuse offences, this is an area in which securities regulators may need to pressure their legislators for stronger regulations. This could include regulations that would extend the length of time that data must be stored and enhanced powers to access such information quickly along with broad powers to share this information with foreign regulators in appropriate cases.

### **Developing closer connections between regulators**

It seems that in recent years securities regulators worldwide have become a more tightly knit community which has facilitated closer cooperation. Significantly, the work of IOSCO in developing the MMoU and ESMA in developing its MoU seems to have increased the ability of regulators to obtain information needed for investigations from a broader range of countries, including those formally known for their secrecy provisions. Such increased cooperation may have also reduced the reluctance of regulators to take action against cross border market abuse on the basis that they are aware that they should be able to obtain the information they need to complete the investigation within a relatively brief period of time.

However despite the progress that has been made the responses by regulators to the author's questions suggest that much more could be done. In particular delays still sometimes occur which can hinder investigations. Such delays may be caused by an imbalance in resources between regulators and, as such, IOSCO could consider expanding its MMoU to include providing a system whereby a smaller regulator is given financial support from a larger regulator if the larger regulator requests information and requires this information quickly. It may also be that the system developed by the IOSCO MMoU is still too bureaucratic and as such more needs to be done to streamline the process. Furthermore, IOSCO could perhaps also consider specifying the time period in which a regulator should aim to respond to a request.

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<sup>546</sup> MAR, *supra* note 355 at Article 23.

Another issue that may assist the success of cross border market abuse investigations is that, over the long term, IOSCO could work towards the development of more consistent definitions of what constitutes market abuse across jurisdictions, as well as more consistent penalties for those who commit such market abuse. Some work has already been done in this regard as, because of the MAD and MAD II, securities regulators in Europe are developing similar definitions of what constitutes market abuse as well as broadly consistent laws regarding the applicable penalties.<sup>547</sup> Over time this should result in a common understanding between regulators in the EU of the parameters of market abuse offences, foster cooperation and reduce the potential for miscommunication. Taking its lead from the EU, IOSCO could perhaps take some steps to developing a similar policy.

### **Eliminating manipulation in penny stock markets**

Lightly regulated or penny stock markets seem to be particularly susceptible to cross border market abuse. There appear to be groups of individuals in the world actively looking for opportunities to engage in systematic pump and dump manipulation schemes. It also seems that these individuals are not reluctant to structure their activities across jurisdictions and use accounts and corporations located in offshore financial centres in order to attempt to avoid detection by the authorities.

It remains to be seen whether the steps taken by BaFin, FINRA and the SEC will significantly reduce manipulation in the penny stock markets. However, even if successful, there is likely to be continuing demands on governments and regulators to allow the operation of such markets. This is because of the advantages such lightly regulated markets offer for small to medium enterprises, together with pressures on governments and regulators to work towards fostering such enterprises in the interests of economic growth generally.<sup>548</sup>

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<sup>547</sup> MAD and MAD II, *supra* note 12 and 354.

<sup>548</sup> In relation to this issue see the recent push by some jurisdictions to facilitate equity raising for start-ups and small companies by way of crowdfunding, see *Jumpstart Our Business Startups Act*, Pub L No 112-106, § 302, 126 Stat 306 (2012). It should also be noted that it is possible that another similar lightly regulated market could

From one perspective, perhaps the fact that these lightly regulated markets seem to generate a relatively high level of market abuse is an unavoidable trade-off for giving smaller companies the capacity to access equity funds. However, this seems to be an unacceptable situation from the point of view both of the victims of such manipulation, as well as the markets themselves, which need to work towards improving market integrity in order to encourage confidence in investment in such enterprises. Given the clear susceptibility of such markets to manipulation it is likely that any lightly regulated market established in the world may become a target for individuals tempted to engage in market abuse. As such, it may be appropriate for regulators in countries which have such markets to more frequently work closely together to ensure that strong and quick enforcement action is taken against perpetrators of market abuse in those markets and, in particular, recidivist offenders who look for opportunities to engage in such activities on a more or less predatory basis. Furthermore it may also be appropriate for regulators to cooperate so that much more severe penalties are imposed upon those who are found to have engaged in market abuse in these markets, again particularly for recidivist offenders, to deter them from finding other penny stock markets to exploit using such schemes. In other words the cost benefit analysis that will be undertaken by such market predators needs to be much more weighted towards the higher cost of being detected and subject to significant penalties, including prison.

## **Conclusion**

The transformation of the markets over the last few decades has altered the landscape upon which those charged with the responsibility to enforce laws and regulations against market abuse must operate. As a result cases have become more complex and this has presented new challenges for them in terms of their enforcement activities.

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be allowed to operate in Germany in the future and BaFin would have limited control in preventing this from occurring. This is because it does not set the listing rules which are set by the exchanges and approved the exchange supervisory authorities of State in which the exchange is situated. Furthermore efforts by larger exchanges to facilitate access to equity markets for small to medium companies, such as the Toronto Venture Exchange, are subject to relatively high levels of regulation and, as such, impose costly listing and continuous disclosure requirements on listed enterprises, for example see TMX Group “TSX and TSX Venture Exchange Listing Costs”, online: <[http://tmx.com/en/listings/listing\\_with\\_us/costs/index.html](http://tmx.com/en/listings/listing_with_us/costs/index.html)>.

These challenges have been met in a number of ways, including new detection mechanisms, upgrading existing detection methods as well as improved channels to exchange information between securities regulators. However it is arguable that there is still more that could be done to improve regulators' efforts in this regard.

Going forward it is likely that the role of IOSCO may be critical in developing policies that foster coordination and cooperative efforts between regulators as they attempt to respond to the growing sophistication and globalization of markets. IOSCO has emerged as the main organization involved in the development of international securities regulation policy. In addition it also plays a pivotal role in the coordination of enforcement efforts of securities regulators via the IOSCO MMoU. This has proven to be a very useful mechanism in enhancing the abilities of securities regulators to obtain information and evidence required in relation to securities offences which do not take place wholly within their own jurisdiction. As such the significance of the IOSCO MMoU and its increasing importance is the subject of the next chapter. Chapter 6 then moves on to consider the future of the IOSCO MMoU as well other areas in which IOSCO could work towards the improving the success of regulators efforts to address cross border market abuse.

## Chapter 5

# IOSCO AND THE IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation

The SEC, ASIC and many other signatories use the MMOU thousands of times every year. In the SEC's last fiscal year, for example, we made more than 700 requests for assistance to our fellow regulators, and ourselves responded to more than 500 requests for assistance, the majority of which were made pursuant to the IOSCO MMOU.

Former SEC Chair Mary Jo White <sup>549</sup>

The International Organisation of Securities Commissions (IOSCO) is now the foremost international organisation utilized by securities regulators internationally to work cooperatively to solve problems which cannot be addressed at the national level. In particular, as referred to in the previous chapters, regulators are increasingly turning to IOSCO for assistance as they work to investigate and prosecute securities offences where not all of the activity takes place within their national borders.

IOSCO is an international network of securities regulators. Although it has no formal status in international law, over the last three decades it has emerged to become established as the world's central organisation responsible for the coordination of securities regulation. Its growth has been spurred on by increased links between securities markets, the growing sophistication of the markets, cross border flow of investment funds and shocks to the world financial systems, such as the Global Financial Crisis. These factors have led governments and securities regulators to increasingly recognize that effective domestic regulation and stability cannot be achieved solely by action and policy formation at an exclusively national

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<sup>549</sup> SEC Chair Mary Jo White "Perspectives on Strengthening Enforcement", Speech to the Annual Forum of the Australian Securities Commission, 24 March 2014, online: SEC <<http://www.sec.gov/News/Speech/Detail/Speech/1370541253621>>.



or bilateral level. Rather it seems that stability is best achieved by attempting to find global solutions to such problems.

A central part of IOSCO's mission is to formulate and have implemented universal standards of securities regulation and secondly to assist regulators to cooperate on enforcement.

Specifically this is set out in its key goal:

- to cooperate in developing, implementing and promoting adherence to internationally recognised and consistent standards of regulation, oversight and enforcement in order to protect investors, maintain fair, efficient and transparent markets, and seek to address systemic risks.<sup>550</sup>

IOSCO's other key goals are related to this objective.

- to enhance investor protection and promote investor confidence in the integrity of securities markets, through strengthened information exchange and cooperation in enforcement against misconduct and in supervision of markets and market intermediaries; and
- to exchange information at both global and regional levels on their respective experiences in order to assist the development of markets, strengthen market infrastructure and implement appropriate regulation.<sup>551</sup>

In furtherance of these goals, and in particular with a view to promoting effective enforcement and exchange of information, in 2002 IOSCO formulated the *Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information*<sup>552</sup> (the 'MMoU'). This MMoU standardizes the process by which securities commissions who are members of IOSCO can obtain information from other member securities commissions for enforcement purposes. It provides a simple framework of procedures by which securities regulators request and receive information they need to enforce of their own domestic laws. IOSCO views this MMoU as one of its greatest

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<sup>550</sup> IOSCO "The International Organization of Securities Commissions", online: IOSCO <[http://www.iosco.org/about/?subsection=about\\_iosco](http://www.iosco.org/about/?subsection=about_iosco)>.

<sup>551</sup> *Ibid.*

<sup>552</sup> IOSCO "Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information" (May 2002), online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD126.pdf>>.

achievements to date as 105 members of IOSCO have become parties to the MMoU and most of the remaining member commissions have made a commitment to take steps to sign this MMoU.<sup>553</sup> Furthermore the frequency with which its members are using this MMoU is increasing. IOSCO promotes this MMoU as a crucial weapon in the arsenal of securities commissions to tackle securities offences which increasingly are no longer confined to a regulator's jurisdictional boundary.

Given the growing importance of the IOSCO MMoU to the enforcement of securities offences across international borders, the focus of this chapter is on this MMoU. The history and contents of the MMoU is examined as well as its impact both on the parties to the MMoU and on IOSCO in its role as the world's coordinator of securities regulation. In particular it becomes apparent on closer examination that this MMoU is working as more than just a mechanism for exchanging enforcement related information. IOSCO is using this MMoU as a lever to realize its other main goal that is to reach worldwide convergence of securities regulation.

## **Part 1 IOSCO History and Governance**

### **Establishment and structure**

IOSCO was formed in 1983 from an inter-American regional organisation of securities regulators which had been established in 1974.<sup>554</sup> As such its membership consisted of just eleven securities regulatory agencies from North and South America.<sup>555</sup> In 1984 IOSCO expanded its membership beyond America when the United Kingdom, France, Indonesia and South Korea joined.<sup>556</sup> The pressure to expand membership beyond the Americas came

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<sup>553</sup> IOSCO "Current Signatories and Members listed on Appendix B", online: IOSCO <<http://www.iosco.org/about/?subSection=mmou&subSection1=signatories>>.

<sup>554</sup> IOSCO "About IOSCO", online: IOSCO <[http://www.iosco.org/about/?subsection=about\\_iosco](http://www.iosco.org/about/?subsection=about_iosco)>.

<sup>555</sup> *Ibid.*

<sup>556</sup> Davies, *supra* note 203 at 60.

initially from market institutions who wanted the development of common standards for prospectuses in response to the increasing globalisation of markets.<sup>557</sup>

IOSCO is not the subject of any international treaties and has no formal status in international law.<sup>558</sup> As an organization, originally it was incorporated by a bill of the Quebec National Assembly.<sup>559</sup> In 2001 it changed its domicile to Spain and now operates as a non-profit organization funded by members.<sup>560</sup> IOSCO now has 124 ordinary members comprising over 95% of the world's capital markets.<sup>561</sup> Ordinary members of IOSCO consist of national securities commissions or a similar governmental body with significant authority over securities or derivatives markets.<sup>562</sup>

IOSCO also has 17 associate members and 64 affiliate members.<sup>563</sup> Associate members are regulatory bodies within a jurisdiction where the national regulatory body is already an ordinary member, other bodies responsible for securities regulation, supranational bodies with responsibility for securities regulation and intergovernmental international organizations and other international standard-setting bodies.<sup>564</sup> Affiliate members consist of Self-Regulatory Organisations ('SRO's), securities exchanges, financial market infrastructures (including clearing and settlement agencies), international bodies other than governmental organizations with an appropriate interest in securities regulation, investor protection funds and compensation funds and any other body with an appropriate interest in securities regulation that the IOSCO Board may decide for the purpose of furthering the objectives of the Organization.<sup>565</sup> For example the European Commission and the International Monetary

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<sup>557</sup> Blair, *supra* note 172 at 468.

<sup>558</sup> See Anne-Marie Slaughter *A New World Order* (Princeton University Press, 2004) at 33.

<sup>559</sup> David Zaring "International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations" (1998) 33 *Tex. Int'l. J.* 281 at 292. See also *An Act Respecting the International Organization of Securities Commissions 1987*, S.Q. 2437 1987 ch.143.

<sup>560</sup> IOSCO Annual Report 2011, online: IOSCO <[http://iosco.org/annual\\_reports/2011/](http://iosco.org/annual_reports/2011/)> at 60.

<sup>561</sup> See IOSCO "International Organization of Securities Commissions", *supra* note .

<sup>562</sup> IOSCO Annual Report 2008, online: IOSCO <[http://www.iosco.org/annual\\_reports/annual\\_report\\_2008/generalInformation3.html](http://www.iosco.org/annual_reports/annual_report_2008/generalInformation3.html)> at 26.

<sup>563</sup> IOSCO "General Membership Lists", online: IOSCO <<https://www.iosco.org/about/?subsection=membership&memid=1>>.

<sup>564</sup> *Ibid.*

<sup>565</sup> IOSCO "Membership Categories and Criteria", online: IOSCO <<http://www.iosco.org/about/index.cfm?section=membership>>.

Fund (IMF) as well as organisations such as the Canadian Investor Protection Fund and the UK CFA Institute Centre for Financial Market Integrity are affiliate members. It is unclear from what the IOSCO board would accept as an ‘appropriate interest’ in securities regulation, however it appears that the organization must be concerned with the broader public interest of securities regulation, above and beyond purely a private business interest.<sup>566</sup>

### **Governance of IOSCO**

IOSCO’s constitution is such that each ordinary member of IOSCO is entitled to one vote on the Presidents Committee which meets once a year at IOSCO’s Annual Conference.<sup>567</sup> Until 2012 IOSCO was governed by an Executive Committee comprised of the Chairmen of the various IOSCO Committees and 13 members who were elected by the ordinary members.<sup>568</sup> In 2012 IOSCO changed its governing structure to a governing Board. The governing Board consists of 36 members, 18 of which are from the countries with the largest markets.<sup>569</sup>

This change was made to more accurately reflect the make-up of IOSCO’s changing membership base which has now expanded far beyond developed nations. In addition the change is intended to reflect IOSCO’s growing importance in the setting of global standards for securities regulation. The IOSCO 2011 Annual Report noted that:

This structural reform is intended to enhance IOSCO’s presence in global discussions by enabling it to express its views with a single voice that is clear, coherent and forward-thinking. It also seeks to improve the quality and timeliness of IOSCO’s standard setting by strengthening its communication with members and stakeholders. A priority is to ensure

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<sup>566</sup> Recently IOSCO tightened the criteria for Affiliate membership. Previously all that was required was that the organization just have an “appropriate interest in securities regulation.”

<sup>567</sup> IOSCO Annual Report 2008, *supra* note 562 at 25-27.

<sup>568</sup> The Executive Committee was composed of 19 members being the Chairmen of the Technical and Emerging Markets Committees, the Chairmen of the four Regional Committees, one ordinary member elected by each Regional Committee and 9 ordinary members elected by the Presidents Committee: See IOSCO Annual Report 2008, *supra* note 562 at 24-25.

<sup>569</sup> IOSCO “Resolution of the Presidents’ Committee on the Composition of the IOSCO Board, May 2013, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES49.pdf>>. The other members consist of the Chair and Vice Chair of the Growth and Emerging Markets Committee, the Chairs of the four Regional Committees, two members elected by the Growth and Emerging Markets Committee and two members elected by each of the four Regional Committees.

IOSCO's inclusiveness through increased engagement with its broad membership, in particular with members from emerging markets.<sup>570</sup>

In 2012 IOSCO also increased its membership fees, no doubt because of its growing international significance and the needs for funds to support these operations. Whereas previously it was a flat fee of €15,000 per annum, it is now set by a sliding scale of up to €30000 for members from high income/high GDP nations.<sup>571</sup>

IOSCO maintains a small secretariat in Madrid however most its work is carried out by Committees. These committees are allocated particular responsibilities and are comprised of a number of persons employed by IOSCO members. Up until 2012 the main committees were the Technical Committee and the Growth and Emerging Markets Committee ("GEM Committee") (formally called the Emerging Markets Committee). Also up until 2012 the Technical Committee undertook most of the policy work of IOSCO and made most of the recommendations to the President's Committee for the adoption of new policies.<sup>572</sup> This work was undertaken via five permanent Standing Committees and specific Task Forces which report to it. When it was established, the Technical Committee was intended to represent the world's largest more developed internationalized markets and its membership was biased towards IOSCO's roots in the Americas. The 15 members of this committee were two members from the United States (the Securities Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC)) two members from Canada (the Ontario Securities Commission and Auto rite des marches financiers of Quebec) and Mexico had one. The other members were Australia, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Spain, Switzerland and, from 2009, Brazil, China and India.<sup>573</sup> Since 2012 the

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<sup>570</sup> IOSCO Annual Report 2011, *supra* note 560 at 10.

<sup>571</sup> IOSCO "Resolution of the Presidents Committee on Funding the new Strategic Direction" April 2011, online: IOSCO < <https://www.iosco.org/library/resolutions/pdf/IOSCORES30.pdf> >.

<sup>572</sup> Davies, *supra* note 203 at 60

<sup>573</sup> Davies, *supra* note 203 at 60. See also the "Report from the Chairman of the Technical Committee" IOSCO Annual Report 2008, *supra* note 562. See also IOSCO Media Release "IOSCO Technical Committee invites Brazil, China and India to join its membership", 19 February 2009, online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS136.pdf>>.

newly constituted Board has absorbed the functions of the Technical Committee. There are now seven Standing Committees and a number of Task Forces reporting directly to it.<sup>574</sup>

The other main IOSCO Committee is the GEM Committee. This Committee is focused on improving the efficiency of emerging markets by providing assistance to such markets via the establishment of principles and standards, training programs and transfer of technology and expertise.<sup>575</sup> IOSCO has also formed four regional committees for Africa/Middle-East, Asia-Pacific, Europe and the Americas. Like the GEM Committee the focus of these committees is not primarily on policy formation but to discuss problems specific to their region.<sup>576</sup>

Currently 80% of IOSCO's membership consists of emerging markets. Accordingly, unlike in past when developed nations had a dominant role, emerging markets are likely to play an increasingly important role in IOSCO both in terms of governance, direction and the development of policy and standards.

## **Part 2 The Development of the MMoU**

### **History of cooperation leading up to the MMoU**

#### ***a) Early attempts at cooperation***

Cooperation and the exchange of information have been at the forefront of IOSCO's mission almost since its inception. One of the first resolutions passed by IOSCO's members concerned the exchange of information. In 1986 the then members passed a very brief resolution calling upon members:

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<sup>574</sup> The Committees are Committee 1 on Multilateral Disclosure and Accounting, Committee 2 on Regulation of Secondary Markets, Committee 3 on Regulation of Market Intermediaries, Committee 4 on Enforcement and Exchange of Information, Committee 5 on Investment Management, Committee 6 on Credit Rating Agencies and Committee 7 on Commodity Futures Markets, see IOSCO Annual Report, *supra* note at 25-30.

