Market Manipulation and Insider Trading

Regulatory Challenges in the United States of America, the European Union and the United Kingdom

Ester Herlin-Karnell
and
Nicholas Ryder
Introduction

I. Introduction

This book explores the phenomenon of market manipulation and insider trading, and how it is regulated and dealt with by the European Union (EU), the United Kingdom (UK) and the United States of America (US) respectively.

The ban on market manipulation in European law, for example, has its roots in the US, where the courts developed it based on the general common-law provisions on fraud. The EU regime for fighting market manipulation and insider trading – commonly referred to as market abuse – was significantly reshuffled in the wake of the financial crisis of 2007/08, and a new Directive and Regulation were proposed in 2011 and subsequently adopted in 2014. In all of the EU, US and the UK frameworks, the aftermath of the financial crisis, security concerns and increased legislation and policy responses to the fight against irregularities and market failures demonstrate that we need to understand the regulatory responses in this area in context. Specifically, the aim of this book is to investigate how the regulatory responses have changed since the start of the 2007/08 financial crisis, and to place the fight against market abuse within the broader picture of the fight against white-collar crime and the associated questions it raises in the context of the EU, US and the UK.

What, then, is market abuse? As stated, the notion of ‘market abuse’ is the umbrella label used to define insider trading and market manipulation. The insider trading ban, as Niamh Moloney explains, has several justifications. As she observes:

The first rationale for insider-dealing regulation has a micro focus. It characterizes insider dealing as a breach of the fiduciary relationship of trust and confidence (a related strand characterizes insider dealing in terms of the allocation of property rights), where one can be established, between, typically, the insider and the company concerned.

---

2 Introduction

The macro focus of the second theory (which has shaped the EU regime) is on market efficiency, and on the support of efficient price formation and deep liquidity. The definition of ‘market manipulation’ is somewhat more vague, however. In short, market manipulation may arise in circumstances where investors have been unreasonably disadvantaged, directly or indirectly, by others who have used information that is not publicly available to trade in financial instruments to their advantage (insider dealing), have distorted the price-setting mechanism of financial instruments, or have disseminated false or misleading information. In short, market manipulation can be defined as conduct that may misinform or deceive others into making ill-considered misleading investment decisions. 

'Market manipulation' is a term that has been used in the broader sense as including 'practices deemed harmful to the capital markets'. It has also been defined as an 'unwarranted interference in the operation of ordinary market forces of supply and demand; an interference in the market's normal price-forming mechanism'.

For example, according to the definition provided by the UK Financial Services Authority, market manipulation encompasses three elements. First, it includes financial dealings that provide fictitious indicators to obtain the price of a monetary tool at a synthetic level. Secondly, it involves a series of contracts or orders to utilise fabricated devices or products. Thirdly, it incorporates the sharing and dispersal of information that provides false or misleading signals. Examples of conduct that amounts to market manipulation include providing false statements or transactions that could result in the fluctuation of share prices.

Furthermore, market manipulation can also include 'disseminating misleading information which moves the price of investments up or down', or 'improper use of market power'. Other instances of market manipulation include a process called 'share romping', as illustrated during the Guinness fraud in the 1980s. Wayne Carroll stated:

Market manipulation is a general term covering a number of practices deemed harmful to the capital markets. Conduct that can lead to a violation of the market manipulation

---

5 Action Fraud 'Market manipulation' (n/d), available at www.actionfraud.police.uk/a-z-of-fraud/market-manipulation.
9 ibid.
10 See Lomnicka (n 7) 298.
provisions extends from active trading to merely spreading information about a particular security or company. Market manipulation comes in many forms, whose number is limited only by human ingenuity.\textsuperscript{12}

The EU Market Abuse Directive (MAD) offers a slightly different version.\textsuperscript{13} Article 5 defines market manipulation as (inter alia) someone entering into a transaction, placing an order to trade or any other behaviour which: gives false or misleading signals as to the supply of, demand for, or price of, a financial instrument or a related spot commodity contract; or secures the price of one or several financial instruments or a related spot commodity contract at an abnormal or artificial level.\textsuperscript{14}

Moreover, in Article 8 of the Market Abuse Regulation (MAR), insider dealing (the common term in the EU context) – on the other account – is defined as arising where 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.

