Law of financial crime

Section B: Fraud and market manipulation

A. Hudson

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Publications Office
University of London International Programmes
Stewart House
32 Russell Square
London WC1B 5DN
United Kingdom

www.londoninternational.ac.uk

Published by the University of London Press

Printed by Central Printing Service, University of London

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2.1 Introduction

In this chapter we consider the criminal offence of market manipulation which was introduced into UK finance law by s.397 of the Financial Services and Markets Act 2000 (FSMA 2000). In 2000, the Labour government in the UK radically reformed the regulation of financial markets.[1] The criminalisation of market manipulation in its current form was a part of that process of reform.

[1] *For a summary of the UK financial markets regime, see: www.alastairhudson.com Note that this may be set to change following the election of a new government in May 2010.*

'Market manipulation', briefly put, is the process by which a market for securities is manipulated either upwards or downwards by a person who is seeking to make it appear that securities are worth either more or less than their true value. The simplest example of market manipulation would be for the issuer of securities to give money to a number of people whom it controls so that those people will acquire those securities and make it appear that there is a market for them: as basic economic theory tells us, if there is high demand for an asset, its market value will increase. For a fictional example, see the Hollywood film *The Boiler Room*, in which a securities broker sells securities in companies which have no real value to ordinary investors by funding his associates to promote those securities (in part by allowing their names to appear on the prospectus) as though acting at arm's length.

Market manipulation has a long pedigree in the United Kingdom. In 1720, the South Sea Company was fraudulently promoted to the public by John Blunt in part by loaning influential people money to buy shares in the company. The company purported to be about to embark on successful trading ventures in South America, but in fact it had no business at all and was simply a means of swindling money out of the investing public in eighteenth-century London. Lending money to people to buy shares in the company had the effect of making it appear that the shares were worth more than they actually were because it appeared that there were influential buyers who were prepared to buy them. This was a form of market manipulation in that the people who were lent the money bought shares for a value far above their intrinsic worth, with the effect that other potential investors thought that there was a demand for the shares at that value and in consequence their market value appeared to rise.

It is a fundamental part of the logic of markets that all participants must be acting on the basis of equal access to information. The only permissible inequalities arise from the various participants' abilities to analyse that information and act on it. Unequal access to certain types of information goes against the underlying philosophy of market regulation. Whereas insider dealing is predicated on the use of inside information to make a profit (as discussed in Section A of this course), market manipulation is about creating a false appearance as to the value of securities. But the underlying policy justifications are very similar for both offences. We will consider those policy justifications in the final chapter of this Study Guide.

In this chapter we will focus specifically on how the criminal offence of market manipulation can be applied to a range of hypothetical factual scenarios. As with our similar approach to the law on insider dealing

in Section A, our approach here should help you both to understand the law and to demonstrate that understanding by successfully answering a problem question on the law.

Like the law on insider dealing that we examined in Section A, English law on market manipulation includes both criminal law and financial regulation. In the later parts of this chapter, we will examine regulatory provisions relating to market manipulation, comparing them with the criminal law and considering what they might add to its practical application.

Learning outcomes

Having studied this chapter and the relevant readings, you should be able to:

- identify the sources of law for the criminal offences in relation to market manipulation:
  - making misleading statements
  - creating a false or misleading impression as to the market
- analyse each offence and identify its key principles
- identify the sources of financial regulation relating to market manipulation
- analyse the relevant regulatory provisions to identify their key principles
- compare the regulatory provisions with the criminal law
- identify and compare the policy reasons for, and the desirability of, the regulatory provisions and the criminal law
- apply the principles of the law on market manipulation to factual problems, and present an argument identifying the application of those principles to the facts
- evaluate the effectiveness of the criminal law and of regulation in relation to market manipulation
- exercise critical judgment in relation to these issues.

Essential reading

- Hudson, Chapters 3, 12 and 14.

We give specific references to relevant parts of these chapters in the course of the discussion below.

2.2 The criminal law on market manipulation

Essential reading

- Hudson, Chapter 14, 14.71–14.81.

One of the uses of the criminal law in the financial markets context is to dissuade people from indulging in types of activity which are considered unsuitable. In this sense, it is used as a form of bulwark to support non-criminal financial regulation. We will look at this point in more detail in Section D of this course. For now, you just need to be aware that the criminal law on market manipulation has a preventative as well as a punishment role.

There are a number of offences relating to market manipulation created by the Financial Services and Markets Act 2000. We will look at each of them in turn.

Your main objective at this stage is to identify each of the statutory elements of each offence – the requirements that the prosecution must show, beyond reasonable doubt, have been met in order to prove that the offence has been committed. Learning activities will lead you through the application of each offence to a hypothetical factual scenario.

As we will see, a literal reading of the statute might effectively mean that there would be no offence in relation to certain forms of financial product, such as derivatives, so a broad interpretation of the statute would seem necessary. Later in this chapter, we will consider some of the key regulatory provisions dealing with market manipulation. The financial regulation is not part of the criminal law, but arguably the definition of market manipulation in the regulatory context may nevertheless be helpful for us in considering the best interpretation of the criminal offences.