<sup>575</sup> IOSCO Annual Report 2011, *supra* note 560 at 51-52

<sup>576</sup> *Ibid.*

to the extent permitted by law, to provide assistance on a reciprocal basis for obtaining information related to market oversight and protection of each nation's markets against fraudulent securities transactions.<sup>577</sup>

This resolution also asked members to designate a contact who would be responsible to process any requests. The preamble to this resolution makes it clear that that IOSCO foresaw that further mechanisms for the exchange of information would be developed over time.<sup>578</sup>

Initially it was envisaged that cooperation and the exchange of information between members would take place primarily via bilateral and multilateral memoranda of understanding negotiated by individual members with other members, rather than negotiated by IOSCO. As such in 1989 IOSCO passed a further resolution which referred to the 1986 resolution and called on the members of IOSCO to consider negotiating bilateral and/or multilateral memoranda of understanding. This resolution also stated that such cooperation and exchange of information should be without regard to whether the matter under investigation would be a violation of the law of the requested member. This resolution also called upon members to make recommendations to their legislature to implement laws to facilitate such memoranda of understanding.<sup>579</sup> The main champion of this resolution was the United States which, as a result of problems in its international enforcement efforts, had issued a 'Policy Statement on Regulation of International Securities Markets' in 1988. This Policy Statement, inter alia, called on regulators to "forge a network of... information sharing arrangements that are effective from an enforcement standpoint and sensitive to national sovereignty concerns".<sup>580</sup>

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<sup>577</sup>IOSCO "A Resolution Concerning Mutual Assistance, ("Rio Declaration")", November 1986, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES1.pdf>>.

<sup>578</sup>*Ibid.* The preamble states "desiring to develop new mechanisms for mutual cooperation and assistance among securities authorities".

<sup>579</sup> See IOSCO "A Resolution On Cooperation" June 1989, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES2.pdf>> .

<sup>580</sup> Felice B. Friedman, Elizabeth Jacobs and Stanley C Macel IV "Taking stock of information sharing in securities enforcement matters" July 2002 10(1) Journal of Financial Crime 37 at 39.

Following the 1989 resolution in 1991 the IOSCO Technical Committee released a document setting out ten principles which should be included when members were negotiating Memoranda of Understanding with their foreign counterparts.<sup>581</sup> This drew upon a 1990 report which considered the difficulties members were encountering while negotiating and implementing Memoranda of Understanding.<sup>582</sup>

Problems in relation to exchanging information clearly continued to be a significant issue as observed by the IOSCO Technical Committee in 1994 when it conducted a study of the problems experienced by securities regulators in obtaining access to information located in a foreign jurisdiction relevant to an enforcement action. The resulting report, "Report on Issues Raised for Securities and Futures Regulators by Under-Regulated and Uncooperative Jurisdictions"<sup>583</sup>, found two key reasons why such information was not available. First, some jurisdictions did not require sufficient records to be maintained to, for example, identify the beneficial owners of securities. Second, there were barriers to transmitting information to foreign securities regulators. These barriers consisted of first, legal provisions protecting privacy or individual rights. Second, authorities lacked the power to compel the production of documents and/or testimony, the authority to provide information to a foreign regulator and/or resources to conduct the investigations on behalf of the foreign authorities.<sup>584</sup>

As a result of this report the President's Committee passed a further resolution asking members to evaluate their own laws, regulations and procedures, considering the existence of requirements to create and maintain records and also obstacles to the transmission of information. The resolution asked members to provide IOSCO with an assessment of each member's abilities in this regard and stated that IOSCO intended to monitor these

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<sup>581</sup> IOSCO Technical Committee "Principles for Memoranda of Understanding", Released at the XVI the Annual Conference - September 1991 - Washington, D.C, online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD17.pdf>>.

<sup>582</sup> *Ibid.*

<sup>583</sup> IOSCO Technical Committee "Report on Issues raised for Securities and Futures Regulators by Under-Regulated and Uncooperative Jurisdictions", October 1994, online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD41.pdf>>.

<sup>584</sup> *Ibid.*



assessments. To the extent that members lacked the legal ability to maintain records and transmit information, members were asked to use their best efforts to obtain it.<sup>585</sup>

Following this resolution IOSCO sent its members a detailed questionnaire which contained information about this self-evaluation exercise. The results were the subject of a further IOSCO report in November 1997. Although not all IOSCO members completed the questionnaire the report found substantial shortcomings in record keeping requirements and the ability of regulators to share information with foreign regulators.<sup>586</sup> This report resulted in further resolutions by the Presidents Committee asking IOSCO members to:

- Ensure that records were kept of all securities and futures transactions to identify the relevant parties behind the transactions;
- To ensure that they have the power to collect such information and that domestic secrecy laws should not prevent such collection;
- Ensure that they are capable of obtaining statements and documents that may be relevant to investigating and prosecuting potential violations of laws and that such information can be shared with other IOSCO members;
- Work with domestic governments to identify and remove any impediments to such cooperation.<sup>587</sup>

### ***b) IOSCO's key policy statement – the Objectives and Principles of Securities***

#### ***Regulation***

In 1998, as part of its goal to promote high standards of securities regulation throughout the

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<sup>585</sup> IOSCO “A Resolution on Commitment to Basic IOSCO Principles of High Regulatory Standards and Mutual Cooperation and Assistance (Self-Evaluation)” October 1994, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES11.pdf>>.

<sup>586</sup> IOSCO “Report on the self-evaluation conducted by IOSCO members pursuant to the 1994 IOSCO resolution on “Commitment to Basic IOSCO principles of High Regulatory Standards and Mutual Cooperation and Assistance.”, November 1997, online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCO76.pdf>>.

<sup>587</sup> IOSCO “A Resolution on Enforcement Powers”, November 1997”, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES14.pdf>> and IOSCO “A Resolution on Principles for Record Keeping, Collection of Information, Enforcement Powers and Mutual Cooperation to Improve the Enforcement of Securities and Futures Laws”, November 1997, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES15.pdf>>.

world, IOSCO formulated what has become its key policy statement being its *Objectives and Principles of Securities Regulation*.<sup>588</sup> In this document IOSCO set out the two objectives of securities regulation, namely the protection of investors and ensuring that markets are fair, efficient and transparent.<sup>589</sup> In addition IOSCO initially laid out 30 principles of securities regulation which it advises should be incorporated within a country's system of securities regulation.<sup>590</sup>

A number of these principles reflect the problems found by IOSCO in relation to the sharing of information for enforcement purposes. In particular principles 13-15 which provide:

13 The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.

14 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

15 The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.<sup>591</sup>

### **c) The Shift to a Multilateral Approach to the Exchange of Information**

In 1999 the predecessor of the European Securities and Markets Authority (ESMA), the Committee of European Securities Regulators, formulated its own Multilateral Memorandum of Understanding on exchanging information between its members (the ESMA MoU).<sup>592</sup> However at that time it seems that IOSCO members were satisfied with the process of them continuing to negotiate bilateral or multilateral memoranda of understanding without the direct involvement of IOSCO. In particular the US had pursued the policy of directly

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<sup>588</sup>IOSCO *Objectives and Principles of Securities Regulation*, September 1998, online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82.pdf> >. These were amended in 2003, see IOSCO Principles, *supra* note 39 and again in 2010, see IOSCO Principles, *supra* note 37.

<sup>589</sup> *Ibid*, more recently a third has been added, namely the reduction of systemic risk, see 2010 amendments.

<sup>590</sup> *Ibid*, since that time this has expanded to 38 principles.

<sup>591</sup> IOSCO, *Objectives and Principles*, *supra* note 37 at 6.

<sup>592</sup> ESMA MoU, *supra* note 375.

negotiating bilateral/multilateral memoranda of understanding<sup>593</sup> and by the end of 2000 had negotiated and signed bilateral memoranda of understanding with 22 countries and a memorandum of understanding with the Commission of European Communities.<sup>594</sup>

However the events of September 11, 2001 resulted in an important shift in approach, particularly by the US. These events triggered a concern that financial markets may have been used for terrorist financing.<sup>595</sup> In October 2001 IOSCO announced the formation of a special Project Team to “explore actions that securities regulators should take in view of the events of 11 September and their aftermath.”<sup>596</sup> Specifically this Project Team was asked to consider three areas, Contingency Planning, Expanded Cooperation and Information Sharing and Client Identification. In relation to the latter two areas the Project Team was asked to “examine the capacity and willingness of securities regulators to implement high quality standards on information sharing and the expansion of the standards to include other financial regulators and law enforcement authorities” and “explore the components of a robust identification regime, taking into account practical implications for the industry.”<sup>597</sup>

The Chairman of this Project Team was the President of the French Commission des Operations de Bourse. It appears that the Project Team was formed at the instigation of the Technical Committee and so probably its membership reflected the then membership of the Technical Committee.<sup>598</sup> It was this Project Team that formulated the MMoU which was then

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<sup>593</sup> See for example comments by SEC General Counsel James R. Doty “The Role of the Securities and Exchange Commission in an Internationalized Marketplace” (1992) 60 Fordham L. Rev. S77 at S83.

<sup>594</sup> See list of bilateral/multilateral Memorandum of Understanding see SEC “Cooperative Arrangements with Foreign Regulators” online: SEC <[http://www.sec.gov/about/offices/oia/oia\\_cooparrangements.shtml](http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml)>. For a discussion in relation to some of the terms of these bilateral Memoranda of Understanding see Michael D. Mann & William P. Barry “Developments in the Internationalization of Securities Enforcement” (2005) 39 Int’l Law 667 at 675-680.

<sup>595</sup> See IOSCO “Final Communiqué of the XXVIIIth Annual Conference of the International Organization of Securities Commissions” October 2003 at 9, online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS61-English.pdf>>.

<sup>596</sup> IOSCO Press Release “Creation of a Special Project Team” 12 October 2001, online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS14-English.pdf>>.

<sup>597</sup> *Ibid.*

<sup>598</sup> *Ibid.*

put before the Annual Conference of IOSCO in May 2002<sup>599</sup> and endorsed by the Presidents Committee.<sup>600</sup>

### **Adoption of MMoU by IOSCO members**

Following the endorsement of the Presidents Committee, IOSCO members were asked to sign the MMoU. However the initial response by members to becoming signatories was lacklustre. By the end of 2004 only 25 members were signatories, another five had made a commitment to seek the legal authority to become signatories and seventeen applications were in process.<sup>601</sup>

In February 2005 the Technical Committee of IOSCO produced a report titled “Strengthening Capital Markets against Financial Fraud” prepared in response to uncertainty as to the integrity of the capital markets as a result of the large financial collapses, in particular the collapse of Enron Corporation and WorldCom in the US, and Parma at Spa. in Italy.<sup>602</sup> Part of this report considered cross border enforcement cooperation. In this report the Technical Committee recommended that the Presidents Committee resolve that the MMoU be the:

Benchmark for enforcement cooperation among IOSCO members, with the goal of eventually making the ability to sign on to the IOSCO Multilateral MOU a primary benchmark for continued IOSCO membership, particularly for historically uncooperative jurisdictions.<sup>603</sup>

However the form of the resolution adopted at the next Presidents Committee was ultimately not as strong as this recommendation of the Technical Committee because the President’s Committee resolution did not require the ability to sign the MMoU a condition of continued membership. Rather, in April 2005 the President’s Committee passed a resolution that all members would have to become a full signatory to the MMoU by 1 January 2010 or would

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<sup>599</sup> IOSCO Press Release “IOSCO announces the endorsement of the First Multilateral MOU for Securities Regulators”, May 2002, online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS6.pdf>>.

<sup>600</sup> IOSCO “A Resolution of the Presidents’ Committee on the IOSCO MOU”, May 2002, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES21.pdf>>.

<sup>601</sup> IOSCO Annual Report 2004 at 3, online: IOSCO <[http://www.iosco.org/annual\\_reports/annual\\_report\\_2004/docs/index1.html](http://www.iosco.org/annual_reports/annual_report_2004/docs/index1.html)>.

<sup>602</sup> IOSCO Technical Committee “Strengthening Capital Markets against Financial Fraud”, February 2005, online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD192.pdf>>.

<sup>603</sup> *Ibid* at iv.

have to commit to becoming a full signatory to the MMoU. In addition resources would be allocated to assist members become signatories.<sup>604</sup> The IOSCO Presidents committee also passed a resolution that IOSCO would not accept new members who did not sign the MMoU.<sup>605</sup>

From April 2005 IOSCO committed significant resources in a push for members to become signatories to the MMoU. This comprised not just specialized workshops, but also individual consultation between member regulators and IOSCO.<sup>606</sup> Much of this work was done via the Emerging Markets Committee of IOSCO, presumably because members from those markets were perceived to require the most assistance.<sup>607</sup>

In addition the Technical Committee started a process of identifying jurisdictions which did not exchange information either because they were under-regulated or uncooperative. It commenced a dialogue with these jurisdictions with a view to resolving problems and establishing “roadmaps to foster communication.”<sup>608</sup> This was referred to as the IOSCO Contact Initiative.<sup>609</sup>

It appears that IOSCO also put pressure indirectly on under-regulated/uncooperative jurisdictions via the Financial Stability Forum (FSF) and Financial Action Task Force (FATF). In 2000 the FSF had published a list of under-regulated/uncooperative jurisdictions, also known as Offshore Financial Centres (‘OFC’s’).<sup>610</sup> This list was removed in 2005 in response

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<sup>604</sup> IOSCO “Resolution of the Presidents Committee on the International Benchmark for Enforcement Related Cooperation and Exchange of Information”, 6 April 2005, online: IOSCO <https://www.iosco.org/library/resolutions/pdf/IOSCORES24.pdf> and IOSCO “Final Communiqué of the XXXth Annual Conference of the International Organization of Securities Commissions (IOSCO)”, 7 April 2005, online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS88-English.pdf>>.

<sup>605</sup> IOSCO Annual Report 2008, *supra* note 562 at 8. See also IOSCO “Resolution of the Presidents Committee on the International Benchmark for Enforcement Related Cooperation and Exchange of Information” 6 April 2005, online: IOSCO <<https://www.iosco.org/library/resolutions/pdf/IOSCORES24.pdf>>.

<sup>606</sup> See for example comments by the Secretary General in the IOSCO Annual Report 2008, *supra* note 562 at 19.

<sup>607</sup> Reports of the Chairman of the Emerging Markets Committee in the IOSCO Annual Reports 2008 online: IOSCO <[http://www.iosco.org/annual\\_reports/annual\\_report\\_2008/pdf/emergingMarketsCommittee.pdf](http://www.iosco.org/annual_reports/annual_report_2008/pdf/emergingMarketsCommittee.pdf)>.

<sup>608</sup> IOSCO Report, *supra* note 602 at vii.

<sup>609</sup> IOSCO Annual Report 2008, *supra* note 562 at 22.

<sup>610</sup> Financial Stability Forum Releases “Grouping of Offshore Financial Centres (OFCs) to Assist in Setting Priorities for Assessment”, 26 May 2000, online: FSF <[http://www.financialstabilityboard.org/press/pr\\_000526.pdf?noframes=1](http://www.financialstabilityboard.org/press/pr_000526.pdf?noframes=1)>.

to assessments by the IMF and reforms in these jurisdictions.<sup>611</sup> However at the same time the FSF said that:

problems remain in several OFCs with respect to compliance with international standards, notably in the areas of effective cross border cooperation and information exchange and adequacy of supervisory resources.<sup>612</sup>

To deal with these problems, in 2005, the FSF adopted a number of measures including endorsing IOSCO's efforts in identifying and working with under-regulated and uncooperative jurisdictions so that they could meet IOSCO's requirements to sign the MMoU.<sup>613</sup> In 2006, in turn, the IOSCO Technical Committee delivered a status report to the FSF concerning under-regulated and/or uncooperative jurisdictions and briefed the FATF International Co-operation Review Group concerning under-regulated and/or uncooperative jurisdictions.<sup>614</sup>

IOSCO continued to add signatories to the MMoU throughout 2007-2009. On its self-imposed deadline of January 2010 IOSCO announced that of the 115 securities regulators that were then are members of IOSCO, 64 had signed the MMoU and that most of the remaining member regulators had met the requirements needed to become signatories or had made a commitment to seeking national legislative changes to allow them to do so in the near future.<sup>615</sup> Notwithstanding the fact that this deadline had passed, IOSCO continued to push its members to sign the MMoU. In July 2010 IOSCO passed a further resolution creating a new deadline of January 2013 for all members to sign and resolved to create a 'watch list' of those members who had not signed the MMoU. It also resolved that IOSCO would make a greater effort to provide assistance to those members who had not signed to

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<sup>611</sup> Financial Stability Forum Press Release "FSF announces a new process to promote further improvements in offshore financial centres (OFCS)", 11 March 2005, online: FSF <<http://www.iosco.org/news/pdf/IOSCONEWS86.pdf>>.

<sup>612</sup> *Ibid.*

<sup>613</sup> *Ibid.*

<sup>614</sup> IOSCO Annual Report 2006, online: <[http://www.iosco.org/annual\\_reports/annual\\_report\\_2006/annual\\_report\\_2006.html#](http://www.iosco.org/annual_reports/annual_report_2006/annual_report_2006.html#)> at 8.

<sup>615</sup> IOSCO Media Release "IOSCO completes global framework to fight against cross border market abuse", 22 January 2010, online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS176.pdf>>.

enable them to make the necessary legislative changes to enable them to sign. In addition the resolution resolved to provide greater assistance to enable non-applicants to apply to become signatories.<sup>616</sup>

In May 2012, when it presumably became clear all members would not be signatories by January 2013, IOSCO approved a further resolution said to “allow it to take tougher measures to encourage compliance by IOSCO members who have not yet signed the MMoU”<sup>617</sup> This resolution called on the IOSCO Board to first, “ensure that a program of technical assistance and political support is made available to non-signatory members to enable them to make the changes necessary to become signatories.” Second the IOSCO Board was required to closely monitor progress towards complying with the 1 January 2013 deadline and, from 1 January 2013, disclose on the IOSCO website the names of those members who had not become signatories to the MMoU. Third after 1 January 2013 deadline, the transitional IOSCO Board was requested, if necessary, to propose to the Presidents Committee “graduated additional measures to encourage those members who have failed to become MMoU signatories”. Finally this resolution called on its members to take into account, from 1 January 2013, “when exercising their responsibilities, the more limited enforcement co-operation that regulators who are non-signatories to the MMoU are able to provide.”<sup>618</sup>

In June 2013 the Presidents committee passed a further resolution aimed at compelling members to become signatories to the MMoU. It ask members to “take precautions when exercising their authorization or supervisory and enforcement responsibilities in respect of entities or individuals linked to non-signatory jurisdictions.” It also requires that all members who are not signatories are restricted from nominating candidates for leadership positions

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<sup>616</sup> IOSCO “Resolution on IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, July 2010, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES27.pdf>>.

<sup>617</sup> IOSCO Media Release “The MMoU: Ten Years of Enhancing Cross-border Enforcement Cooperation”, 16 May 2012, online: IOSCO <<http://iosco.org/news/pdf/IOSCONEWS234.pdf>>.

<sup>618</sup> “Resolution of the IOSCO Presidents Committee”, online: IOSCO <<http://iosco.org/library/resolutions/pdf/IOSCORES36.pdf>>.

and from serving on leadership positions or on policy committees. Furthermore it also provides that the voting rights of members who are not signatories to the MMoU are suspended from 30 September 2014 until those members become signatories.<sup>619</sup>

### **Part 3 The Impact of the MMoU**

#### **The express terms of the MMoU**

The influence of the United States is readily apparent in the express terms of the MMoU. The preamble of the MMoU specifically makes reference to events of September 11, 2001 said to “underscore the importance of expanding cooperation among IOSCO members.” Furthermore throughout IOSCO’s history the US has been at the forefront of the push for international cooperation and the exchange of information. In 1988, at the behest of the SEC, the US Congress passed the Insider Trading and Securities Fraud Enforcement Act<sup>620</sup> which amended the Securities Exchange Act 1934 in relation to enforcement cooperation and information sharing. These amendments provided that:

- when the SEC provides information it is not to distinguish between the use the foreign regulator can make with the information. That is the foreign regulator can use the information for administrative, civil or criminal purposes;
- that the SEC could withhold assistance if it prejudiced the “public interest”; and
- that the SEC could provide information to foreign regulators even if the same activity would not breach the law in the US. That is, the SEC was not subject to a ‘dual criminality’ requirement. This in contrast to the requirements of many Mutual Legal Assistance Treaties between countries which contain such a requirement.<sup>621</sup>

Statements similar to these amendments are contained in the MMoU.