However, whom exactly do market manipulation and insider dealing harm? For a long time there has been a scholarly debate on what is wrong with insider dealing and who exactly is harmed by it. Scholars have asked why insider trading is banned and what the justification is.\textsuperscript{15} The question asked is whether insider trading and market manipulation are unethical if no one is harmed by them.\textsuperscript{16} Who exactly is harmed? The traders themselves? While the answers to these questions remain

\textsuperscript{12} See Carroll (n 6) 300.
\textsuperscript{13} MAD (n 2).
\textsuperscript{14} MAD, Article 5 defines market abuse as: (a) entering into a transaction, placing an order to trade or any other behaviour which: (i) gives false or misleading signals as to the supply of, demand for, or price of, a financial instrument or a related spot commodity contract; or (ii) secures the price of one or several financial instruments or a related spot commodity contract at an abnormal or artificial level.
Introduction

somewhat obscure, for the EU legislator, for example, the most important reason for banning market manipulation and insider trading is the protection of consumer confidence and investors by ensuring integrity in the market and fairness. While these matters have been debated for a long time, as a result of the global economic crisis, concerns were raised again about the effectiveness of the regime and the need to update it in light of current circumstances. Clearly, the financial crisis appeared to trigger policy reforms in this area but, as this book explains, it was not the only trigger. The development of the EU’s fight against irregularities and criminal activity in the financial sector should therefore be seen in tandem with the EU’s attempts to save the economy by boosting investor confidence in the EU market and securing an honest market place.

On that broader background, as a response to the financial crisis, both the EU and the US have increasingly focused on the phenomenon of white-collar crime as one of its major causes. The next section will therefore introduce the financial crisis that started over a decade ago and which is still ongoing, and explain why it is still relevant for understanding the law on market manipulation and insider trading.

II. The Financial Crisis and the Fight against Financial Crimes: Some Hardcore Data

The 2007/08 financial crisis began within the conduct of numerous US mortgage lenders, who offered a variety of mortgages, including ‘prime loans’, ‘alt-A loans’ and ‘subprime loans’. In the lead-up to the onset of the largest financial crisis since the Great Depression, the growth of subprime loans was unparalleled, and by 2007 approximately 25 per cent of all US mortgages were subprime. The growth of subprime loans was assisted by the introduction of the Fair Housing Act 1968 and the Civil Rights Act 1968, which both fuelled access to convenient credit. The collapse of the subprime market was accelerated by a process called securitisation.
which seeks to provide finance to financial institutions by the sale of assets.\(^{23}\) The impact of the 2007/08 financial crisis on subprime lenders was catastrophic, and it claimed many corporate casualties – New Century Financial,\(^{24}\) Lehman Brothers,\(^{25}\) the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, American Insurance Group (AIG)\(^{26}\) and Bear Stearns.\(^{27}\) It is interesting to note that prior to its takeover by the Government and JP Morgan, Bear Stearns shares were trading at $170.\(^{28}\) The total losses from the collapse of the US subprime market surpassed $600 billion,\(^{29}\) there was $20 trillion of lost wealth, 20 million people lost their jobs and 4 million US homeowners found their homes were repossessed.\(^{30}\)

The US response was led by the Federal Reserve and the Department of Treasury, who provided emergency ‘liquidity in the financial sector’\(^{31}\) The Federal Reserve reduced US interest rates, increased access to short-term liquidity, created a weekly loan service and arranged the takeover of Bear Stearns.\(^{32}\) These actions were soon followed by the introduction of an over-abundance of legislative measures, including the Economic Stimulus Act 2008,\(^{33}\) the Emergency Economic Stabilization Act 2008,\(^{34}\) the Housing and Economic Recovery Act 2008,\(^{35}\) the American Recovery and Reinvestment Act 2009,\(^{36}\) the Fraud Enforcement and Recovery Act 2009\(^{37}\) and the Dodd-Frank Wall Street Reform Act 2012.\(^{38}\)
Introduction

In the UK, the corporate casualty list included Northern Rock, Bradford & Bingley, Lloyds TSB, HBOS and the Royal Bank of Scotland (RBS), who required emergency liquidity from the Bank of England. The legislative response to the 2007/08 financial crisis in the UK included the Banking (Special Provisions) Act 2008, the Banking Act 2009, the Financial Services Act 2010 and the Financial Services Act 2012. The last of these resulted in the creation of a new system of financial regulation in the UK, managed by the Bank of England, the Financial Conduct Authority (FCA), the Prudential Regulation Authority and the Financial Policy Committee.39

The origins of the 2007/08 financial crisis are of course well documented, and it is not the purpose of this chapter to explore them in detail. However, it is important to provide a very brief overview of the factors leading up to it. In the UK, for example, the Financial Services Authority concluded that the causes of the financial crisis were macro-economic disparities, the multifaceted nature of securitisation, access to convenient credit, weak credit standards and the unsustainable increase in property prices.40 The US Department of Treasury argued that the financial crisis was caused by weaknesses in the regulation of subprime mortgages, ineffective market discipline, weaknesses in the performance of credit-rating agencies and weak financial regulation.41 Other documented factors include the subprime mortgage crisis,42 weak banking regulation,43 high levels of consumer debt,44 toxic debts,45 securitisation,46 deregulation of banking legislation,47 ineffective macroeconomic policies,48

---

39 For a more detailed discussion of the UK’s financial regulatory regime following these legislative reforms, see Alison Lui, Financial stability and prudential regulation: A comparative approach to the UK, US, Canada, Australia and Germany (Abingdon, Routledge, 2016).
46 For a critical discussion of securitisation, see Michael Nwogugu, ‘Securitisation is illegal: racketeer influenced and corrupt organisations, usury, antitrust and tax issues’ (2008) 23(6) Journal of International Banking Law and Regulation 316.
weak credit regulation,\textsuperscript{49} deregulation of consumer credit legislation\textsuperscript{50} and the culture of banking practices.\textsuperscript{51}

Moreover, financial crime was an important factor that contributed towards the 2007/08 financial crisis. For example, Wim Huisman stated that ‘misconduct in the financial industry is widely seen as having triggered the credit crunch that has pushed the world into an economic crisis’.\textsuperscript{52} Other commentators, such as Tomson Nguyen and Henry Pontell, asserted that prevalent mortgage fraud was associated with the financial crisis.\textsuperscript{53} The link between the financial crisis and financial crime has been demonstrated by an increase in the related enforcement actions of the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), the Federal Bureau of Investigation (FBI), the Department of Justice (DoJ), the Financial Services Authority, the FCA and the Serious Fraud Office (SFO).

As will be expounded in chapter two, the financial crisis and the Euro crises have also had a considerable impact on EU law and shaped the EU responses to fight market abuse and related activity. The EU’s strategy to combat irregularities in the market should be seen in the light of the history of the debate on the market abuse regime and the question as to why the suppression of financial crime is relevant in EU law. The underlying theme of the EU’s involvement in the fight against financial crime is boosting investor confidence and thereby contributing to the establishment of the internal market. Against the backdrop of the financial crisis, the EU again decided to get tough on white-collar crime, and as part of this endeavour sought to remedy the alleged loopholes of the previous Market Abuse Directive by adopting a new Regulation and a Directive, as already mentioned.\textsuperscript{54} The Directive on criminal sanctions to fight market abuse offers the first example of use of Article 83(2) of the Treaty on the Functioning of the European Union (TFEU), the ‘extended’ competence clause for ‘harmonisation’ of an area, which is essential for the effective implementation of EU law and where harmonisation measures have already been adopted. The rationale for the Directive, which is to be read in conjunction with the Regulation\textsuperscript{55} on insider trading and market manipulation, is to ensure market integrity and enhance public confidence in securities and derivatives. The Directive creates a new framework for the purposes of fighting crime, while it regroups the previous market abuse regime into a separate

\textsuperscript{49}Choi and Papaioannou (n 31) 443.