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<sup>619</sup> Presidents Committee of IOSCO, “Resolution on IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information”, September 2014, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES50.pdf>>.

<sup>620</sup> *The Insider Trading and Securities Fraud Enforcement Act* of 1988, 100PL 704, 102 Stat.4677, 19<sup>th</sup> November 1988.

<sup>621</sup> Friedman, *supra* note 580 at 40. This article also notes (at 41) that France, the UK, Australia and Ontario followed the US and adopted information similar legislation shortly thereafter.



The MMoU makes specific reference to dual criminality not being a condition of a regulator providing assistance. Article 7(c) of the MMoU makes it clear that a party to the MMoU cannot deny assistance based on the fact that the type of conduct under investigation is not a violation of the laws of that country. This lack of a dual criminality requirement was also a feature of the 1989 IOSCO resolution, championed by the US, following the 1988 amendments to the Securities Exchange Act 1934.

The scope of the information that can be requested under the MMoU is framed in quite broad terms. It provides that the following assistance can be provided:

The assistance available under this Memorandum of Understanding includes, without limitation:

(i) providing information and documents held in the files of the Requested Authority regarding the matters set forth in the request for assistance;

(ii) obtaining information and documents regarding the matters set forth in the request for assistance, including:

- contemporaneous records sufficient to reconstruct all securities and derivatives transactions, including records of all funds and assets transferred into and out of bank and brokerage accounts relating to these transactions;
- records that identify: the beneficial owner and controller, and for each transaction, the account holder; the amount purchased or sold; the time of the transaction; the price of the transaction; and the individual and the bank or broker and brokerage house that handled the transaction; and
- information identifying persons who beneficially own or control non-natural Persons organized in the jurisdiction of the Requested Authority.

(iii) In accordance with Paragraph 9(d), taking or compelling a Person's statement, or, where permissible, testimony under oath, regarding the matters set forth in the request for assistance.

Accordingly, although it must be directed towards the enforcement of member's securities and derivatives laws,<sup>622</sup> the type of information that can be requested is not limited. However while the information is not limited, the key focus of the MMoU seems to be the obtaining of information in relation to the identity of persons behind a transaction.<sup>623</sup>

The MMoU provides that a requested party can deny providing assistance on "public interest" or "essential national interest" grounds. These terms are not defined. If a denial is made on these grounds then reasons must be provided to the regulator that requested the information.<sup>624</sup>

Once the information is handed across it can be used for a broad range of purposes without referring back to the securities regulator from which it obtained the information. In addition to the purposes set out in the request it can be used for "a purpose within the general framework of the use stated in the request for assistance" including for civil, administrative or criminal proceedings and for "assisting a self-regulatory organisations surveillance or enforcement activities".<sup>625</sup> Although the information is subject to confidentiality provisions it can be disclosed in certain limited circumstances or in accordance with a legally enforceable demand.<sup>626</sup>

Importantly, the MMoU also specifically provides a signatory to the MMoU "represent that no domestic secrecy or blocking laws or regulation should prevent the collection or provision of the information."<sup>627</sup> Secrecy laws have been the source of frustration for the SEC in their enforcement efforts and have resulted in the failure of some actions taken by the SEC.<sup>628</sup>

Given the Chairman of the French Securities Commission was the Chairman of the Project Group in charge of preparing the MMoU, it is likely that the 1999 ESMA MoU may have been

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<sup>622</sup> IOSCO MMoU, *supra* note 268. These are defined in Article 4.

<sup>623</sup> *Ibid*, article 7(b)(ii)

<sup>624</sup> *Ibid*, article 6

<sup>625</sup> *Ibid*, article 10.

<sup>626</sup> *Ibid*, article 11.

<sup>627</sup> *Ibid*, article 6(b).

<sup>628</sup> For examples of such cases see Friedman, *supra* note 580.

influential.<sup>629</sup> In fact a comparison between the documents appears to demonstrate some similarities. However the scope of the MMoU is somewhat narrower. For example, the ESMA MMoU states that in some circumstances the authority making the request for assistance and the authority receiving the request should consider joint investigations.<sup>630</sup> However the IOSCO MMoU contains no mention of joint investigations. The IOSCO MMoU merely provides that a representative of the regulator requesting information may be present during, for example, the taking of statements.

One notable absence from the express terms of the MMoU is that there is scant mention of the sharing of costs of complying with requests. The only mention is a provision requiring the authorities to consult where “it appears that responding to a request will involve substantial cost”.<sup>631</sup> It seems therefore that authorities receiving the request for information are expected to meet the costs of complying with the requests. This is somewhat surprising given the substantially different size of securities regulators around the world and that IOSCO’s own guidelines for members negotiating a bilateral MMoU state that a Memorandum of Understanding should provide a process whereby the requesting authority share the costs of providing assistance that are incurred by the requested authority.<sup>632</sup>

### **Impact beyond the express terms of the MMoU**

The express terms of the MMoU belies the fact that the MMoU is not just concerned with regulators agreeing to share information. Rather the MMoU is inextricably linked to IOSCO’s agenda of having countries incorporate into their own laws the *Objectives and Principles of Securities Regulation* promulgated by IOSCO. This dual purpose of the MMoU was, in fact, acknowledged by the IOSCO Technical Committee in 2005:

...the IOSCO Multilateral MOU is more than just an information-sharing mechanism. Signing the agreement involves a review process through which prospective signatories must demonstrate

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<sup>629</sup> ESMA MoU, *supra* note 375.

<sup>630</sup> *Ibid*, article 5.

<sup>631</sup> IOSCO MMoU, *supra* note 268, article 12(b).

<sup>632</sup> IOSCO Technical Committee Report, *supra* note 581, article 10.

they have the legal authority to provide the kinds of assistance the Multilateral MOU describes. Signing the IOSCO Multilateral MOU necessarily entails an extensive assessment of the prospective signatory's implementation of IOSCO's Core Principles in this area.<sup>633</sup>

Securities regulators cannot sign the MMoU until they have undergone a screening process by IOSCO.<sup>634</sup> A member wishing to sign the MMoU must be assessed by a screening group of other members to ensure that they have in place laws which comply with Principles 11-13 of IOSCO's *Objectives and Principles of Securities Regulation*. If the member lacks laws reflective of these principles IOSCO will provide assistance to these countries to achieve the necessary changes.

This process ensures that IOSCO is satisfied that the domestic laws of the regulator wishing to sign the MMoU are such that they can comply with their obligations under the MMoU. So, for example, as is referred to above, the MMoU requires that a party "represent that no domestic secrecy or blocking laws or regulation should prevent the collection or provision of the information."<sup>635</sup> Therefore countries which have such secrecy laws cannot become parties to the MMoU and their only option is to pressure the legislature of that country to change the laws to comply with the requirements of the MMoU. Removing blocking laws and increasing the regulators access to information aligns the laws of that country with Principle 13 of IOSCO's *Objectives and Principles of Securities Regulation* which provides:

The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.<sup>636</sup>

The MMoU also provides that the Regulator must be able to provide a range of information to foreign regulators, including banking records and information about the beneficial ownership behind transactions. In addition the regulator must also be able to take or compel

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<sup>633</sup> IOSCO Report, *supra* note 603 at 30.

<sup>634</sup> IOSCO Annual Report 2005 online:

<[http://www.iosco.org/annual\\_reports/annual\\_report\\_2005/pdf/Technical\\_Committee.pdf](http://www.iosco.org/annual_reports/annual_report_2005/pdf/Technical_Committee.pdf)> at 5.

<sup>635</sup> IOSCO MMoU, *supra* note 268, article 6(b).

<sup>636</sup> IOSCO, *Objectives and Principles*, *supra* note 37 at 7.

a person's statement.<sup>637</sup> Accordingly, to become a party to at MMoU the powers of the regulator in that particular country may need to be strengthened. This would in turn align the powers of the regulator with Principle 10 of IOSCO's *Objectives and Principles of Securities Regulation* which provides:

The regulator should have comprehensive inspection, investigation and surveillance powers.<sup>638</sup>

Accordingly IOSCO is using the process of having parties sign the MMoU to coerce members to have in place domestic legislation which reflects some of principles contained in IOSCO's the *Objectives and Principles of Securities Regulation*, its key policy statement. Therefore the MMoU is being used by IOSCO as a tactic to work towards the global convergence of the principles governing the regulation of securities.

This link between the MMoU and changes to domestic legislation is a significant achievement by IOSCO. Through the use of the MMoU IOSCO has managed to cause changes domestic laws, including the domestic laws of countries such as Switzerland, the Cayman Islands and the British Virgin Islands who are all signatories to the MMoU. These countries were once known for their banking secrecy laws and perhaps thought of by those engaging in violations of securities laws as places which were beyond the reach of investigations undertaken by securities regulators such as the SEC. However as referred to in chapter 3, information as to the beneficial owners of companies and bank accounts can be now be obtained from these and many other similar countries via the IOSCO MMoU.

Part of IOSCO's success in causing the changes to the domestic laws is the detailed nature of the screening process adopted by IOSCO. As is referred to above this involves not just assessing if the laws are compatible with IOSCO principles, but also providing assistance in making the necessary changes. This process involves an initial analysis of the member's laws, in some cases in some detail, as to whether or not the member's laws are such that they would be able to comply with the obligations under the MMoU. If there are deficiencies

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<sup>637</sup> IOSCO MMoU, *supra* note 268, article 7(b).

<sup>638</sup> IOSCO, *Objectives and Principles*, *supra* note 37 at 6.

this list of deficiencies is sent back to the member to draft complying legislation. The member then drafts legislation to put before its legislative body. IOSCO then follows up as to whether these changes have become law. If the member cannot get the government to make the necessary changes to its laws, IOSCO will do everything within its financial constraints to get the changes enacted. This includes the Secretary General of IOSCO speaking to or visiting government officials. On occasion the changes have been blocked by the opposition or even the political party in power. In such cases IOSCO has worked with the member securities regulator and, on occasion, has developed some creative solutions such as incorporating the changes in packages of legislation designed to tackle fraudulent activities such as money laundering.<sup>639</sup>

Apart from furthering the success of the MMoU, this process in achieving change in domestic laws is a significant development in the importance of IOSCO as an organization as well as its role in global governance. It also perhaps signals an important development in the importance of transnational regulatory networks. The last few decades have seen the establishment and growth of a number of transnational regulatory networks, such as IOSCO. These networks are characterised by their members not being states but national regulatory agencies. They also tend to have no international status beyond that conferred by the national law of their host countries.<sup>640</sup> In relation to global financial regulation, other transnational regulatory networks exercise similar functions to IOSCO in that they seek standardization of laws, coordination and cooperation. For example the International Association of Insurance Supervisors (IAIS) seeks to “promote effective and globally consistent supervision of the insurance industry in order to develop and maintain fair, safe and stable insurance markets”.<sup>641</sup> The Basel Committee on Banking Supervision provides a forum for cooperation on banking supervisory matters and setting international banking

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<sup>639</sup> Interview with IOSCO.

<sup>640</sup> See generally P. Verdier “Transnational Regulatory Networks and Their Limits” (2009) 34(1) *Yale Journal of International Law* 113 and Slaughter, *supra* note 558.

<sup>641</sup> See International Association of Insurance Supervisors, online: IAIS <<http://www.iaisweb.org/>>.

standards.<sup>642</sup> But transnational regulatory networks are not limited to global financial regulation. There are such networks in relation to competition law,<sup>643</sup> environmental law<sup>644</sup> and international criminal law.<sup>645</sup>

One of the key reasons why these networks have grown in importance is because of problems with the bilateral and multilateral treaty process to solve global problems. The treaty negotiation and subsequent ratification process is time consuming and complex and may not result in a resolution. It can be particularly inappropriate to problems which require more immediate or comprehensive solutions.<sup>646</sup>

However the main difficulty with the use of transnational regulatory networks such as IOSCO to solve global problems is that their agreements, guidelines, policy statements, etc. have no international legal status and impose no binding obligations. As such, generally these networks are limited to relying upon 'soft law' techniques such as networking, socialization, discussion and persuasion to have members adopt their recommendations. Soft law however creates a 'compliance challenge', compliance often being dependent upon coercion, self-interest and the legitimacy of the proposed law.<sup>647</sup> As such, some question the effectiveness of networks as the solution to the need for global governance.<sup>648</sup>

However, as the MMoU demonstrates, perhaps transnational regulatory networks such as IOSCO can effectively achieve compliance not by relying on the 'stick' of international law but by using a 'carrot'. If networks can develop a valuable tool, like the MMoU, which is needed by regulators and it can make the obtaining of this 'carrot' conditional upon domestic legislative reform, this may in turn successfully coerce regulators to approach their domestic

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<sup>642</sup> Basel Committee on Banking Supervision, online: BIS <<http://www.bis.org/bcbs/>>.

<sup>643</sup> International Competition Network, online: ICN <<http://www.internationalcompetitionnetwork.org/>>.

<sup>644</sup> International Network for Environmental Compliance and Enforcement, online: INECE <<http://www.inece.org/>>.

<sup>645</sup> See, for example, the International Criminal Police Organization – INTERPOL, online: INTERPOL <<http://www.interpol.int/public/icpo/default.asp>>.

<sup>646</sup> For a description of failures in formal treaty negotiations, see G. J. Ikenberry, 'The Global Governance Crisis' (2006) 4 *The Interdependent* 32, 33.

<sup>647</sup> R S Karmel & C R Kelly, "The Hardening of Soft Law in Securities Regulation" (2008-2009) 34 *Brook. J. Int'l L.* 883 at 896.

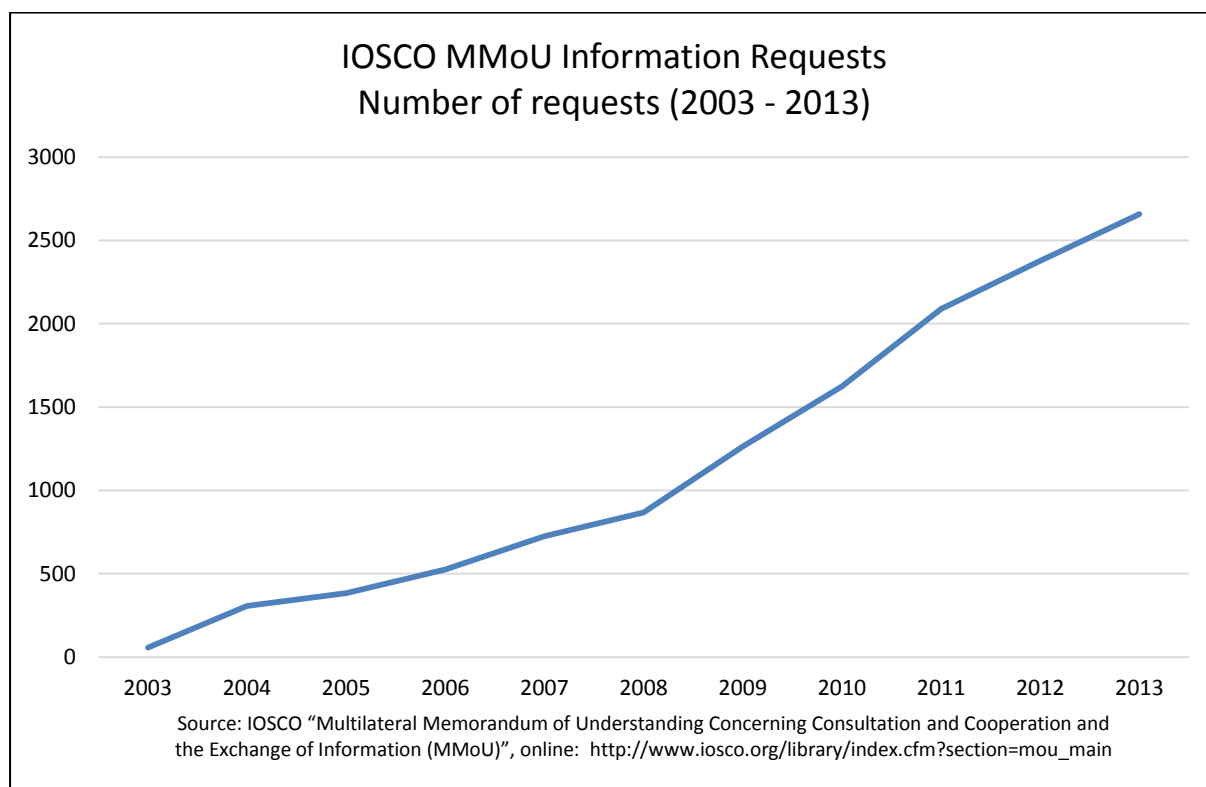
<sup>648</sup> Verdier, *supra* note 640.

legislature to undertake such reform. As a result, over time, domestic regulation in such jurisdictions will accord with the standards promulgated by the network. This may, in turn, work towards strengthening the power and influence of the network.

## The use of the MMoU

### a) Frequency of use

Requests under the IOSCO MMoU have been increasing exponentially rising from just 56 requests in 2003 to 2658 requests in 2013 (Figure 5.1).<sup>649</sup> As such it seems clear that the MMoU is becoming used more frequently over time and has become an important mechanism which securities regulators use for their investigations.



It also appears that the MMoU is becoming important in tackling cross border market abuse as the majority of requests made are for information related to insider dealing, market

<sup>649</sup> See also R Cunha, "The IOSCO Multilateral Memorandum of Understanding (MMoU): an international benchmark for securities enforcement" (2010) 15 (3-4) Unif. L. Rev 677.



manipulation, misrepresentation of material information and other fraudulent or manipulative practices.<sup>650</sup>

Some of these increases in requests can no doubt be attributed to the increased number of signatories to the MMoU which has allowed IOSCO members to obtain information from a larger number of countries. However some of this increase in requests must also be due to a growing awareness by enforcement staff of individual members that this option is available to them to obtain information where the investigation trail leads outside of the jurisdiction. As the MMoU is used more frequently by enforcement staff and they become familiar with the process this may, in turn, lead them to use it again.

The MMoU is also less complex and has a broader reach than alternative mechanisms available to enforcement staff to obtain this information, for example Mutual Legal Assistance Treaties. For example, some countries are signatories to the Inter-American Convention on Mutual Assistance in Criminal Matters. However obtaining information pursuant to this treaty is more cumbersome and information that can be obtained is limited to the investigation, prosecution and proceedings that pertain to criminal offences and then only criminal offences which are punishable by one year or more of imprisonment. Furthermore this Convention was adopted in 1992, it was not ratified by the US until 2001 and 7 of the 34 states comprising the Organisation of American States have still not ratified it.<sup>651</sup>

The increase in the number of requests under the IOSCO MMoU may also indicate that IOSCO members are now more willing to take action and commit resources to matters which cross international boundaries. In a newspaper article published in 2010 Jane Diplock, the former chairman of IOSCO and the former Chairman of the New Zealand Securities Commission opined that the MMoU had changed the dynamics of international investigations. She commented that before the MMoU the situation was very different and

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<sup>650</sup> IOSCO Media Release “IOSCO Identifies Non-Signatories to the MMoU on the Exchange of Information”, 28 February 2013, online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS269.pdf>>.

<sup>651</sup> Organisation of American States, online: OAS <<http://www.oas.org/juridico/english/Sigs/a-55.html>>.

that “There were some jurisdictions where we would write a letter asking for information and we wouldn’t hear back for months,” but that “now the response is almost instantaneous.”<sup>652</sup>

In the same article Martin Wheatley, chief executive of Hong Kong’s Securities and Futures Commission supported this view and said “The structure of trading and market access has changed so much that this process that we have set up is integral to doing our job.”<sup>653</sup>

The prevalence of the use of the MMoU also appears to be reducing the necessity for securities regulators to negotiate additional bilateral Memorandums of Understanding in relation to the exchange of information required for investigations. For example, the SEC has negotiated only a further 3 bilateral enforcement Memoranda of Understanding since the signing of the MMoU.<sup>654</sup> Furthermore where new bilateral Memorandum of Understanding have been negotiated, these tend to build on, rather than replace the IOSCO MMoU.<sup>655</sup> This suggests that the US, at least, is mostly satisfied with the effectiveness of the MMoU.

#### **b) Who is using the MMoU?**

As the MMoU was instigated primarily by policies promulgated by the Technical Committee, it is perhaps no surprise that the countries with the largest capital markets appear to be benefiting the most from the MMoU. A survey conducted by IOSCO in April 2007 of regulators in 32 ‘emerging markets’ found that the traffic of incoming requests compared to outgoing requests in those countries is not equal and that they receive more requests for information than they make.<sup>656</sup> Nevertheless it does seem that these countries with less developed markets are still making a significant number of requests. Furthermore the survey

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<sup>652</sup>B Masters “IOSCO pact reshapes market enforcement” FT Times, 8 January 2010, online: FT Times <<http://www.ft.com/intl/cms/s/0/b843b8f0-ee45-11de-a274-00144feab49a.html#axzz2WZsAGfOD>>.

<sup>653</sup> *Ibid.* As an example Mr. Wheatley pointed to the 2007 insider trading case brought by the US. In this matter David Li, a prominent banker and former Dow Jones board member, and two of his contacts in Hong Kong paid \$24m to settle allegations that they traded ahead of the announcement that Rupert Murdoch’s News Corp was making an unsolicited offer for Dow Jones as a case where the IOSCO MMoU was used.

<sup>654</sup> SEC “Cooperative Arrangements with Foreign Regulators” online: SEC <[http://www.sec.gov/about/offices/oia/oia\\_cooparrangements.shtml](http://www.sec.gov/about/offices/oia/oia_cooparrangements.shtml)>.

<sup>655</sup> For example SEC and ASIC “Memorandum of Understanding”, 25 August 2008, online: SEC <[http://www.sec.gov/about/offices/.../enhanced\\_enforcement\\_mou.pdf](http://www.sec.gov/about/offices/.../enhanced_enforcement_mou.pdf)>.

<sup>656</sup> IOSCO Emerging Markets Committee “Obstacles to Joining the IOSCO MOU”, April 2007 at 7, online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD246.pdf>>. This survey found that most of these jurisdictions received between 6 to 15 requests each year, two jurisdictions received no requests and four jurisdictions received over 50 requests each year.

found that these regulators reported that their requests for information were increasing each year.<sup>657</sup> This suggests that although the formulation and implementation of MMoU was driven by developed countries for their own enforcement needs it is becoming a valuable instrument for all countries in tackling securities violations. It seems that the MMoU is something that all countries interested in promoting fair and efficient markets and attracting investment need and want.

## **Conclusion**

IOSCO has gradually become the leading international organisation working towards improving the enforcement capacities of its members to tackle cross border market abuse and its MMoU has become the most important way in which it is making progress towards this goal. The MMoU has increased the ability of securities regulators to obtain information from other countries for enforcement purposes and has thereby increased their ability to take action against securities violations notwithstanding the fact that evidence needs to be obtained from outside of their jurisdiction.

Furthermore the effect of the MMoU on cross border market abuse may be more significant than just the direct impact it has on the success of investigations where information is obtained pursuant to a request. As enforcement staff become more familiar with the process they may be more likely to pursue investigations of cross border market abuse which they may have otherwise not pursued due to the difficulties involved in completing the investigation. If this leads to more investigations of cross border market abuse, this may eventually act as a deterrent to those considering engaging in such violations if they become aware that structuring a transaction across borders does not reduced the likelihood that they will be pursued by the authorities.

Moreover the MMoU has shown that, despite being merely a network of securities regulators IOSCO can significantly influence the content of domestic laws. Through the MMoU, IOSCO has shown that even though it cannot resort to international law to enforce its policies, is not

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<sup>657</sup> *Ibid* at 8.

thereby limited to the 'soft law' tools such as negotiation socialization and persuasion. IOSCO has shown that it can exercise real power and insist that members change their domestic law in order to gain the advantage of valuable tools such as the IOSCO MMoU. Perhaps over time IOSCO may be able to increasingly use what it has learnt in the development and implementation of the MMoU to work towards convergence of securities regulation, not just the area of enforcement of securities laws, but also in other areas. Rather than just setting the discourse of securities regulation and formulate 'soft law' policies, it may be able to use incentives such as access to enforcement tools such as the IOSCO MMoU as a 'carrot' to members to change their domestic laws to comply with IOSCO policies. This may increase the possibility that the 'soft law' policies of IOSCO change into the 'hard' law of domestic statutes. This may also signal the beginning of a trend by which transnational regulatory networks, such as IOSCO, can have significant influence and thereby wield significant power globally.<sup>658</sup>

Yet although the MMoU and IOSCO have been largely successful to date, going forward a number of questions arise in relation to the MMoU and the role of IOSCO generally in the enforcement of cross border market abuse. For example, can IOSCO achieve its aim of having all members sign the MMoU? What will happen if this does not occur? Will signatories continue meet their obligations under the MMoU? In other words, as the use of the MMoU expands it is likely that conflicts will arise. How will IOSCO address these conflicts?

Furthermore it seems clear that IOSCO does not intend to rest on its achievements to date and aims to continue to work towards achieving its goals, including its goal of strengthening the enforcement capacities of its member regulators to tackle market misconduct. Given the success of the MMoU this may take the form of expanding the scope of the MMoU or developing another Multilateral Memorandum of Understanding. For example, the MMoU is focused on assisting regulators obtain information in relation to the investigation and

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<sup>658</sup> See Slaughter, *supra* note 558 at 33 and A.M. Slaughter & D. Zaring. 'Networking Goes International: An Update' (2006) 2 Annual Review of Law and Social Science 211.

enforcement of securities offences which cross international boundaries. Exchange of information which may assist in the *detection* of such offences appears to be largely outside its scope as presently drafted. Alternatively or in addition to expanding the MMoU IOSCO may try other strategies to further its enforcement goals. The possible expansion of the MMoU and IOSCO's future role in the enforcement of cross border market abuse is the subject of the next chapter.

## Chapter 6

### THE ROLE OF IOSCO GOING FORWARD

IOSCO also has a proud record in promoting cooperation between regulators. The Multilateral Memorandum of Understanding on cooperation and information sharing, now with 95 members as full signatories, has been an important support for cooperation in enforcement matters that span multiple jurisdictions. There are opportunities for us to extend this same level of cooperation to investigations, to promote better supervision of global market players and solving global issues.

Chair of the IOSCO Board, David Wright, *IOSCO Annual Report 2012*<sup>659</sup>

As links between securities markets have increased, the complexity of the cases nationally based securities regulators are required to investigate and prosecute has also increased. As highlighted in previous chapters, this has increasingly resulted in them turning to the IOSCO MMoU to assist them in that task.

IOSCO has become the main international organisation dedicated to the advancement of the coordination of securities regulation and enforcement, its rise to prominence driven partly by the success of the MMoU which appears to have increased the likelihood that securities regulators will undertake cross border investigations. Another factor which has contributed to its profile is that it has become one of the key organisations to which international bodies, such as the G20, delegate responsibility for the development the policies needed to strengthen and stabilise securities markets.<sup>660</sup>

In 2010 IOSCO formulated its goals and priorities for the years 2010-2015. These were to:

1. identify and address systemic risks to the fair and efficient functioning of markets;

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<sup>659</sup>David Wright, *IOSCO Annual Report 2012*, online: IOSCO  
<[http://www.iosco.org/annual\\_reports/2012/boardIncomingChairReport1.html](http://www.iosco.org/annual_reports/2012/boardIncomingChairReport1.html)>.

<sup>660</sup>Reuters, "G20 finance chiefs' communiqué" (15 October 2011), online: Reuters  
<<http://www.reuters.com/article/2011/10/15/g2o-communique-idUSL9E7LE01I20111015>>.

2. Maintain and improve the international regulatory framework for securities markets by setting international standards; and
3. Strengthen IOSCO's role within the international financial community in order to advance the implementation of high-level objectives and principles of securities regulation.

Within the second goal IOSCO articulated that it intends to build regulatory capacity through the systematic implementation of the *IOSCO Objectives and Principles of Securities Regulation*. In addition it intends to work towards this goal by:

Supporting the development of the enforcement and surveillance framework, through full implementation of the IOSCO MOU by asking all IOSCO ordinary members and associate members, with primary responsibility for securities regulation in their jurisdictions to become signatories to the IOSCO MOU, possible enhancements to the IOSCO MOU, and working with uncooperative and/or under regulated jurisdictions.<sup>661</sup>

Mindful of IOSCO's stated goals, this chapter considers IOSCO's future role in relation to the enforcement of cross border market abuse. Given the fact that the level of sophistication and interconnectedness of the markets is likely to continue to increase, can IOSCO do more to assist regulators as they endeavour to detect, investigate and prosecute cross border market abuse?

In evaluating IOSCO's future role this chapter considers whether IOSCO should be proactive in relation to three possible areas. First, given that IOSCO has stated that it will pursue 'full implementation' of the MMoU, the initial part of the chapter considers the future of the MMoU including how this full implementation can be achieved. In addition this part also considers the future of the MMoU generally and how IOSCO should seek to develop it and capitalize on its success to date. The second part of this chapter moves on to set out possible policy initiatives IOSCO could consider developing with a view to assisting securities regulators in

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<sup>661</sup> IOSCO, Presidents Committee, "Resolution on IOSCO's Mission, Goals and Priorities", July 2010, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES26.pdf>>.

their cross border enforcement actions. As such, this section draws upon shortcomings in regulation suggested by the analysis of the previous chapters.

The third part of the chapter considers what role IOSCO could or should have beyond the MMoU and policy development. This part concludes that although it is unlikely that IOSCO could have an operational role, IOSCO could develop systems and mechanisms to assist securities regulators detect, investigate and prosecute market abuse. Finally I consider whether these other systems and mechanisms could, like the MMoU, be used as leverage by IOSCO as it continues to work towards its goal of achieving global convergence of securities regulations.

### **Part 1 Building upon the Success the MMoU**

It seems that the MMoU has had a largely positive impact on the enforcement capabilities of IOSCO members as well as IOSCO's status as an organization. For this reason, and as indicated in its goals for 2010-2015, IOSCO will continue to champion its use by its members and will continue to press its members to become signatories. However in continuing its progress in this regard IOSCO may find that it may have to confront certain challenges. First, it may not be able to coerce all jurisdictions to sign the MMoU. If that is the case this may leave a gap in its enforcement framework. Second as regulators receive and make more and more requests for information under the MMoU, and regulators become more reliant on the MMoU for the success of their investigations, tensions and conflicts may arise. In such circumstances will members continue to meet their obligations? Third, the MMoU is now over a decade old and IOSCO and its members have had time to consider their experiences with it and perhaps discover its shortcomings. Do these experiences suggest that changes should be made to attempt to improve its effectiveness and, if so, how can these changes be made?

#### **Persuading all jurisdictions to sign the MMoU**

Since the creation of the MMoU, IOSCO has stressed the need for all of its members to



become signatories. Recently IOSCO stated:

30 members have yet to become signatories. As long as these jurisdictions remain outside the international enforcement regime, they offer potential safe havens for wrong doers and create gaps in IOSCO's international enforcement network.<sup>662</sup>

Accordingly, the rationale for insisting that members sign the MMoU is that as long as some countries have not signed there will be gaps in the enforcement capacity of members who are signatories. Without all members signing other members of IOSCO may not be able to obtain information they require for their investigations. As such perpetrators of securities violations could potentially escape investigation and enforcement action. Indeed this may even embolden such persons to continue and possibly even expand their fraudulent activities.

IOSCO is also aiming to set high standards globally for securities regulation and enforcement and the MMoU seems to be a key part of achieving this objective. Without the setting of such high standards there is the risk of a 'race to the bottom' for securities regulation due to the temptation for countries set lax standards of regulation and enforcement as a way of attracting corporations which issue securities to their jurisdictions.

Given this goal of having all members sign the MMoU, over the last few years IOSCO's rhetoric in relation to those that have not signed has become increasingly robust as each self-imposed deadline for all members to sign passes without this goal being achieved. In addition, as was outlined in the preceding chapter, IOSCO has also increasingly ratcheted up its actions to pressure members to sign. Initially these actions consisted only of providing what was called 'technical assistance' to help non signatories make the necessary legislative changes required as a prerequisite to allowing the member to sign the MMoU. Next IOSCO moved to establish a public watch list on its website of members who had not signed. Presumably this was designed to 'name and shame' those members and thereby pressure

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<sup>662</sup> IOSCO, "IOSCO to progress reform agenda under new leadership", 1 April 2013, online: IOSCO <<http://iosco.org/news/pdf/IOSCONEWS273.pdf>> at 6.

them into signing. Following this action, IOSCO restricted the ability of non-signatories to vote, serve on leadership positions or nominate persons for leadership positions.

In 2012 IOSCO also called for its members to take precautions in dealing with entities or individuals linked to non-signatory jurisdictions.<sup>663</sup> Again this action is calculated to pressure members who are not signatories to sign. Some members of IOSCO are already acting on this recommendation. IOSCO has reported that India now requires that foreign investors in Indian mutual funds and equity shares must be resident in a country that is a signatory to the MMoU or a signatory of a bilateral MoU with India's securities regulator, the Securities and Exchange Board of India. The Hong Kong Securities and Futures Commission also requires that a company seeking a listing on an exchange that it supervises be incorporated in a jurisdiction where arrangements are in place to ensure reasonable regulatory cooperation.<sup>664</sup> In Canada the BCSC is considering imposing a condition upon Investment Dealers who trade in the US Over the Counter Markets requiring that they not engage in any activity involving a security of an OTC issuer with any financial institution which is located in a jurisdiction that is not a signatory to the MMoU.<sup>665</sup>

Although the majority of IOSCO members have signed the MMoU but there are still 21 regulators who have not. Twenty of these have taken some steps to signing the MMoU, for example have expressed a commitment to having their laws changed so that the laws will become compliant with the obligations of signatories under the MMoU, a precondition to IOSCO allowing a member to sign.<sup>666</sup> However the remaining three, namely Bolivia,

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<sup>663</sup> IOSCO, Presidents Committee, "Resolution on IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information", May 2012, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES36.pdf>>.

<sup>664</sup> IOSCO, "IOSCO Reinforces Standard on Cross-Border Cooperation", 18 September 2013, online: IOSCO <<http://www.iosco.org/news/pdf/IOSCONEWS299.pdf>>.

<sup>665</sup> See British Columbia Securities Commission, "Conditions of Registration: Investment Dealers with a BC Office that Trade in the U.S. Over-the-Counter Markets" (29 October 2013), online: British Columbia Securities Commission <[https://www.bsc.bc.ca/Securities\\_Law/Policies/PolicyBCN/PDF/OTC\\_Conditions\\_of\\_Registration\\_\\_Clean\\_\\_October\\_29\\_2013/](https://www.bsc.bc.ca/Securities_Law/Policies/PolicyBCN/PDF/OTC_Conditions_of_Registration__Clean__October_29_2013/)>.

<sup>666</sup> IOSCO, "2013 List of Non-signatories to the MMoU", online: IOSCO <[https://www.iosco.org/about/?subSection=mmou&subSection1=2013\\_list](https://www.iosco.org/about/?subSection=mmou&subSection1=2013_list)>.

Uzbekistan and Venezuela, have not yet even made this commitment.<sup>667</sup> There are also a small number of countries in the world that are not yet members of IOSCO including Monaco, Liberia, the Marshall Islands and Vanuatu. Each of these countries is considered an under-regulated, uncooperative jurisdictions or offshore financial centre. As it is now a condition of new members of IOSCO that they sign the MMoU, if these countries wish to become members each will also have to ensure that their laws are consistent with the obligations of signatories of the MMoU, and sign the MMoU, before IOSCO will allow them to join.

One problem for IOSCO may be that, as the ability to become a signatory often requires a change in the domestic laws of a jurisdiction, it may be that in some cases this simply cannot be achieved. Accordingly, despite the best efforts of IOSCO, some regulators may never be able to become full signatories if they cannot convince their domestic legislative body to make the necessary changes. Other reasons why regulators may be reluctant to sign the MMoU emerged in a survey conducted by IOSCO in April 2007 of 32 regulators who were classified as from 'emerging markets'. Apart from an inability to meet the IOSCO MMoU requirements, this reluctance was due to:

- a concern about the confidentiality of shared information;
- there was a belief that the MMoU was irrelevant due to a lack of cross border activity;
- or
- a concern that entering into the MMoU was unnecessary because they engaged in effective information exchange via bilateral Memoranda of Understanding.<sup>668</sup>

A particular focus of IOSCO has been offshore financial centres (OFCs).<sup>669</sup> In 2005 a report of the IOSCO Technical Committee stated:

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<sup>667</sup> *Ibid.*

<sup>668</sup> IOSCO, Emerging Markets Committee, "Obstacles to Joining the IOSCO MOU", April 2007, online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD246.pdf>.> at 16.

Financial regulators in OFC jurisdictions are not unique in their abilities (or inabilities) to cooperate with their foreign counterparts in enforcement cases. However, the significant role OFCs play in the global capital market means that their inability to provide enforcement-related information to other regulators may pose greater systemic risks to financial stability than might similar inabilities in other jurisdictions with less of a nexus to the global financial system. Further, because the financial sector frequently makes up a significant portion of the economies of many OFCs, more cooperative jurisdictions may feel competitive pressures if other, less cooperative, OFCs “market” themselves as offering a more “anonymous” or “less bureaucratic” legal system.<sup>670</sup>

The same report commented that these OFC jurisdictions have caused significant difficulties in enforcement:

Many recent financial scandals have focused attention on OFCs and their abilities to share enforcement-related information with other jurisdictions. Many of the subsidiaries and SPEs (*Special Purpose Accounting Entities*) implicated in these cases in efforts to disguise issuer debt were incorporated in OFCs and, in some cases, regulators were unable to collect information essential to an investigation from the supervisors based in these jurisdictions. Further, historically, regulators in several prominent OFC jurisdictions have been unable or unwilling to cooperate with their foreign counterparts.<sup>671</sup>

In 2005 an IOSCO Technical Committee report stated that it was “mindful of the competitive pressures OFCs face”<sup>672</sup> and its work has involved engaging in persuasion to “emphasize to OFCs the benefits to be gained through greater cross border enforcement cooperation, as well as the costs that a continued lack of cooperation may entail”.<sup>673</sup> Another focus has been the provision of technical assistance through its GEM Committee to enable OFC’s to achieve

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<sup>669</sup> The Financial Stability Board (formally the Financial Stability Forum), “Report on the Working Group of Offshore Centres” (5 April 2000), online: Financial Stability Board < [http://www.financialstabilityboard.org/publications/r\\_0004b.pdf](http://www.financialstabilityboard.org/publications/r_0004b.pdf) > at 9.

<sup>670</sup> IOSCO Report, *supra* note 602.

<sup>671</sup> *Ibid* at 31.

<sup>672</sup> *Ibid* at 33.

<sup>673</sup> *Ibid*.

the required legal capacity and infrastructure.<sup>674</sup> As discussed in the preceding chapter, to date IOSCO has made significant progress in terms of persuading a number of OFCs to sign the MMoU in the sense that the number of uncooperative members and countries is now relatively small.