\textsuperscript{50}See, eg, the impact of the decision in \textit{Marquette National Bank of Minneapolis v First Omaha Service Corp} 439 US 299 (1978).

\textsuperscript{51}It is not our objective to revisit these but to add to the existing literature by recognising the importance of the previously under-researched factor, market manipulation.


\textsuperscript{53}Tomson Nguyen and Henry Pontell, ‘Mortgage origination fraud and the global economic crisis’ (2010) 9(3) \textit{Criminology & Public Policy} 592.

\textsuperscript{54}See the MAD and MAR respectively (n 2).

\textsuperscript{55}ibid.
Regulation to increase the effectiveness of the system. The new Directive is a prime example of the invocation of criminal law to guarantee the effectiveness of European policies in this area.

III. Market Manipulation: The Major Crime

An emerging financial crime associated with the financial crisis is market manipulation. This is illustrated by the continual manipulation of the London Interbank Lending Rate (LIBOR), the Euro Interbank Offered Rate (EURIBOR) and the foreign exchange market (FOREX) by numerous financial institutions and traders. LIBOR is a ‘benchmark that gauges the interest rate, credit premium and liquidity premium that a leading bank would expect to be offered by another similar institution’. During the 2007/08 financial crisis, LIBOR was managed and regulated by the British Bankers Association, now UK Finance, the UK trade body of the banking and financial services sector. The EURIBOR rate is founded upon the interest rates at which a number of European banks borrow from each other. FOREX is the foreign exchange market on which foreign currencies are traded. LIBOR and EURIBOR are used across the world for a range of financial products by a wide variety of financial market participants, for both hedging and speculative purposes. The integrity of LIBOR and EURIBOR rates is central to the global financial markets, and any alleged manipulation can have a significant impact on and ramifications for the global markets. The first evidence of the market manipulation of LIBOR occurred in 2005, when the Financial Services Authority determined that Barclays Bank had manipulated both the dollar LIBOR and the EURIBOR interest rates in London and New York. Subsequently, Barclays was fined £59.5 million after the Financial Services Authority determined that the bank had breached 11 of its Principles of Business and Handbook. The second bank to be fined (£160 million), owing to its manipulation of LIBOR, was UBS in December 2012. The regulator concluded that between January 2005 and December 2010, UBS breached regulations 3 and 5 of the Principles of Business when it engaged in illegal behaviour regarding the calculation of LIBOR and EURIBOR. The RBS became the third bank to be fined in February 2013, following revelations of LIBOR

---

Market Manipulation: The Major Crime

rigging. The regulator fined RBS £87.5 million for its conduct between January 2006 and November 2010.\textsuperscript{61} The overall fine would have been £125 million had it not been for a 30 per cent discount granted by the regulator. The conduct of the banks' employees was not limited to the UK; it also occurred in Japan, Singapore and the US. According to the regulator, the illegal conduct was extensive – there were over 200 inappropriate submissions, involving 21 employees and a manager.\textsuperscript{62} The regulator imposed another financial penalty of £14 million on ICAP Europe Ltd in September 2013 for an embarrassing amount of misconduct that involved the firm's traders colluding with UBS traders to manipulate the Japanese Yen (JPY) LIBOR rates, and one trader receiving bonus or corrupt payments for assisting in the manipulation.\textsuperscript{63} In October 2013, Rabobank was fined £105 million for 'poor internal controls that encouraged collusion between traders and LIBOR submitters and allowed systematic attempts at benchmark manipulation'.\textsuperscript{64} In July 2014, Lloyds TSB was fined £104 million for breaches of the LIBOR and other benchmarks.\textsuperscript{65} Additionally, Martin Brokers (UK) Ltd was fined £630,000 for significant failings in relation to LIBOR.\textsuperscript{66}

The DoJ announced that RBS Securities Japan Limited, a wholly owned subsidiary of RBS, had pleaded guilty to wire fraud and its role in influencing the Japanese Yen London (JPY) Interbank Offered Rate. As part of a Deferred Prosecution Agreement, RBS Securities Japan Limited agreed to pay a $50 million fine. Additionally, RBS Securities Japan Limited agreed to pay a $100 million penalty.\textsuperscript{67}

The CFTC has been heavily involved in tackling market manipulation and in particular the LIBOR scandal. In June 2012 the Commission fined Barclays $200 million for its attempted manipulation and false reporting of LIBOR and EURIBOR.\textsuperscript{68} It also fined UBS $700 million for the same offences. David Meister stated that the enforcement action of the CFTC was a clear example of the fact

\textsuperscript{61} Financial Services Authority, 'RBS fined £87.5m for significant failings in relation to LIBOR', 6 February 2013, available at www.fsa.gov.uk/library/communication/pr/2013/011.shtml.