However, it is quite possible that some OFCs are refusing to sign the MMoU and are not applying for IOSCO membership because they perceive that there may be a competitive advantage in protecting the privacy of their residents. For example, Monaco's securities regulator, the Commission de Contrôle des Activités Financières states that it will only provide information to a foreign authority if first, the authority is bound by professional secrecy offering the same level of guarantees as in the Principality and second, the information is exclusively used for the purposes for which it has been disclosed.<sup>675</sup> In 2008 the International Monetary Fund produced a report critical of this restrictive privacy requirement and recommended that it be changed reflect the terms of the IOSCO MMoU.<sup>676</sup> However despite this recommendation it appears that nothing has changed.

As a mere network of securities regulators IOSCO has no power to take any formal action against countries under international law. Nevertheless IOSCO has demonstrated that it is willing to take very robust action within the limitations of its power to coerce members to sign the MMoU. Its latest measure, namely encouraging members to restrict the ability of persons and entities resident in non-signatory jurisdictions from engaging in securities transactions, has the potential to have the greatest influence thus far in pressuring countries to sign the MMoU. This is because if many IOSCO members introduce such restrictions, this could severely constrain some of the activities of investors and entities resident in those non-signatory jurisdictions. For example, it may restrict investors resident in Monaco from

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<sup>674</sup> IOSCO *IOSCO 2008 Annual Report*, online: IOSCO <[https://www.iosco.org/annual\\_reports/annual\\_report\\_2008/](https://www.iosco.org/annual_reports/annual_report_2008/)> at 22. This reported that there were still “a number of jurisdictions that require further attention”.

<sup>675</sup> Commission de Contrôle des Activités Financières, “International Action” (2011), online: CCAF <<http://www.ccaf.mc/en/knowning-the-ccaf/international-action.>>.

<sup>676</sup> International Monetary Fund, “Technical Note on IOSCO Objectives and Principles of Securities Regulation”, 5 June 2008, online: IMF <<http://www.imf.org/external/pubs/ft/scr/2008/cr08218.pdf>>.

accessing investment opportunities in some of the world's largest capital markets. This could in turn lead to such investors pressuring the securities authority of Monaco to sign the MMoU.

In addition, there are other measures that IOSCO could consider introducing with a view to putting pressure on countries to sign the MMoU. For example, apart from publishing the names of members who are not signatories on its website, IOSCO could also consider publishing on its website the names of *all* jurisdictions that are not IOSCO members and therefore also not signatories to the MMoU. Furthermore an education campaign designed to inform investors and financial advisers of the hazards of dealing with persons or entities resident in these jurisdictions is a strategy IOSCO could also consider.

However there are some risks for IOSCO as an organisation in moving towards these stronger coercive measures. What has contributed significantly to IOSCO's growth and strength as an organisation has been its broad and inclusive membership policy and assistance to regulators from emerging markets. The introduction of policies designed to isolate certain countries may paradoxically serve to weaken its organisation and influence, particularly if other nations who are already members align themselves with the recalcitrant nations for perhaps political reasons.

One issue for IOSCO may be that much of the momentum for the MMoU came from the US. As such, it largely reflects a US approach to enforcement cooperation and enforcement generally. Aggressive enforcement of securities laws is a key component of SEC policy and the US stands apart in terms of the greater amount of funding it spends on enforcement, the sheer number of enforcement actions brought and the magnitude of the sanctions imposed.<sup>677</sup> In fact some, like Kal Raustiala, argue that organizations such as IOSCO are essentially exploited by the SEC to spread the 'regulatory gospel' of US securities law.<sup>678</sup>

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<sup>677</sup> Jackson, *supra* note 81 at 211, and Coffee, *supra* note 96.

<sup>678</sup> Kal Raustiala, "The Architecture of International Cooperation: Transgovernmental Networks and the Future of International law" (2002-2003) 43 Va. J. Int'l L. 1 at 31.

...the transgovernmental securities network is active and growing, with the SEC playing a critical and active role. For the SEC, networking with foreign regulators is a conscious strategy aimed at enhancing its enforcement powers in a globalizing economy while at the same time promoting the institutionalization of U.S.-style securities laws abroad through its technical assistance programs. The SEC's unwavering approach is to bring other jurisdictions to the U.S. model, not to modify the U.S. model. This is even true of the SEC's cooperative efforts with regulators from other advanced industrial states.<sup>679</sup>

Up until the global financial crisis in 2008 many nations appeared to be anxious to copy the US model of securities laws and enforcement in an effort to emulate the US's enviable capital markets and associated economic growth.<sup>680</sup> Post the global financial crisis, this push for economic growth through fostering larger and more efficient capital markets continues, although countries may not so slavishly follow the US model. In particular, some countries envisage a broader role for government intervention, for example by placing restrictions on high frequency trading.<sup>681</sup>

The risk for IOSCO in taking more stringent action against uncooperative jurisdictions is a possible backlash against the US hegemony reflected in MMoU and IOSCO's policies generally. There is, however, currently no sign of such a backlash as the march by members of IOSCO to sign the MMoU continues, with most members seemingly able to bring about changes to their domestic laws so that they can become signatories. IOSCO's recent changes to its management structure by broadening the representation of its governing Board to include stronger representation of countries which are not part of the developed world should also reduce the possibility of a backlash. However it is possible that over time this more representative Board may also weaken IOSCO's resolve to continue to push for signatories as a broader management base may include members who might conceivably

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<sup>679</sup> *Ibid* at 35.

<sup>680</sup> *Ibid* at 33. Raustiala refers to the fact that the SEC has been "inundated with requests for training – and to date have only been able to satisfy about 10 percent of the demands".

<sup>681</sup> For example see the restrictions introduced in Germany in relation to high frequency trading, *supra*, note 292.

have political or other reasons for not taking strong action against countries that do not become signatories to the MMoU.

### **Will the signatories to the MMoU continue to meet their obligations?**

It is critical to the overall success of the MMoU that members comply with requests that they receive under the MMoU. The MMoU, like other bilateral memoranda of understanding, is ultimately a form of 'soft law' as they are not binding on the parties. However, as noted by Roberta Karmel, in practice bilateral memoranda of understanding have proved to be quite effective:

But sometimes soft law acts like hard law prior to codification... MOUs are not legally binding instruments. They are negotiated between the SEC and foreign regulators. Despite their nonbinding status, however, these agreements are followed. As previously noted, in 2007, the SEC made 556 requests to foreign regulators for assistance and information under MOUs and responded to 454 requests.<sup>682</sup>

Because of the multilateral nature of the MMoU and the procedures incorporated in MMoU to resolve conflicts, the MMoU seems to be proving to be even more successful than bilateral memoranda of understanding, having the effect of virtually compelling a response to a request for information. These procedures to ensure compliance contained within the MMoU provide that in the event of non-compliance the matter is referred to the 'Monitoring Group' which can consider and recommend a range of possible options including:

providing a period of time for the signatory to comply; full peer review of a signatory that may not be in compliance; public notice of non-compliance; suspension of a signatory from MOU participation; or termination from MOU participation as provided in the MOU.<sup>683</sup>

Any such recommendations are referred to a committee comprised of the Chairmen of the IOSCO Board, the Emerging Markets Committee, and the Monitoring Group. This committee

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<sup>682</sup> Karmel, *supra* note 647 at 940.

<sup>683</sup> IOSCO MMoU, *supra* note 268 article III(c).



makes the for a final decision on the action to be taken after it has provided notice to the non-compliant member and given this member the opportunity to be heard.<sup>684</sup>

Furthermore, despite the increase in requests for information via the MMoU and the fact that IOSCO members represent the full array of political and legal systems, to date there seems to have been little in the way of conflict in relation to member's obligations in complying with requests. IOSCO attributes this lack of conflict to its procedures to ensuring that member countries have the laws which allow them to exchange information prior to signing the MMoU as well as the fact that members are arguably strongly motivated to comply in order to preserve their reputations and credibility.<sup>685</sup> IOSCO usually receives 2 or 3 informal notifications each year in relation to potential non-compliance and, while these can be reported to the MMoU Monitoring Group in accordance with the terms of the MMoU, IOSCO has found that most often the problem results from a misunderstanding and can be resolved informally with the assistance of the IOSCO General Secretariat.<sup>686</sup>

One dispute reported in the press however perhaps shows the first break from the universal cooperation that has so far been characteristic of cooperation under the MMoU. Since 2010 the SEC has been trying to obtain information from the China Securities Regulatory Commission (CSRC) in relation to allegations involving what have been called Chinese 'concept stocks' listed on US exchanges. These were Chinese companies which were floated in the US via reverse-mergers of existing listed companies, thereby avoiding the SEC disclosure rules for new listings.<sup>687</sup> Many US investors lost their investment in these stocks when it became known that some of these companies had falsified their financial statements. As a result the SEC launched an investigation. As part of that investigation the SEC sought, via the MMoU, the audit working papers prepared by the auditors of these companies. However the CSRC claimed that under CSRC rules domestic auditors are prohibited from

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<sup>684</sup> IOSCO MMoU, *supra* note 268 article III(d) and (e).

<sup>685</sup> Cunha, *supra* note 649 at 682.

<sup>686</sup> Interview with IOSCO.

<sup>687</sup> See generally, Katherine T. Zuber, "Breaking down a great wall: Chinese reverse mergers and regulatory efforts to increase accounting transparency" (2014) 102, Geo. L.J 1307.

sending audit working papers on Chinese companies listed overseas to anyone outside of China and that the MMoU did not obligate them to share these audit working papers. It was reported that this issue was not resolved when SEC and CSRC representatives met in May 2012 in Beijing at an annual IOSCO conference. At this meeting SEC and CSRC officials exchanged retorts, the SEC arguing that is not looking to assert itself globally whereas CRSC officials argued China has the sovereign right not to cooperate with U.S. investigators.<sup>688</sup>

This failure of the SEC in gaining access to these audit working papers demonstrates three possible limitations of the MMoU. First, the MMoU may not be specific and/or broad enough in terms of the information that must be provided and consideration may have to be given to expanding its terms. Second it illustrates that the provision in the MMoU that allows a signatory to refuse to comply with a request on “public interest” or “essential national interest” grounds could be exploited if an IOSCO member is lobbied by political or business groups not to comply. Finally it perhaps also indicates that tensions can arise if a signatory aggressively utilize the MMoU to investigate the activities of persons who are not its own nationals.

Another possible issue that may lead to members not complying with their obligations under the MMoU is the lack of procedures to deal with sharing of the costs associated with processing requests that are received. This could conceivably cause regulators from smaller countries with limited resources to renege on their obligations under the MMoU. Even for larger regulators the work required to process requests could be seen to be taking resources away from what may be more pressing domestic concerns, for example assisting new

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<sup>688</sup> Shen Hu, Zheng Fei, Lu Yuan & Zhang Tao “Watchdogs Growl over Concept-Stock Probes”, Caixin Online, 6 November 2012, online: Caixin Online <<http://english.caixin.com/2012-06-11/100399298.html>>. It was also reported that that CSRC officials may not have access to the financial information as many Chinese concept-stock companies are incorporated in the Cayman Islands. See also Shen Hu & Zheng Fei “SEC probels hit a wall in uncooperative China, Regulators refusing to help U.S. counterparts probe fraud charges”. MarketWatch, The Wall Street Journal, 11 June 2012, online: MarketWatch <<http://www.marketwatch.com/story/sec-probes-hit-a-wall-in-uncooperative-china-2012-06-11>>. In December 2012 the SEC charged five accounting firms for failing to provide these accounting working papers. See SEC Press Release “SEC Charges China Affiliates of Big Four Accounting Firms with Violating U.S. Securities Laws in Refusing to Produce Documents”, 3 December 2012, online: <<http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171486452>>.

enterprises. Indeed it was reported that one reason for the tension in relation to the Chinese concept stocks dispute is that only about 200 of CSRC's 1,200 staff are specifically assigned to investigations compared to one third of SEC's 3,700 staff.<sup>689</sup>

Another possible area of concern is the manner in which information that is obtained via the MMoU can be used. The MMoU provides that information disclosed can be used for a broad range of enforcement purposes. This could result in inappropriate release and use of information putting the media spotlight on the MMoU and focus domestic political pressures on securities regulators. It is also not difficult to envisage a scenario whereby information is released by a regulator and it is then used to impose harsh punishment in a country which has little concern for due process. For example, China, who is a member of IOSCO and a signatory to the MMoU, has in the past imposed severe penalties, including the death penalty, for some economic crimes.<sup>690</sup>

There are therefore various issues that may result in members not complying with requests they receive. However it is likely that these will remain in the minority of cases and that most requests will be complied with. It also seems unlikely that such tensions will lead to a widespread non-compliance and or a breakdown in the operation of the MMoU. This is because of the interconnectedness of markets and the fact that the MMoU seems to be fulfilling a need of securities regulators to quickly and easily obtain information to enforce their domestic securities laws.

### **Changes to the MMoU going forward**

The MMoU is now over ten years old and has not undergone a substantial revision during

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<sup>689</sup> *Ibid.*

<sup>690</sup> See for example a report by Amnesty International of 13 February 2009 describing where a businesswoman Du Yimin was sentenced to death in March 2008 for "fraudulent raising of public funds.": Amnesty International, "Imminent Execution", 13 February 2009, online: Amnesty International <<https://www.amnesty.org/en/documents/asa17/007/2009/en/>>. See also B Masters, *IOSCO pact reshapes market enforcement*, FT.com, 8 January 2010, online: Financial Times <[http://www.ft.com/cms/s/0/b843b8f0-ee45-11de-a274-00144feab49a.html?nclick\\_check=1](http://www.ft.com/cms/s/0/b843b8f0-ee45-11de-a274-00144feab49a.html?nclick_check=1)>. This article reported that "Some regulators note privately that the Iosco agreement could lead to some squabbles over time if some of the biggest and strongest enforcement agencies prove reluctant to share the fruits of their labours with regulators which are not seen as sufficiently independent or professional".

that time. To date only relatively inconsequential changes have been made.<sup>691</sup> Given its success and the experiences of those who have used the MMoU there appear to be areas in which it could be improved and expanded.<sup>692</sup> These changes could include increasing the range of organizations which are able to sign the MMoU, broadening the range of information which can be requested pursuant to the MMoU, improving the confidentiality provisions and specifying a mandatory timeframe within which information requested be provided.

***a) Expanding the signatories***

One possible change that it appears might be considered is to expand the organizations who can sign the MMoU to include non-government not for profit self-regulatory bodies (SROs) such as FINRA and IROC. As discussed in Chapter 4, at present when such an SRO needs to obtain material for regulatory purposes from a foreign securities regulator the request must go via the government regulator who is the signatory to the MMoU. This requirement could delay an investigation. Allowing SROs to sign the MMoU and thereby allowing them to obtain information directly from foreign regulators could eliminate any such delay. It may also enhance the enforcement capabilities of all other signatories to the MMoU in that they could seek information directly from these SROs.

***b) Increasing the range of information that can be obtained***

As referred to in the preceding chapter the MMoU sets out categories of the types of information that should be provided, the focus being on providing information in relation to the identity of persons behind a transaction. However the information that can be provided is not limited to this type of information. The introductory statement in the MMoU before these categories are listed provides that the assistance that can be provided “includes, without limitation” these items. However, despite this relatively broad wording, given the conflict that

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<sup>691</sup> In July 2012 the MMoU was amended to reflect the new governance arrangements of IOSCO (Interview with IOSCO).

<sup>692</sup> The IOSCO secretariat currently keeps a record of difficulties which have been encountered with the MMoU which may form the basis of future changes and keeps a record of the interpretation of terms in the MMoU as assessed by the screening group (Interview with IOSCO).

arose when the SEC requested audit papers from the CRSC, it seems that some members may be interpreting its terms narrowly in such a way that will restrict the information provided.

The limitations of the documents that can be obtained via the MMoU is also perhaps demonstrated by the fact that the SEC has entered into 3 bilateral arrangements seeking the exchange of an expanded list of information beyond what is available via the MMoU. For example in 2008 SEC and ASIC signed such a bilateral agreement, even though both were already signatories to the IOSCO MMoU. This bilateral agreement provides that, in addition to bank, brokerage and beneficial ownership records, each regulator agrees to provide to the other audit work papers, internet service provider records, travel histories, credit card and phone records.<sup>693</sup>

Another possible area that could form the basis for expanding the MMoU is in relation to providing assistance in relation to the freezing of assets that constitute the proceeds of the violation of securities laws or comprise investor funds that have been defrauded. The bilateral SEC ASIC agreement provided for this type of assistance.<sup>694</sup> Further still the MMoU could provide for assistance in relation to the recovery of funds to satisfy penalties or fines that have been imposed by requesting members and/or compensation orders that have been made by requesting members.

One problem with seeking such substantial amendments to the MMoU is that it can only be changed by a unanimous recommendation of its signatories.<sup>695</sup> As the number of signatories to the MMoU increases, obtaining such a unanimous agreement may become increasingly problematic. If IOSCO wishes to make substantial amendments and such agreement cannot be obtained, IOSCO may need to develop additional MMoU or MMoUs containing the amendments and then ask members to sign onto these.

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<sup>693</sup> SEC and ASIC Memorandum of Understanding, *supra* note 655. See also SEC speech by Mary Jo White, *supra* note 549.

<sup>694</sup> *Ibid.*

<sup>695</sup> IOSCO MMoU, *supra* note 268 at [g] of Part III of Appendix B.

**c) Reducing delays in responding to requests**

One issue with the MMoU is that it does not provide any guidelines to regulators as to how quickly the information requested needs to be provided. Although the requesting member can specify when the information is needed, there is no obligation to actually provide it within this timeframe. As a result, and as is referred to in chapter 4, the experiences of some securities regulators is that sometimes information is not provided in a timely manner, which has the predictable effect of delaying the investigation. This is a concern as the success of enforcement action is often linked to how quickly the investigation was concluded and delay in an investigation can lead to its failure, as was also discussed in Chapter 4.

Nevertheless the reality is that it may be difficult to specify exact timeframes for the provision of information under the MMoU. This is because what is a “reasonable time” to respond to a request depends upon variables such as the intrinsic urgency of the request, the complexity of the response required and the resources available to the responding regulator to satisfy the request. As such, although IOSCO is aware that delay caused by failure to respond to requests in a timely way might be a problem, it is struggling to develop a possible amendment to the MMoU to address this issue.<sup>696</sup> Perhaps a better way to proceed would be for IOSCO to provide a mechanism whereby funding could be provided by the regulator asking for the information to pay for processing costs, particularly if the assistance sought is urgent or resource intensive.

IOSCO is also streamlining the procedures for resolving disputes between regulators for failure to respond to requests for assistance which may go some way to addressing the problem of delay. As set out above, at present the MMoU prescribes that disputes in relation to the operation of the MMoU are to be considered by the Monitoring Group. As constituted the Monitoring Group comprises all of the signatories to the MMoU.<sup>697</sup> Given the number of signatories to the MMoU, this group is too large to effectively and quickly resolve disputes.

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<sup>696</sup> Interview with IOSCO.

<sup>697</sup> IOSCO MMoU, *supra* note 268 at Appendix B.

As such IOSCO has established an informal Monitoring Group process to resolve disputes and is considering setting up a Monitoring Group Steering Committee to support the Monitoring Group.<sup>698</sup>

**d) Improving confidentiality**

The MMoU provides that a request for information is to be kept confidential and only disclosed after consultation with the authority and then only if disclosure is required to carry out the request.<sup>699</sup> However, as discussed in chapter 4, in some circumstances it appears that parties under investigation have become aware that they are under investigation by the foreign authorities, particularly when information is sought from a financial institution and the institution informs its client that it is under investigation. It is arguable therefore that the confidentiality provisions in the MMoU may need to be tightened. Specifically the MMoU may need to be amended to require signatories to have in place laws which ensure that financial institutions and other market intermediaries are prohibited from disclosing to clients that they have received a request for information.

## **Part 2 Policy Development**

Since its inception IOSCO has been involved in the formulation of policies in relation to securities regulation which can then be used as a guide by members to formulate their own laws and policies. This policy work has involved both the development of an outline of what should be included within the general framework of securities regulation in a country as well as more targeted policy recommendations to address specific issues.

The general framework of securities regulation formulated by IOSCO is contained in its key policy statement, the *Objectives and Principles of Securities Regulation*.<sup>700</sup> As was discussed briefly in chapter 5, these objectives and principles were originally formulated in 1998. Since that time these objectives and principles have remained relatively constant with

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<sup>698</sup> Comments from IOSCO.

<sup>699</sup> IOSCO MMoU, *supra* note 268 at 11(a).

<sup>700</sup> IOSCO, *Objectives and Principles*, *supra* note 37.

only infrequent modifications. The most dramatic change occurred after the global financial crisis in 2008 which exposed gaps in the framework of securities regulation in many countries. As such IOSCO added one objective and 8 more principles.<sup>701</sup> In addition to the *Objectives and Principles* IOSCO has also published a detailed methodology document setting out how these principles should be interpreted and what kinds of factors need to be considered in relation to whether each of these principles have been met.<sup>702</sup>

In addition, IOSCO is constantly promulgating multiple detailed and specific policy statements to address particular issues. These more targeted policy statements are formulated and developed through IOSCO's committee structure. Such policy statements are also designed to be consistent with the overall framework contained in the *Objectives and Principles* and provide more details as to the exact type of rules which should be adopted.

This policy development work by IOSCO will undoubtedly continue and probably also expand as it seems to have widespread support from both IOSCO members as well as from international organisations such as the G20. In developing its policies IOSCO fulfills the need to formulate consistent global policies to deal with issues in securities regulation which cannot be effectively addressed at a national or even bilateral level. Furthermore IOSCO can use these policy statements to encourage countries to adopt more stringent standards for securities regulation.

However, although IOSCO can develop specific policy recommendations it cannot force countries to actually adopt these recommendations. The ultimate decision as to whether a particular policy is adopted by a particular country is determined by the body in that country which sets the rules for securities regulation. That could be the legislature or perhaps the securities regulator if it has been delegated this power. As such, on one view, IOSCO's role

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<sup>701</sup> *Ibid.*

<sup>702</sup> IOSCO, "Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation", September 2011, online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf>>.



in setting the system of global securities regulation can be viewed as relatively weak. For example Roberta Karmel states:

IOSCO's harmonization efforts tend to be at a level of generality that may be an insufficient prod to regulatory reform. When national interests are at stake, securities regulators follow those interests rather than IOSCO directives. Since IOSCO has no enforcement mechanisms aside from peer pressure, and its members are so numerous and varied, it is unrealistic to expect rigorous and detailed harmonization of new standards of conduct or regulation. Nevertheless, IOSCO can play a useful role in highlighting critical emerging areas where securities regulation is in need of reform, and it has done so with regard to a number of systemic risk issues in the trading markets.<sup>703</sup>

However this perspective arguably too readily devalues IOSCO's power and influence in the harmonization of securities regulation. In particular IOSCO can influence in the setting of securities regulation in two important ways. First, IOSCO has had and continues to have an important role in setting the discourse of securities regulation. IOSCO's numerous policy statements often become a first reference point to guide policy makers within a particular country who have been tasked with developing rules and policy for that country in relation to a particular issue. As such many of the ultimate rules that are adopted are likely to contain at least some elements which reflect the policy set by IOSCO. This is particularly likely as IOSCO policy is formulated by actual employees of securities regulators through its committee structure.

Second, as is demonstrated by the MMoU process, IOSCO may be able to exert significant pressure on countries to adjust their laws to fit within the policy framework it has developed. As such IOSCO could perhaps adopt a similar methodology in the future in order to pressure countries to make other adjustments to their laws.

### **Possible IOSCO Policies in relation to Cross Border Market Abuse**

In relation to cross border market abuse the analysis contained in the preceding chapters

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<sup>703</sup> Karmel, *supra* note 259.

suggests there are five areas in which IOSCO could consider developing policies which, if adopted by countries, would enhance the detection, investigation and prosecution of these offences. First IOSCO could work towards building consistency in definitions of market abuse and the applicable penalties. Second IOSCO could develop a policy in relation to improving access to telecommunication information and other data. Third IOSCO could build upon its existing policies to improve market surveillance capabilities. Fourth IOSCO could highlight the issues for regulators as to the vulnerability to market abuse of lightly regulated or penny stock markets and work to develop a more consistent policy framework to address this problem. Finally IOSCO could develop a policy to encourage regulators to take action against cross border market abuse even when the integrity of their own market is not threatened.

**a) Building consistency as to what constitutes market abuse and the applicable penalties**

As highlighted in chapter 3, success in relation to cross border market abuse often depends upon fostering good and open lines of communication. Differences between countries in what constitutes market abuse and the applicable penalties for market abuse violations can complicate the ability of regulators from different countries to work together and share information. Such differences increase the possibility of misunderstandings and could potentially lead to the misuse of the information that is provided. If those differences were reduced and regulators were all 'working off the same page', cooperation is likely to become more intensive and more effective. It may also lead to improvements in how quickly information is exchanged if regulators were familiar as to how this information would be used by their foreign counterpart.

At present, because of variations in laws as to what constitutes insider trading and market manipulation, facts which may be market abuse in one jurisdiction may not constitute market abuse in another. There are also currently significant differences between countries in the kind of enforcement proceedings that can be brought against those who are alleged to have

committed market abuse as well as the type and magnitude of the penalty faced by the perpetrator if the contravention is proven.

In Europe the EU has been standardizing what constitutes insider trading and market manipulation. The first Market Abuse Directive (MAD) in 2003 required countries within the EU to prohibit insider trading and market manipulation and specified what this comprised. The second Market Abuse Directive (MAD II) and the Market Abuse regulations (MAR) in 2014 continued this process and sets out in more detail exactly what member states are to include within their laws as to what precisely constitutes market abuse. It also expands the definition to capture activity which was shown to not be captured by the previous definition, such as manipulation of LIBOR.<sup>704</sup> MAR and MAD II specify that insider dealing is when a person possesses inside information and uses that information by acquiring or disposing of, for its own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates. In addition, member states are to include within their insider trading laws that it will also be a contravention if inside information is used in cancelling or amending an order concerning a financial instrument to which the information relates. Furthermore insider trading laws are also to capture the use of inside information in relation to submitting, modifying or withdrawing a bid in relation to auctions of emission allowances or other auctioned products.<sup>705</sup>

In terms of what constitutes “inside information”, MAR and MAD II set out that it should comprise information of a precise nature, which has not been made public, if it were made public, would be likely to have a significant effect on the prices and that it relates to the price of related financial instruments, the price of related spot commodity contracts, or the price of related derivative financial instruments.<sup>706</sup>

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<sup>704</sup> See MAR, *supra* note 355 and MAD II, *supra* note 354. Member states are required to implement MAD II and MAR by 3 July 2016 at which time MAD will be repealed.

<sup>705</sup> MAR, *supra* note 355 at Article 8.

<sup>706</sup> MAR, *supra* note 355 at Article 7(1).

Similar to the EU, Australia's prohibition against insider trading casts the net broadly and also has a relatively expansive prohibition in relation to what constitutes insider information.<sup>707</sup> By way of contrast in the US what is caught within the offence of insider trading is more limited. It is also not defined in any single statute but the scope of the prohibition has developed as a result of a series of cases interpreting Section 10(b) of the *Securities Exchange Act 1934* and Rule 10B-5 promulgated under this provision.<sup>708</sup>

There are also significant differences between countries in terms of enforcement options and penalties. For example, in Australia, unless the market abuse involves a market intermediary, there is no capacity to impose an administrative penalty. Although a civil penalty can be imposed for market abuse, as has been referred to previously, market abuse is usually pursued criminally and thereby a higher standard of proof is required. As a criminal offence the maximum penalty is 10 years imprisonment.<sup>709</sup>

In the US market abuse can be pursued criminally, by way of a court imposed civil penalty or administratively and it appears that all three remedies are used liberally. As a criminal offence the maximum penalty is 20 years imprisonment.<sup>710</sup>

In Canada market abuse can be pursued administratively, as a regulatory offence under the *Securities Acts* or as a full criminal offence under the federal *Criminal Code*.<sup>711</sup> As a regulatory offence market abuse carries a maximum 5 year penalty. As a criminal offence under the *Criminal Code* the maximum criminal penalty is 10 years imprisonment.<sup>712</sup>

In the EU when MAD II and MAR have finally been implemented by member states there will be greater consistency across Europe in terms of enforcement options and penalties for market abuse. All member states will be required to have laws allowing the imposition of administrative remedies for market abuse. Furthermore all member states are to prescribe

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<sup>707</sup> *Corporations Act 2001*, s 1042A-1043A.

<sup>708</sup> See generally L Loss, J Seligman & T Paredes, *Fundamentals of Securities Regulation*, 6th ed (New York: Wolters Kluwer Law & Business, 2011), Chapter 9.

<sup>709</sup> *Corporations Act 2001*, Part 7.10, s 1311, Schedule 3.

<sup>710</sup> *Securities Exchange Act 1934*, 15 U.S.C. 78a et seq. s 32(a)

<sup>711</sup> See for example *Ontario Securities Act*, RSO 1990, c S.5, s 127.

<sup>712</sup> See *Criminal Code*, RSO 1985, c C-46, s382 and 3.82.1.

that insider trading and market manipulation constitutes a criminal offence when committed with intent.<sup>713</sup> MAD II also requires that criminal sanctions must be “effective proportionate and dissuasive” and that the maximum penalty for insider trading and market manipulation must be at least 4 years imprisonment.<sup>714</sup>

The rationale given by the EU for prescribing specific enforcement options and penalties was that the EU had commissioned a report which found that EU sanctioning regimes for market abuse were “in general weak and heterogeneous” and that this was proving to be “insufficient to ensure compliance with the rules on preventing and fighting market abuse”.<sup>715</sup> The EU report appears to be aimed at encouraging common standards and penalties with the objective of enhancing market integrity. This focus on market integrity is set out in the preamble to MAD II which states:

A genuine internal market for financial services is crucial for economic growth and job creation in the Union. An integrated, efficient and transparent financial market requires market integrity. The smooth functioning of securities markets and public confidence in markets are prerequisites for economic growth and wealth. Market abuse harms the integrity of financial markets and confidence in securities and derivatives.<sup>716</sup>

In addition, the EU report anticipates that common minimum rules for market abuse will make it possible to use more effective methods to investigate market abuse and as such will enable more effective cooperation within and between Member States in relation to their efforts to enforce market abuse laws.<sup>717</sup>

IOSCO has recently foreshadowed that it is considering developing principles in relation to what it has called “credible deterrence frameworks” and called on the IOSCO committee on enforcement to “identify the core elements of a credible deterrence framework for securities

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<sup>713</sup> MAD II, *supra* note 354.

<sup>714</sup> MAD II, *supra* note 354 Article 7.

<sup>715</sup> MAD II, *supra* note 354 at (3) and (5).

<sup>716</sup> MAR, *supra* note 355 at (1) and (2).

<sup>717</sup> MAD II, *supra* note 354 at (7).

regulation, including strategies and good practices". The press release making this announcement stated that the reason for this move was that:

It responds to public demand for tougher sanctions to deter market misconduct. The failure to punish wrongdoers during the current financial crisis has eroded public confidence in capital markets.<sup>718</sup>

Due to the importance of prohibitions against market abuse in maintaining market integrity IOSCO should perhaps consider the development of such a "credible deterrence framework" in relation to market abuse. This would necessarily have to include a policy which would set out:

- what constitutes the elements of insider trading;
- what constitutes the elements of market manipulation;
- the range of appropriate enforcement options which should be available to a regulator seeking to take action against market abuse; and
- appropriate penalties which should be prescribed for violations.

Of course, as already noted, IOSCO cannot force individual countries to adopt any such framework for its market abuse laws. Political differences and the way in which laws are introduced in individual countries are such that the laws in relation to market abuse will likely vary between countries for the foreseeable future. However having such a framework which is continually evolving as new forms of market abuse arise should hopefully, over time, lead to more consistency of market abuse regimes throughout the world. Furthermore this may also lead to more effective cooperation between regulators in taking action against cross border market abuse.

#### **b) Improving access to telecommunications information and other data**

As discussed in chapter 3, data records and records of telecommunications often contain critical evidence of market abuse in prosecutions of market abuse. There are however

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<sup>718</sup> IOSCO Media release, *supra* note 662 at 5.

currently inconsistent requirements between countries as to the ability of regulators to access this type of information as well as inconsistent requirements as to how long those responsible for storing this type of data are required to keep the data.

Given the often critical importance of this type of information to market abuse investigations, as part of MAR, the EU requires member states to introduce laws which will allow authorities to require telecommunication operators and investment firms to produce data traffic records where a reasonable suspicion exists that such records may be relevant to help prove market abuse. Because of the importance of this type of evidence IOSCO perhaps should follow the lead of the EU and consider producing a policy encouraging members to seek broad powers to have access to these types of records and to share such records with other securities regulators. In addition such a policy could also mandate that these laws prescribe that data is stored and maintained for a sufficient period to enable it to be accessed by regulators for their investigations.

Furthermore in order to prove market abuse to a criminal standard, regulators will frequently be required to prove not just that there was communication between two parties but also the actual content of that communication. The content of communications might be proved by a direct confession or by the agreement of one of the participants to give evidence against the other. Frequently such cooperation will be obtained in exchange for a reduced sentence.<sup>719</sup> This investigative technique has often been used successfully by the SEC in market abuse prosecutions.<sup>720</sup>

Absent a confession or cooperation another way to potentially prove the content of communication is by way of telephone intercepts. The problem is however that there are currently inconsistent laws in different countries in regard to if and how securities regulators

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<sup>719</sup> For example, it seems that some of the recent well-publicized successes of the SEC in insider trading prosecutions of those involved in Wall Street Hedge funds such as those of the Galleon Network and SAC Capital Advisors can be attributed to the fact that the SEC and the DOJ secured the agreement of some of the perpetrators to give evidence against the others. See generally *supra* note 543.

<sup>720</sup> See generally, B Protes & A Ahmed, *With New Firepower, S.E.C. Tracks Bigger Game*, 21 May 2012, online: The New York Times <[http://dealbook.nytimes.com/2012/05/21/with-new-firepower-s-e-c-tracks-bigger-game/?\\_php=true&\\_type=blogs&\\_r=0](http://dealbook.nytimes.com/2012/05/21/with-new-firepower-s-e-c-tracks-bigger-game/?_php=true&_type=blogs&_r=0)>

can obtain warrants to intercept telecommunications in relation to market abuse. In some instances market abuse offences are not even in the category of offences for which a warrant to intercept communications can be obtained, perhaps a reflection of an belief that market abuse is not regarded as a serious offence. In other cases it may be possible to obtain a warrant to intercept communications but the power to seek such a warrant is vested in another agency. As such the securities regulator is necessarily compelled to obtain the assistance of that other agency to obtain the warrant. Such arrangements can conceivably add to the delay and complexity of an investigation. This could be because, for example, the other agency may have an enforcement culture so that white collar crime, such insider trading, is not viewed as a priority compared to other types of crimes such as murder or terrorism.

In Australia, for example, legislation has recently changed to enable authorities to obtain a warrant to intercept communications in relation to suspected insider trading or market manipulation.<sup>721</sup> However ASIC still has to obtain the involvement of the Australian Federal Police and convince it to make an application for a warrant. In Canada, a warrant to intercept communications can be obtained in relation to suspected market manipulation but not for suspected insider trading.<sup>722</sup> If the Ontario Securities Commission wishes to obtain such a warrant it also has to obtain the involvement of the police to make the application.<sup>723</sup>

In the UK, the FCA has powers to conduct surveillance but not to intercept communications. The FCA can seek the involvement of another agency with the power to obtain a warrant and subsequently intercept communications. However, any information obtained as a result can only be used as intelligence in the investigation, not as evidence.<sup>724</sup> In Germany market abuse is not within the class of offences where a warrant can be obtained to intercept electronic communications.<sup>725</sup> MAD II and MAR will not assist the FCA and BaFin in this

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<sup>721</sup> *Corporations Act 2001* (Cth) s 7.10 (3A, B) and J Austin, *supra* note 322.

<sup>722</sup> See *Criminal Code*, RSC 1985, c C-46, s 183. This lists that a warrant can be obtained in relation to the offence contained in s.382 (fraudulent manipulation of stock exchange transactions) but insider trading (s.382.1) is not included.

<sup>723</sup> See *Criminal Code*, RSC 1985, c C-46, s 185.



regard as they do not change the status quo of member countries in relation to the power to seek warrants to intercept communications.<sup>726</sup>

Given the impact upon market integrity of market abuse, arguably IOSCO should consider promulgating a policy stressing the importance of eliminating market abuse in relation to market integrity and, at the same time, recommend that a warrant to intercept communications be available for these offences. Furthermore IOSCO should perhaps recommend in such a policy that securities regulators should be able to directly apply for such warrants. In addition, although perhaps more controversial, IOSCO could also recommend laws allowing a securities regulator to apply for such a warrant and obtain evidence on behalf of a foreign regulator when there is sufficient evidence to form a reasonable suspicion that cross border market abuse has occurred or is continuing to occur.

### **c) Improving market surveillance capabilities**

As is apparent from previous chapters market surveillance remains, and is likely to continue to remain, the main way in which market abuse, including cross border market abuse, is detected. Although those responsible for market surveillance, being either regulators, self-regulatory organizations or trading venues, have made continuous investment in improving their market surveillance capabilities, it seems that these capabilities may not have not fully kept pace with the changes that have occurred to the markets over the last decade. As highlighted in chapter 2, in order to increase the efficiency of markets, globalization, fragmentation of markets and the speed of trading have been allowed to proliferate while maintaining and improving the integrity of markets has been less of a focus until relatively recently.

A 2013 report by IOSCO highlighted major issues with market surveillance brought about because of the transformation of the markets in recent years. IOSCO surveyed regulators,

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<sup>724</sup> Kingsley Napley, *Telephone tapping, wire tapping and the FSA – do the FSA have powers to tap phones?*, 18 May 2011, online: Kingsley Napely <<http://www.kingsleynapley.co.uk/news-and-events/news/telephone-taping-wire-tapping-and-the-fsa-do-the-fsa-have-powers-to-tap-phones>>.

<sup>725</sup> *Criminal Procedure Code* (Strafprozeßordnung, StPO), s.100a.

<sup>726</sup> See MAR, *supra* note 355.

self-regulatory organisations and trading venues responsible for surveillance and 42 respondents replied reporting two major challenges. First the respondents reported challenges concerning:

maintaining an effective market-surveillance regime within their jurisdictions. In particular, a large number of respondents, including those from the U.S. and the EU, cited the challenges in monitoring effectively trades occurring on a *cross-market or cross-asset class basis*. They also stated that there was a major challenge in achieving effective cross-border surveillance.<sup>727</sup>

The second challenge stems from ongoing technological developments which make it more difficult to effectively monitor the markets:

The two primary challenges identified were the need to: (1) collect data, including the potential inadequacy of current content and the related collection and storage costs for a vast amount of trade information; and (2) develop a process to use effectively such information for surveillance purposes, particularly for the purpose of identifying customers. One Statutory Regulator also highlighted the increasing amount of *trading noise* produced by the proliferation of fully automated program trading and order execution systems, which has made it a challenge to distinguish *bona fide* orders and trades from manipulative activities.<sup>728</sup>

The report noted that that cross-market and cross-asset surveillance seem to present the greatest challenges and are potentially the areas where there are substantial regulatory gaps.<sup>729</sup>

As a result of its survey, the IOSCO report contained a number of recommendations. In summary these were that:

1. The statutory regulator, SRO or the operator of a trading venue responsible for conducting and/or overseeing market surveillance efforts (referred to as “Market Authorities”) should have the organizational and technical capabilities to monitor the trading venues they supervise effectively. In particular, where a market has

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<sup>727</sup> IOSCO “Technological Challenges to Effective Market Surveillance Issues and Regulatory Tools”, Final Report, April 2013, online: IOSCO < <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD412.pdf> > at 28.