\textsuperscript{62} ibid.


that it will not tolerate instances of corporate misbehaviour and is prepared to utilise its extensive enforcement powers.\textsuperscript{69} In February 2013, the CFTC fined RBS $325 million for its manipulation, attempted manipulation and false reporting of JPY and Swiss Franc LIBOR.\textsuperscript{70} This was followed by the imposition of a financial penalty on Lloyds Banking Group plc and Lloyds Bank plc of $105 million for the attempted manipulation of LIBOR.\textsuperscript{71} In September 2013, the CFTC fined ICAP Europe Limited $65 million in a civil monetary penalty for ‘manipulation, attempted manipulation, false reporting, and aiding and abetting derivatives traders’ manipulation and attempted manipulation’ of LIBOR.\textsuperscript{72} In April 2015, the CFTC imposed its largest financial penalty, $800 million, on Deutsche Bank for the attempted manipulation of the LIBOR and EURIBOR interest rate benchmarks.\textsuperscript{73} In May 2016, Citibank paid a financial penalty of $250 million for attempted market manipulation and false reporting of the US dollar ISDAFIX benchmark.\textsuperscript{74}

Therefore, the enforcement activities of the CFTC are identical to those adopted by the SEC – the imposition of a series of administrative penalties. It is questionable whether the financial penalties imposed by the CFTC will deter any future misconduct by financial institutions. This and other related questions will be explored in further detail throughout this book.

\section*{IV. Structure of the Chapters}

In this chapter, we have sought to introduce the topic and to provide the background for our subsequent discussion. Chapter two begins by looking at the EU system for suppressing market abuse. That chapter sets out the EU framework for


fighting financial crime by bringing market abuse to the fore, as a threat that needs to be dealt with. The chapter explains the EU market-based preventive approach and links to the ongoing construction of the internal market. In addition, the chapter highlights the relationship between market abuse and other white-collar crimes. It surveys the evolution of the EU’s suppression of market abuse by looking at the history of it, exploring how the EU strategy has changed with the measures (2014 Directive and Regulation) adopted following the general EU action for recovery of the market at large as a consequence of the global financial crisis (and links to the Markets in Financial Instruments reformation). Moreover, the chapter looks at the impact of the new criminal law powers (granted by the Lisbon Treaty) and discusses the consequences of using double measures to fight market abuse (ie, civil penalties and criminal penalties) in the specific EU context. In addition, chapter two looks at the impact of the principle of proportionality and EU fundamental rights protection, and briefly discusses the reception of the legal instruments in the Member States and possible challenges for the Court of Justice of the European Union (CJEU).

Chapter three looks more specifically at the regulatory challenges involved in tackling market abuse in the EU, UK and the US, respectively, in the context of criminal law and civil/administrative law responses, addressing the question whether market abuse should be banned at all through the use of criminal law. The chapter focuses on the use and choice of sanctions in a comparative context, and discusses the proportionality of the regime.

Subsequently, in chapter four, a detailed foray is made into the EU’s approach to combating market abuse. The chapter places the EU’s fight against market abuse in the broader context of the fight against white-collar crime in the EU more generally, and addresses associated questions about data protection as well as the establishment of a European Public Prosecutor’s Office (EPPO) and its possible impact on the law on market abuse. In addition, the chapter discusses fundamental rights protection and the hot issue of data protection in the EU context, examining why it is relevant to understanding the contemporary regime for combatting market abuse. In doing so, the chapter discusses the EU stance on, and the importance of, consumer confidence in the EU internal market as one of the driving motivations for the EU, and thus scans the market abuse regime in the framework of the classic Article 114 TFEU case law on the harmonisation powers of the EU and market making. The chapter links the discussion to the increased EU criminal law cooperation in EU financial crimes legislation more generally as one of the consequences of the global financial crisis, along with measures to combat terrorism and transnational criminality. Thus, the chapter also addresses the political question of to what extent the EU is a norm follower or a trendsetter in this area.