<sup>728</sup> *Ibid.*

<sup>729</sup> *Ibid.*

dispersed trading venues, or where trading can take place across asset classes, this necessitates cross-asset surveillance.

2. It is critically important that Market Authorities review and update their surveillance capabilities, including systems, tools and surveillance staff skills, particularly with respect to technological advances.
3. Market Authorities should have the capability to access data in a way that enables them to conduct their surveillance obligations effectively. This may include developing a central reporting point within a domestic jurisdiction for all data.
4. Market Authorities should have the capability to associate the customer and market participant for each order and transaction.
5. Market Authorities should require that data be reported for use and storage in a useable format and should take steps to standardize the format of the data which is collected.
6. Market Authorities should establish and maintain appropriate confidentiality safeguards to protect surveillance data that is reported to them.
7. Market Authorities should consider requiring trading venues within their jurisdiction, to synchronize, consistent with industry standards, the business clocks they use to record the date and time of any reportable event.<sup>730</sup>

In relation to cross-border surveillance, IOSCO recommended that such Market Authorities should, as a minimum, map and be aware of the extent of their cross-border surveillance capabilities. In addition IOSCO recommended that Market Authorities should also work collectively and take any steps that would be appropriate to strengthen their cross border surveillance capabilities.<sup>731</sup> This would include encouraging and facilitating quick, efficient

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<sup>730</sup> *Ibid.*

<sup>731</sup> *Ibid* at 37.

and flexible cooperation between regulators and market operators, regardless of jurisdictional boundaries.<sup>732</sup>

Full adoption of all these recommendations by those responsible for market surveillance could be anticipated to greatly enhance surveillance capabilities and should make it much easier to detect market abuse, particularly cross market, cross asset and cross border market abuse. However, many, if not most, of these recommendations appear to be somewhat ambitious and it will probably be many years before these recommendations are fully incorporated within the surveillance capabilities of those responsible for market supervision. Fully implementing the IOSCO recommendations will be costly and those costs are likely to fall primarily on market participants. As such, there is likely to be resistance by the financial industry to incurring these costs particularly as it is difficult to measure the benefits in terms of improvements in market integrity that may accrue as a result.

Furthermore, it also seems likely that because many markets are a long way from fully implementing these recommendations IOSCO may have moderated its recommendations to reflect this fact. This is because it can be argued that improvements in surveillance capabilities should go beyond these recommendations. For example, in relation to recommendation 4, the IOSCO report recommended only that Market Authorities should have the capability to associate the customer and market participant with each order and transaction. The IOSCO report did not go further as it might have to recommend that Market Authorities should ensure that each customer be allocated an individual customer identifier and mandate that this unique customer identifier be used every time that customer made an order wherever that order was made. This is despite the fact that the IOSCO report notes that there was near unanimous consensus from commentators on its draft report that there should be such individual customer identifiers.<sup>733</sup>

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<sup>732</sup> *Ibid.*

<sup>733</sup> *Ibid* at 35.

It should perhaps be noted that few countries currently require that each customer be uniquely identified across all markets and their unique identifier be used when an order is placed. Some countries, for example Canada, now require that each broker be identified with a unique identifier along with clients who have been allowed direct electronic market access. In the US, once the Consolidated Audit Trail has been fully implemented, FINRA should have the capacity to access a database to link customers to orders and trades. Ensuring that customers use one identification marker across all their trading, irrespective of what market is used, which all authorities responsible for surveillance could see in real time would greatly assist detection of market abuse. This is because that information now has to be collected manually from brokers, a time consuming process. Individual customer identifiers should allow authorities to very quickly and cost effectively identify manipulative trades and take appropriate action. It should also deter those who contemplate undertaking market abuse if they know that such misconduct will be more immediately transparent to the authorities and likely to result in swift intervention.

However notwithstanding these perceived benefits, if implemented, there would be significant challenges in requiring the use of unique client identifiers even within a single jurisdiction, let alone across jurisdictions. For example, there will inevitably be privacy concerns in requiring identifying information, such as social security numbers, to be produced before a unique customer identity number is allocated. In its report IOSCO noted that although commentators on its draft report were nearly unanimous in supporting the concept that customer identifiers should be used, there was at the same time a recognition that there were practical difficulties in achieving this, particularly in a cross-border scenario.<sup>734</sup> The report did note that there is currently a project, being conducted by the Financial Stability Board at the instigation of the G-20, to establish a unique global identifier for every legal entity to use in financial transactions. However although the Financial Stability

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<sup>734</sup> *Ibid* at 35.

Board has done some work on this project it is still in its infancy.<sup>735</sup> The future success of this project will also depend upon robust support by governments, who may face resistance from industry because of the increased scrutiny it will focus upon their activities.

Nevertheless, despite the difficulties inherent in introducing such a system, over the long term, efforts should arguably be made to work towards unique customer identifiers. This is because it should enhance the detection of market abuse as well as result in significant cost savings for the authorities charged with the detection and investigation of market abuse. Furthermore, such a system is also likely to contribute to the success of any matters that are detected because of a likely reduction in the time lost between detecting and initiating an investigation of such matters.

Moreover IOSCO's report has identified a number of other issues in relation to market surveillance capabilities. Given the importance of these capabilities to the detection of market abuse, cross border market abuse and the preservation of market integrity, IOSCO should continue its policy development work in this area. In particular IOSCO could consider developing more specific guidelines in relation to each of its recommendations and monitoring progress by countries in meeting each of these recommendations.

#### **d) Addressing market abuse problems with lightly regulated markets**

As identified in chapters 3 and 4, lightly regulated markets seem to be particularly prone to market abuse. For those countries which have such lightly regulated markets, securities regulators seem to have to devote a disproportionate amount of resources to combat these markets being exploited for the proliferation of pump and dump schemes.

Such schemes have existed for many years. Indeed the South Sea Bubble scheme in 1720 was essentially a pump and dump scheme.<sup>736</sup> What has changed, however, is that now the

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<sup>735</sup> See Financial Stability Board Steering Committee, "A Global Legal Entity Identifier for Financial Markets" (8 June 2012), online: Financial Stability Board <[http://www.leiroc.org/publications/gls/roc\\_20120608.pdf](http://www.leiroc.org/publications/gls/roc_20120608.pdf)> Following this report a Regulatory Oversight Committee was established with a view to establishing a secretariat. See generally LEIROC, "The Legal Entity Identifier Regulatory Oversight Committee – LEIROC" (2014), online: LEIROC <<http://www.leiroc.org/>>.

perpetrators can be outside of the jurisdiction conducting wash sales and matched orders by virtue of entities being spread over a number of countries. In addition, the 'pumping' – that is the spreading of false information - can take place outside of the jurisdiction via the internet or even by using Facebook or Twitter.

In relation to the issue of obtaining evidence, the IOSCO MMoU appears to be successfully assisting regulators obtain evidence from outside of the jurisdiction. However the impact of the IOSCO MMoU in combating such schemes could perhaps be further strengthened. In particular, perhaps other regulators should consider following the lead of the BCSC and its proposed restriction on investment dealers not being permitted to trade in the US Over the Counter Markets involving a security of an OTC issuer which is located in a jurisdiction that is not a signatory to the MMoU. If it became common practice to impose a similar condition upon market intermediaries who trade in lightly regulated markets, this might deter individuals from instigating such schemes or at the very least make them easier to investigate.

Furthermore, as outlined in chapter 4 more could be done to take more robust and rapid enforcement action against such schemes by better coordination between regulators and with the aid of stronger penalties. In this respect IOSCO could assist by devising a policy statement highlighting the problems with such schemes in lightly regulated markets. Such a policy statement could, for example, recommend the need for higher penalties. It could also recommend closer coordination of enforcement efforts in such markets and perhaps also encourage the sharing of intelligence as to the types of schemes operating.

#### **e) Taking Action to Protect the Integrity of Foreign Markets**

As discussed in chapter 3 and 4, case selection policies of some securities regulators seems to result in regulators giving preference to investigating those matters which impact upon the integrity of their own markets. This is perhaps understandable given the mandate of the

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<sup>736</sup> For a description of the South Sea Bubble scheme see Tim Phillips, *Charles Mackay's Extraordinary Popular Delusions and the Madness of Crowds: A Modern-Day Interpretation of a Finance Classic* (Oxford: Infinite Ideas, 2009).

regulator is usually to protect the integrity of their own markets and the added complexity in investigating cases which have a cross border dimension.

However as a result it seems that some perpetrators may be escaping prosecution, or at least escaping the imposition of serious penalties, because the market abuse is not contained within one jurisdiction. Such policies also may encourage perpetrators to structure their offences across jurisdictions to minimise the possibility of enforcement action and move their activities to another jurisdiction when they are detected.

As such IOSCO should develop policies to ensure that perpetrators of market abuse do not escape enforcement action because of these policies of securities regulators which give preference to protecting the integrity of local markets. In addition IOSCO could facilitate cooperation between regulators to ensure that matters that are referred by one securities regulator to another are pursued.

One way in which IOSCO could start to address this issue is to add to its *Objectives and Principles of Securities Regulation*. Currently these provide that securities regulators should have contained within their mandate the following:

13. The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.

14. Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.

15. The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and the exercise of their powers.<sup>737</sup>

To encourage regulators to work together to prosecute perpetrators of market abuse consideration could be given to introducing another principle of cooperation. This would be that regulators should take action, where practicable, against perpetrators of securities fraud when requested to do so by a foreign regulator and when the perpetrators reside within their

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<sup>737</sup> IOSCO, *Objectives and Principles*, *supra* note 37 at 6.



jurisdiction. IOSCO could also develop more detailed guidelines as to which regulator should be principally responsible for taking action against securities offences which are not confined to one jurisdiction.

### **Part 3 IOSCO's role in relation to cross-border market abuse going forward**

It seems clear that IOSCO's role will continue to expand as it works towards pursuing standardization of principles of securities regulation and improving the enforcement outcomes of its members. To this end IOSCO will probably continue to develop policy in relation to problem areas of securities regulation and perhaps also develop the MMoU. What is open to debate is whether it should have a role beyond these two areas and, if so, what this role could be.

#### **The impetus for change**

The momentum for an expanded role for IOSCO is likely to come not from its prominence now as the world leader in the coordination of securities regulation alone. The push for an expanded role for IOSCO will continue as closer links are forged between governments, securities regulators and securities industry participants over the next few decades. As such there will be continued pressure for more consistent global regulation and problems in securities regulation are likely to continue to emerge for consideration by global political bodies such as the G20. Although this may suggest that there is a need for a global securities regulatory body to set, coordinate and enforce compliance with consistent standards of securities regulation, the likelihood of such a global regulator is small to nonexistent. As summarized succinctly by Chris Brummer it is difficult to envisage that there would be the political will to create such a regulator:

First, and perhaps most obvious, it would be almost impossible to generate sufficient international support for the creation of a single, global regulator that would carry with it, for individual states, the relinquishment of national sovereignty and autonomy. Establishing a global authority would require countries to delegate authority to a supranational authority, an act involving a "dynamic" delegation of authority such that any decision made by that authority would

create de facto changes in the domestic laws of member regulators. It is unlikely that national legislatures would agree to compromise their domestic powers of policymaking and governance in that way, especially in relation to large domestic financial institutions and firms.<sup>738</sup>

For these reasons it is very likely that it will fall to IOSCO to defacto fulfill the role as a global securities regulator to the extent that is possible within the limitations of its mandate. This is particularly the case as the G20 to date has no permanent secretariat. Whilst establishing a permanent secretariat has been suggested, at present there is no consensus as to whether this should be established, how it will be staffed and where it will be located.<sup>739</sup>

### **An operational role in relation to detection, investigation and enforcement?**

IOSCO currently does not play an operational role in the detection, investigation and prosecution of cross border market abuse nor does it play an active role in coordinating current investigations by members. The closest it comes to assuming such a role is by assisting members in resolving disputes which may arise in the process of requesting information under to the MMoU.<sup>740</sup> As connections between regulators develop there may be a need for IOSCO to take a more operational role, for example by helping conduct or coordinate investigations that cross international boundaries. IOSCO's links with other international organisations and networks, such as Interpol, could possibly be used to facilitate such investigations.<sup>741</sup>

However it is unlikely that IOSCO would obtain or even seek such an operational role. Again this is because of the substantial jurisdictional hurdles that would have to be overcome for

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<sup>738</sup> Chris Brummer, *Soft Law and the Global Financial System*, (New York: Cambridge University Press, 2012) at 269.

<sup>739</sup> See generally Johannes F. Linn, *Preliminary Suggestions for a G20 Summit Secretariat*, Wolfensohn Center for Development, The Brookings Institution, online: KDI <<http://www.kdi.re.kr/upload/15230/2-3.pdf>>; Barry Cavin, *A G20 "Non-Secretariat"*, Center for International Governance Online, online: CIGI <<https://www.cigionline.org/sites/default/files/A%20G20%20'Non-Secretariat'.pdf>> and Jongryn Mo, *Placing the G20 in an Emerging System of Global Governance*, Yonsei University, online: CSIS <[http://csis.org/files/publication/HGCY\\_Working\\_Paper\\_No\\_1002.pdf](http://csis.org/files/publication/HGCY_Working_Paper_No_1002.pdf)>

<sup>740</sup> Interview with IOSCO. It also collects statistics as to the use of the MMoU.

<sup>741</sup> For example in the 2007 Annual Report of IOSCO stated the following "In tackling securities violations IOSCO has also increased its contact and engagement with other international bodies in this area including the Financial Action Task Force, the FSF Offshore Financial Centre Review Group, Interpol and the Egmont Group." IOSCO, *IOSCO Annual Report 2007*, online: IOSCO <[http://www.iosco.org/annual\\_reports/annual\\_report\\_2007/pdf/workOfIosco2007.pdf](http://www.iosco.org/annual_reports/annual_report_2007/pdf/workOfIosco2007.pdf)> at 21.

IOSCO to be able function in such a position. This would include the challenges of different legal systems as well as the fact that it may require sovereign nations conceding powers to IOSCO. Even more established organizations under international law, such as the International Criminal Court, have difficulties in persuading countries to concede jurisdiction to them.<sup>742</sup>

Nevertheless, although IOSCO is unlikely to have an operational role in investigations in the foreseeable future, as the MMoU has demonstrated, it is nevertheless possible that IOSCO can have an impact beyond the mere formation of policy. As such it could potentially develop other mechanisms or tools which its members might utilize in relation to their regulation and enforcement functions.

Indeed IOSCO has signalled that it is considering developing new tools for members. However to date the main focus appears to be not on deterring cross border market abuse but rather upon ways in which it can facilitate the mutual recognition of market intermediaries across borders. IOSCO has set up a taskforce to develop just such a mutual recognition regime. This taskforce has been directed to:

develop a tool box of measures in regulating securities markets that cross borders. If appropriate, it will then develop principles to guide the coordinated use of these tools. The tools to be considered may include substituted compliance, mutual recognition and supervisory co-operation. The Task force's work is intended to help policy makers and member regulators in addressing the challenges they face in regulating cross-border activity.<sup>743</sup>

Although the details have yet to be developed it appears that such a mutual recognition regime will likely comprise a system that would allow a market participant registered in one country, and subject to the supervision of that jurisdiction's securities regulator, to easily

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<sup>742</sup> See e.g. W A Schabas, *An Introduction to the International Criminal Court*, 2<sup>nd</sup> ed. (Cambridge, UK: Cambridge University Press, 2004) at 420.

<sup>743</sup> IOSCO Media Release, *supra* note 662 at 4. See also comments of Jane Diplock, former IOSCO chairman in the financial times where she stated "Now that almost all of the enforcers are signed up, she says, Iosco's next cooperative effort will focus on cross-border supervision.", Brooke Masters, *IOSCO Pact Reshapes Market Enforcement*, 8 January 2010, online: Financial Times <[http://www.ft.com/cms/s/0/b843b8f0-ee45-11de-a274-00144feab49a.html?nclick\\_check=1](http://www.ft.com/cms/s/0/b843b8f0-ee45-11de-a274-00144feab49a.html?nclick_check=1)>.

obtain recognition in another country. In devising such a system it seems inevitable that IOSCO will set universal standards which will have to be met by securities regulators in relation to the supervision of their market intermediaries.

Such a mutual recognition system may operate to deter and detect market abuse depending upon the breadth and comprehensiveness of the requirements imposed upon the market intermediaries. For example such a system could work towards deterring and detecting market abuse if it contained comprehensive requirements mandating that market intermediaries:

- undergo regular inspections and audits;
- report transactions which they suspect to be market abuse and;
- have in place compliance mechanisms to detect such suspicious transactions.

#### **Development of other systems to improve enforcement of cross border market abuse**

Although such a system of mutual recognition may assist to detect and deter market abuse there is also scope for IOSCO to go further and develop other systems which could assist securities regulators in their role to detect and take action against cross border market abuse. IOSCO recently resolved that:

With regard to building on the IOSCO MOU after 1 January 2013, the Executive Committee is asked to consider if a further standard beyond the existing IOSCO MOU should be developed, taking into account developments in markets and supervisory and enforcement practices.<sup>744</sup>

There are a number of such standards or systems which could be developed by IOSCO. First these could include taking its lead from the EU and developing a system to exchange suspicious transaction reports between regulators. Second, in a similar manner to the MMoU, IOSCO could develop a system to share information between regulators in relation

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<sup>744</sup> IOSCO, Presidents Committee, *Presidents Committee of the International Organization of Securities Commissions Resolution on IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information*, online: IOSCO <<http://www.iosco.org/library/resolutions/pdf/IOSCORES36.pdf>>.

to market surveillance. Third IOSCO could develop a system or systems designed to facilitate the sharing of intelligence information of possible market abuse.

***a) A system to exchange suspicious transactions reports.***

Similar to the system that exists in the EU, IOSCO could consider developing a Memorandum of Understanding to facilitate the exchange of reports of transactions suspected to constitute market abuse. Securities regulators who signed this MOU would have to have laws in place whereby suspicious transaction reports of market abuse are communicated directly to them by brokers and others involved in the securities industry. Again similar to the system that exists in the EU, securities regulators could be required to immediately send any report to any other regulator whose markets are potentially impacted by the report. In addition, IOSCO could also consider developing a database of such reports for securities regulators who had signed the MOU. Such a database could potentially prove to be a valuable source of intelligence for IOSCO members.

As referred to in chapters 3 and 4, the number of such reports exchanged between securities regulators in the EU has dramatically increased over the last few years. Furthermore, as reported by BaFin these reports are proving to be valuable and, in some cases, the ultimate trigger for an investigation. A system developed by IOSCO has the potential to be similarly effective. Such a system would possibly also have the advantage that it could be relatively cheap to implement compared to the substantial investment needed to improve market surveillance capabilities.

***b) A system to share data in relation to cross border market surveillance***

Currently most organisations responsible for market surveillance share information about possible market abuse via the Intermarket Surveillance Group (ISG). In fact the sharing of such information is ISG's stated primary function.<sup>745</sup> The ISG's other functions are to assist

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<sup>745</sup> See ISG "Organizational Overview", which states that the ISG is "to provide a framework for the sharing of information and the coordination of regulatory efforts among exchanges trading securities and related products

with the coordination of regulatory efforts and to provide a forum for discussing common regulatory concerns with a view to enhancing members' ability to efficiently fulfill their regulatory responsibilities.<sup>746</sup> As reported in chapter 3, for self-regulatory organisations such as FINRA and IIROC the ISG plays an important role in facilitating the exchange of information and thereby assists in the detection and investigation of market abuse. In addition, its ability to share intelligence about the activities of market participants and schemes that may constitute market abuse may be useful in facilitating the detection of new schemes as they arise.

ISG is able to facilitate the sharing of information as each member is under “an obligation to cooperate with other ISG members in the acquisition and sharing of regulatory information on an “as needed” basis.”<sup>747</sup> It is surmised that this obligation comes from the terms of an agreement each ISG Member must sign, although this is only supposition as the terms of this agreement have not been made public.<sup>748</sup>

However, as highlighted in chapter 2, as markets become increasingly global and trading becomes more dispersed there are some real concerns if it is the ISG that continues to be the organisation charged with facilitating the exchange of surveillance information. First these concerns stem from firstly its membership limitations. Membership of the ISG is currently limited to self-regulatory organizations and certain non-governmental associations that provide regulatory services to home markets. The ISG currently does not allow government securities regulators to become members, and, accordingly, BaFin, FSA, OSC, ASIC and the SEC are not members. This is despite the fact that ASIC, a government regulator, has sole responsibility for conducting market surveillance in Australia. Because it is carrying out the same functions as other members of the ISG, logic would suggest that it should be able to join this organization. However currently this is not possible.

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to address potential intermarket manipulations and trading abuses”, Intermarket Surveillance Group, “Organizational Overview” (2006), online: ISG <<https://www.isgportal.org/isgPortal/public/overview.htm>>.

<sup>746</sup> *Ibid.*

<sup>747</sup> ISG, *supra* note 275.

<sup>748</sup> ISG, *supra* note 745.

A second concern is that the ISG does not allow members to share information to any third party, including any government entity, without the specific written permission of the information provider. It is not clear how, or even if, this requirement is hindering the provision of information to government securities regulators. Nevertheless it potentially could frustrate an investigation of market abuse if information necessary to an investigation was to be withheld. At the moment it appears that securities regulators may have to resort to obtaining surveillance information on an ad hoc basis from other regulators, via bilateral MOUs or, in Europe, via the ESMA.<sup>749</sup>

Finally, as was pointed out in chapter 2, the control and management of the ISG is not transparent. It does not publish accounts so it is unclear as to how it is funded, how any such funds are spent and the extent of its operations. This is of concern in that first market surveillance is the main form of detection of market abuse. Second the detection of market abuse is critical to market integrity and third there is a strong public interest in preserving market integrity.

Given that ISG's sole function seems to be to enhance the regulatory capacities of its members to fight market abuse, it seems paradoxical that government regulators cannot be members and that information can be withheld from government regulators. Furthermore, given ISG's regulatory mandate, it also seems anomalous that the work done by the ISG is somewhat opaque, particularly in relation to its governance structure and the terms of the information sharing agreement between members.

Whilst comments made by enforcement personnel from IRROC and FINRA suggest that the work undertaken by the ISG appears to be valuable, at present it does not seem that it is the ideal organisation to be charged with sharing surveillance information. Reforms are necessary so that government regulators can become members and for there to be more transparency in relation to ISGs governance and funding structure. In the absence of such reforms, given the importance of this work to the preservation of market integrity, IOSCO

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<sup>749</sup> IOSCO Report, *supra* 727 at 25-26.

should perhaps take a more active role in the enabling the sharing of this type of information between securities regulators and those responsible for market surveillance. Given the success of the MMoU, perhaps this could take the form of a new MOU to quickly and easily facilitate the sharing of this type of information.

**c) *Sharing intelligence***

One major deficiency with the MMoU is that its focus is on the investigation and enforcement of securities violations that have already been detected by the requesting member. It was not designed to share other types of information. The MMoU does provide that:

Each Authority will make all reasonable efforts to provide, without prior request, the other Authorities with any information that it considers is likely to be of assistance to those other Authorities in securing compliance with the Laws and Regulations applicable in their jurisdiction.<sup>750</sup>

This paragraph could possibly lead members to share other types of less precise information, commonly referred to as 'intelligence'. This could include, for example, information as to possible market abuse schemes or the names of persons and organizations under investigation. Yet given the imprecise nature of this paragraph in the MMoU, it is unlikely that this does, in reality, lead regulators to proactively assist each other with the sharing of intelligence information. As such the MMoU could be strengthened and expanded by providing more specifics of the intelligence information to be shared. However given the complications inherent in amending the MMoU, as outlined earlier in this chapter, it may be more effective to develop an alternative system to share such information.

If such a system was to be developed the types of intelligence that would be shared would have to be delineated. Most securities regulators maintain one or more databases of information. For example, as is referred to in chapter 4, FINRA maintains a list of possible market abuse matters and mines that information for possible connections as new possible cases arise. Regulators also maintain databases of information they have collected such as

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<sup>750</sup> IOSCO MMoU, *supra* note 268.



complaints received from the public. They may also have access to further intelligence databases such as databases maintained by other law enforcement agencies.

Of course many regulators may not be comfortable with sharing such information generally with other regulators. The concern might be that information may be imprecise or even wrong and as such there would be legitimate concerns with releasing it in that it might be used inappropriately and could therefore expose the regulator who released it to liability if it was misused. However, notwithstanding such concerns, it may be something which IOSCO could at least explore as a possibility as there may be some information that regulators are willing to share.

Furthermore most regulators publically publish information in relation to the names of persons and organisations that have been banned or prosecuted. Often this is accompanied by information in relation to the nature of their activities and penalties imposed. It is likely that there would be little resistance to more effectively sharing this type of information. Therefore IOSCO could, as a minimum, develop a way to facilitate the sharing of this type of information by, for example, establishing a database requiring members to provide information about persons and organizations that had been banned or prosecuted for securities violations. Having access to such a database may assist members select cases for investigation.

#### **Part 4 Replicating the MMoU Methodology to obtain Regulatory Convergence**

A key part of IOSCO's mission is to work towards the worldwide harmonization of securities regulation. This is reflected in the fact that in 2010 it changed one of its aims from "cooperation to promote high standards of regulation" to "developing, implementing and promoting adherence to internationally recognised and *consistent* (my emphasis) standards of regulation."<sup>751</sup> As is set out at the beginning of this chapter this is also referred to in its goals for 2010-2015 as it seeks to "maintain and improve the international regulatory

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<sup>751</sup> IOSCO, *supra* note 661 (emphasis added).

framework for securities markets by setting international standards".<sup>752</sup>

### **The push to harmonize Securities Regulation**

Part of IOSCO's strategy to date in terms of working towards achieving harmonization of securities regulation has been an evaluation process in relation to the level of implementation by each country of the IOSCO *Objectives and Principles of Securities Regulation*.<sup>753</sup> Initially IOSCO's instigated this process by way of a self-assessment exercise. This self-assessment exercise asked each member to answer a list of questions in relation to each principle and to reach a conclusion as to whether the principle was fully implemented, broadly implemented, partly implemented or not implemented. Alternatively a member could elect to have the International Monetary Fund (the IMF) assess its compliance through what is called its Financial Sector Assessment Program.<sup>754</sup>

In 2011 IOSCO established an Assessment Committee to develop and deliver programs to identify and assess implementation of both IOSCO's *Objectives and Principles of Securities Regulation* as well as other standards and polices contained in IOSCO reports or resolutions.<sup>755</sup> Although self-assessment will continue IOSCO is moving from a focus on self-assessment to IOSCO assessing each of its members. The Assessment Committee will conduct assessments of individual members and will also conduct thematic reviews of particular IOSCO principles across members. The rationale for the establishment of the Assessment Committee is to systematically monitor the implementation of IOSCO standards and to help build members regulatory capacity through this systematic implementation.<sup>756</sup>

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<sup>752</sup> *Ibid* .

<sup>753</sup> IOSCO, *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*, September 2011, online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf>> This replaced IOSCO, *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation*, October 2003, online: IOSCO <<http://www.iosco.org/library/pubdocs/pdf/IOSCOPD155.pdf>>

<sup>754</sup> See International Monetary Fund, *The Financial Sector Assessment Program (FSAP)*, 24 March 2010, online: IMF

<<http://www.imf.org/external/np/exr/facts/fsap.htm>>, accessed 10 May 2012.

<sup>755</sup> IOSCO Annual Report 2011, *supra* note 560 at 44.

<sup>756</sup> Comments by IOSCO on file.

### Using the MMoU Methodology to achieve harmonization

At present IOSCO envisages the assessment process as key to working towards harmonization. It has stated:

The assessment is not an end in itself. Rather, assessment should be viewed primarily as a tool for identifying potential gaps, inconsistencies, weaknesses, and areas where further powers or authorities may be necessary, and as a basis for framing priorities for enhancements or reforms to existing laws, rules and procedures. This Methodology specifically contemplates that the assessment process will involve a dialogue in which the regulator will explain the details of its market structure, laws, and regulatory program and how, in view thereof, the regulator believes its regulatory program addresses the Key Questions and Key Issues so as to meet the objectives of the Principles.<sup>757</sup>

IOSCO therefore appears to expect that once a member identifies gaps in its framework of securities regulation it will take steps to adopt new laws to bring its securities regulation into line with IOSCO's *Objectives and Principles*.

Despite this intention, it is likely that this assessment process methodology will not, of itself, be sufficient over the longer term to persuade members to harmonize their securities regulation to conform to the IOSCO framework. However as has been referred to in previous chapters IOSCO may have been able to effectively work towards compliance in other ways. IOSCO has successfully increased convergence of domestic regulation by holding out the ability to access the MMoU as a 'carrot' to encourage members to change their laws to bring them into line with some of IOSCO's *Objectives and Principles*.

Given this success IOSCO could perhaps consider trying to replicate this methodology with a view to working towards convergence in relation to some of the other *Objectives and Principles*. As referred to above, there appears to be potential for IOSCO to develop other systems which are needed by securities regulators. Giving securities regulators access to these systems could be made contingent upon securities regulators making changes to their

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<sup>757</sup> IOSCO, *supra* note 752 at 15.

laws and, in turn, this could be used as a lever to bring about further convergence of securities regulation. As such IOSCO could work towards hardening its 'soft law' policies by having them incorporated into domestic statutes.

The success of such a strategy may depend upon the area in which IOSCO is seeking convergence. Critics of the capacity of transnational regulatory networks (TRNs) like IOSCO, to secure global cooperation, such as Pierre-Hugues Verdier, contend that there are limits to obtaining convergence. He argues that securities regulators will cooperate where preferences are aligned. However where there are divergent domestic preferences agreement is unlikely to take place.<sup>758</sup> In 2009 Verdier predicted that IOSCO would not be able to continue to have OFCs cooperate under the umbrella of the IOSCO MMoU:

OFCs have incentives to renege, and it is doubtful that sustained compliance can be obtained through TRNs.<sup>759</sup>

However, despite Verdier's predictions, IOSCO has been able to obtain significant cooperation from some OFCs. IOSCO has managed to have some jurisdictions change their domestic laws from that which may have given them a competitive advantage. For example, countries previously known for their secrecy laws, such as Switzerland, have signed the MMoU indicating that in some circumstances domestic preferences are giving way to considerations of international cooperation.

As an example of a situation where domestic preferences diverged Verdier points to the fact that in early 1990s IOSCO failed to reach agreement on capital adequacy rules for securities firms, despite the fact that this would have reduced global systemic risk. IOSCO failed to reach agreement principally because US banks, concerned about their international competitive position, pressured US regulators to resist agreeing to the proposed rules.<sup>760</sup>

It is true that cooperation in relation to market abuse and fraud prevention is something that would be attractive to most countries. IOSCO may not experience the same level of

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<sup>758</sup> Verdier, *supra* note 640.

<sup>759</sup> *Ibid* at 150.

<sup>760</sup> *Ibid*.

cooperation in relation to some areas of securities regulation. There may be more diverse domestic preferences in relation to other areas, such as disclosure standards required for companies engaging in public fundraising, and countries may perceive a competitive advantage in keeping their securities regulations distinct.<sup>761</sup> However even in those areas, as markets become more global, pressure for international cooperation is likely to come not just from increased and repeated interactions between governments and their officials but also from corporations that operate globally who are seeking consistent standards. This is likely to result in an increased likelihood that, over time, domestic agendas may yield to international pressures for convergence of securities regulations. The impact of the GFC and the spotlight it brought on global financial stability no doubt has contributed to these developments and will continue to do so.

Furthermore, whilst divergent national preferences may limit IOSCO's capacity to employ the methodology it used in relation to the MMoU in respect to some areas of securities regulation, it has proven that it can work, at least with regard to the investigations and enforcement of securities violations. Therefore it seems there is scope to employ other systems that assist securities regulators in eliminating market abuse as levers to work towards further convergence of securities regulation.

## **Conclusion**

Over the last two decades IOSCO has evolved to become an important organisation for securities regulators, improving, via the MMoU, their ability to enforce cross jurisdictional securities offenses. The importance of the MMoU it is likely to continue to grow as the number of requests increase and the number of countries that have not signed continues to decline as IOSCO's initiatives to coerce countries to sign the MMoU take effect.

IOSCO has also emerged as an important organisation in setting global standards for securities regulation through its *Objectives and Principles* as well as by way of more specific

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<sup>761</sup> See generally: A. N. Licht, "Games Commissions Play: 2x2 Games of International Securities Regulation" (1999) 24 Yale Journal of International Law 61.

policy recommendations. This standard setting role is also likely to continue to develop as governments and corporations recognise the advantages associated with universal standards. As set out in this chapter, IOSCO could use this policy setting role to improve enforcement outcomes in relation to cross border market abuse by, for example, setting standards as to what should come within the definition of market abuse and assigning appropriate penalties for such conduct.

Moreover, as described in the final part of this chapter, in addition to policy work and the MMoU it seems that there is further scope for IOSCO to increase its influence. Whilst this is unlikely to take the form of operational role in investigations, IOSCO does seem to have capacity to develop systems and other multilateral MoUs to improve the detection, investigation and enforcement of cross border market abuse. Such systems and multilateral MoUs could, in turn, be used by IOSCO as a lever as it works towards its mission of harmonizing of securities regulation. If IOSCO proceeds along such a path it is likely to further increase in importance. Whilst this will not result in it being a supranational regulator this will, to at least some extent, enable it to play an increasingly significant part in the global governance of securities regulation and securities regulators.

## CONCLUSION

In short, this past decade has seen a tectonic shift in how securities regulators combat cross-border financial crime. In a sense, what we have now is a philosophy of collective security for regulators—we have the authority to view a threat to the integrity of foreign markets as a threat to our own. Those who commit financial crimes can run across borders, but they cannot hide.

Ethiopsis Tafara, Director of the Office of International Affairs, SEC<sup>762</sup>

The above statement was made by Ethiopsis Tafara in 2003 however as the insights gleaned from the preceding chapters have demonstrated, this comment appears to be more a expression of aspiration than reality. While it is true that regulators are working more cooperatively in relation to cross border market abuse than they did in the past there are still impediments hindering truly effective action.

This dissertation set out to investigate whether the integrity of the markets has been threatened by the increased globalization and sophistication of the markets. Specifically its focus has been on cross border market abuse and the threat that this could pose to market integrity and the capital markets if effective action was not taken to address it. Initially an analysis was undertaken in regard to the changes to the markets. The focus then shifted to consider first whether there has been a transformation in the nature of cross border market abuse from the perspective of securities regulators and second, if there had been, how regulators had responded to it. Finally the role of IOSCO was examined to determine if and how it could assist regulators in responding to this threat.

The restricted nature of the research conducted for this dissertation necessarily limits the nature of the conclusions that can be drawn. Measuring changes to market integrity and the exposure of markets to market abuse presents a significant challenge and further research arguably needs to be undertaken in this area. However what is clear is that the changes to the markets have been dramatic and one effect of this is increased avenues for those who

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<sup>762</sup> SEC Annual Report 2003, online: SEC < <http://www.sec.gov/about/annrep03.shtml> > at 25.

engage in market abuse to exploit the global nature of trading and information exchange. This becomes apparent from the nature of the cases of market abuse which securities regulators are increasingly detecting, investigating and prosecuting and is reinforced by the comments made in interviews by enforcement staff of securities regulators. In particular, securities regulators are detecting more market abuse which straddles jurisdictions and those cases tend to be complex and resource intensive to investigate.

This dissertation has also sought to outline some of the responses to market developments in terms of both changes to regulation as well as the methods employed to detect and investigate cross border market abuse. It identified that there have been tangible advances in detection methods, such as investment in technology in relation to market surveillance and systems to analyse data obtained from voluntary reports of market abuse. In addition it demonstrated that the suspicious transaction report system in Europe seems to be detecting otherwise unobserved instances of market abuse. In terms of developments in investigatory techniques, this dissertation illustrated that securities regulators are tending to work more cooperatively in exchanging the information they need to complete investigations and that this is in no small part due to the operation of the IOSCO MMoU.

However it also appears that in some respects the capacity of securities regulators to detect, investigate and effectively enforce laws against market abuse has lagged, and continues to lag, behind the evolution of the markets. In particular there seems to be a growing need for significant investment in cross border and cross market surveillance in order to detect market abuse yet only a handful of securities regulators have developed or are developing this capacity. In addition currently the capacity to engage in such cross border market surveillance is largely facilitated by the ISG, a relatively opaque organisation whose regulatory mandate is seemingly at odds with its self-imposed restriction on providing information to government regulators. This suggests that the appropriateness of the ISG undertaking this function demands further and closer academic analysis. It seems that it may



be more appropriate for IOSCO to take over and improve the exchange of surveillance information between exchanges and regulators.

Furthermore, whilst the MMoU has improved the ability of securities regulators to obtain the information they need from other regulators, it appears that more could be done to improve the cooperation between regulators from different jurisdictions with a view to enabling them to more quickly bring enforcement actions and to improve enforcement outcomes. As noted by a number of the regulators, enforcement success tends to be related to the speed of an investigation just as enforcement failure is related to delay. Improving cooperation is important not just to the success of investigations but may also be important to deterring further offences and ensuring that perpetrators, particularly recidivist offenders, are appropriately punished. The deterrence impact of cooperation is also reinforced by the empirical study by Cumming et al, referred to in chapter 2, which showed that formalized cooperation agreements between supervisory authorities was associated with a decrease in fraud, as well as the study by Madura which suggested that there may be less insider trading across borders if regulators enter into bilateral enforcement agreements with the SEC.<sup>763</sup>

In relation to improved cooperation and enforcement across borders it seems that IOSCO could take a more proactive role in working with regulators to improve their enforcement outcomes. IOSCO has proved through the development and use of the MMOU that it can significantly contribute to the enforcement capacity of its members. It has developed as a broadly based representative organisation and its objectives are focused on standardizing securities regulations and enforcing those regulations. In relation to cross border market abuse IOSCO could develop specific policies targeting cross border market abuse, such as developing standardized penalties and more standardized enforcement options. Arguably it also needs to also push its members to commit more resources to enforcement, given the findings of Jackson & Rowe of the impact of such resources to capital market outcomes.<sup>764</sup>

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<sup>763</sup> See Chapter 2

<sup>764</sup> See Chapter 2

IOSCO should also build on the momentum it has achieved from the MMoU by continuing to work towards all countries signing this MMoU. This is important given how, as shown in chapters 3 and 4, perpetrators of market abuse can utilize different jurisdictions in an attempt to avoid prosecution. IOSCO should also expand or further develop this MMoU to include, for example, expanding the range of material that can be requested. IOSCO could also develop other tools or systems, such as a system for regulators to exchange suspicious transaction reports, which might work both to assist securities regulators in their enforcement efforts and, at the same time, be used by IOSCO to achieve better global harmonization of securities regulations.

Overall this dissertation raised questions about whether securities regulators, focused upon efficiency concerns and their mandate to maintain the integrity of their own markets, have been too slow to adjust to global market developments. As Ethiopis Tafara's statement makes clear, there needs to be a shift towards securities regulators altering their approach so that they will come to view a threat to the integrity of foreign markets as a threat to their own and act accordingly. It seems that securities regulators need to commit more resources to enforcement and work to improve the integrity of all markets by driving cooperative efforts, very possibly via IOSCO, in order to ensure that those who engage in market abuse have no place to hide. This emphasis on market integrity is important not just to ensure the market is fair, but also to improve capital market outcomes, and in turn, the economies of all countries. While such a focus on the integrity of global markets, along with securities regulation generally, will need to be a process of adaption and re-adaptation as markets develop, such an approach would appear to be essential in order to instil and secure market confidence and stability in world that has become increasingly interconnected.

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