In chapter five the aim is to critically consider the UK’s efforts to tackle insider dealing and market abuse. The chapter highlights how the UK criminalised insider dealing under the Criminal Justice Act 1993 and introduced the civil enforcement
regime: the Market Abuse Regime. The chapter moves on to critically consider the 2007/08 financial crisis and the FSA’s response to it, which included imposing a large number of financial penalties on firms and individuals. The chapter also discusses the impact of Brexit and to what extent the UK, in the event of a ‘hard Brexit’, will end up keeping the EU’s norms.

The purpose of chapter six is to offer a detailed case study of the US approach to insider trading and market manipulation. The first part of the chapter briefly outlines the evolution of the US legislative approach towards insider trading and highlights the role of the US judiciary. The chapter then moves on to appraise the responses to market manipulation and insider trading arising from the financial crisis. This involves a detailed analysis of the responses of the SEC, the DoJ and the CFTC.

Chapter seven summarises the arguments.

V. Conclusion

The law on market manipulation and insider trading/dealing offers a fascinating picture of many interacting questions and layers in the area of financial crimes as they touch upon consumer confidence in the market, data protection, fundamental rights and – in the case of the EU – allocation of competences. This volume seeks to scan and critically examine the contemporary law and practices in the area of market manipulation and insider trading/dealing, and to explain why they are important. Why, then, the different case studies from the EU, US and the UK? The present chapter will now conclude by briefly outlining the key points explaining why we have chosen these cases.

A. Why the EU?

The EU’s fight against market abuse raises many interesting regulatory questions within the EU’s internal policy areas (the internal market vis-à-vis the Area of Freedom, Security and Justice (AFSJ)), as well as its external impact and cooperation with third states, most prominently the US. As will be shown, both the security concern and the financial crisis have shaped this area and illuminate a fascinating relationship between the EU internal market and the EU AFSJ, and currently shape EU integration processes. However, challenges to the EU like the Brexit negotiations also mean that the political dimension is very strong in this area, since EU law is enforced through national law. The EU is very much concerned with ensuring confidence in the market, and market abuse offers a good test of the interaction between EU internal market law, AFSJ law and broader questions about and related to the EU’s fight against financial crimes.
B. Why the United States of America?

The US presents an interesting case study for this book. Since the start of the financial crisis, there have been several high-profile white-collar crimes that have either emanated from the US or been exposed by it. Consequently, US regulatory agencies have instigated numerous investigations and imposed record civil financial penalties for the illegal activities of corporations. As will be explained in this book, the decision to impose financial penalties has done little to prevent any future misconduct by US corporations.

C. Why the United Kingdom?

The UK provides a unique comparator to the US due to the impact of the financial crisis on its financial corporations, the adoption of a similar enforcement strategy to the US and the fact that the city of London is one of the largest financial centres in the world. The UK has imposed a series of substantial financial administrative penalties on corporations, which have attracted no criminal liability. The FCA has imposed a higher number of financial penalties since 2010, which have largely resulted from the LIBOR and FORX scandals. Brexit, however, presents a major challenge to the UK legislative framework, as most of the laws in this area are so intertwined with European integration. The EU Withdrawal Act (2018) is set to repeal the European Communities Act when the UK leaves the EU. The EU Withdrawal Act also seeks to convert directly applicable EU law into UK domestic law. Of relevance here are the draft Market Abuse (Amendment) (EU Exit) Regulations 2018, which would seek to address deficiencies that could arise when the UK leaves the EU. For example, this includes maintaining the scope of the regulation, transaction reporting and notification requirements, which will be retained, dealing with transfer of functions, supervisory cooperation and information sharing.75

---