2.3 The offence of making misleading statements

2.3.1 The activity which will give rise to the offence

The offence of making misleading statements is set out in s.397 FSMA 2000. The offence is predicated on **both** the elements set out in ss.397(1) and (2). The first element of the offence is set out in s.397(1):

> (1) This subsection applies to a person who –
>
> (a) makes a statement, promise or forecast which he knows to be misleading, false or deceptive in a material particular;
>
> (b) dishonestly conceals any material facts whether in connection with a statement, promise or forecast made by him or otherwise; or
>
> (c) recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular.

The word 'or' is important here. The offence applies to any of those scenarios. Therefore, three possible avenues of liability arise, raising the following issues:

(a) The offence is made out when a person makes a statement, promise or forecast which 'he knows to be misleading, false or deceptive in a material particular'. What is not made clear in this context is what will constitute 'knowledge': actual knowledge; or simply knowledge of circumstances which would have put a reasonable person on inquiry; or suspicion of the circumstances? Case law on 'knowledge' in criminal law:
   - *Westminster CC* v *Croyalgrange* 83 Cr App Rep 155
   - *Warner* v *Metropolitan Police Comr* [1969] 2 AC 256.

(b) The offence is made out when a person 'dishonestly conceals any material facts' in relation to a statement, promise or forecast. Again, it is unclear whether dishonesty in this context would require actual fraud or whether it could be established in circumstances (as in *R* v *Ghosh* [1982] QB 1053) in which the defendant fails to act as an honest person would have acted in the circumstances while realising that honest and reasonable people would consider that behaviour to have been dishonest.

(c) The offence is made out when a person 'recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular'. Recklessness in criminal law requires that the defendant was aware of the harm which would result from the act but that they nevertheless acted so as to cause that harm (*R* v *G* [2004] 1 AC 1034; *Brown* v *The Queen* [2005] 2 WLR 1558).

There is no case law on these issues in relation specifically to s.397. That being so, we are left to speculate on the best interpretation, and to consider the application of the policies underpinning the legislation so as to aid that interpretation. In practice, you need to use the general principles of criminal law relating to the *mens rea* elements of the offence.

We will consider how the law might be applied to a hypothetical factual scenario in a moment; but before we do that, we must consider the second element of the offence. This is set out in s.397(2) FSMA 2000:

> (2) A person to whom subsection (1) applies is guilty of an offence if he makes the statement, promise or forecast or conceals the facts for the purpose of inducing, or is reckless as to whether it may induce, another person (whether or not the person to whom the statement, promise or forecast is made)-
>
> (a) to enter or offer to enter into, or to refrain from entering or offering to enter into, a relevant agreement; or
>
> (b) to exercise, or refrain from exercising, any rights conferred by a relevant investment.

So the defendant commits the offence if they intend to induce or are reckless as to whether or not it would induce another person to enter into an agreement or exercise rights (such as rights under an option), or to refrain from entering into an agreement or exercising rights. It is significant that the offence is limited in this way. It is not enough that a misleading statement is made; the statement must induce some action by another person. That action can include entering into a transaction or exercising rights, or refraining from entering into a transaction or exercising rights. What this statutory language is meant to cover is a situation in which a person makes a forecast, for example as to the future prospects of securities, with the intention that either a specific individual or people in the marketplace generally will decide to buy those securities as a result of their being artificially overvalued; or, alternatively, that they will decide not to buy those securities because they seem to be worthless.

It is important perhaps that this offence covers both intention and recklessness. If it was simply an offence of intention then it would not have the collateral ethical dimension of requiring market participants to take sufficient care when dealing with securities and other investments. It has always been a part of the law on civil fraud that recklessness as to whether or not something is true is as much a fraud as a demonstrable intention to tell an untruth (*Derry* v *Peek* (1889) LR 14 App Cas 337). In part this must be because it will be difficult to prove a person's intention, whereas in situations in which it is unclear what somebody's motivation was it will often be possible to demonstrate that they were at the very least reckless as to whether or not they were telling the truth.

2.3.2 The statutory defence

The statutory defence to this offence is set out in s.397(4) FSMA 2000:

> (4) In proceedings for an offence under subsection (2) brought against a person to whom subsection (1) applies as a result of paragraph (a) of that subsection, it is a defence for him to show that the statement, promise or forecast was made in conformity with –
>
> (a) price stabilising rules;
>
> (b) control of information rules; or
>
> (c) the relevant provisions of Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments.

The defence is thus made out when the defendant is complying with rules relating to price stabilisation or control of information. This is a very narrow category of defences relating primarily to people passing information, for example, to the Bank of England as part of its regulatory control over monetary policy.

2.3.3 Applying the law

Let us now look at how the offence of making misleading statements might apply. What will emerge from this learning activity is that while patterns of facts may appear to be straightforwardly criminal, it is often difficult in practice to prove definitively that each element of the criminal offence has been made out. Instead, a prosecutor will often seek to draw inferences from a set of facts so as to encourage a jury to believe that the only possible interpretation which can be put on the defendant's actions is that they intended to defraud another person. However, it is so difficult to demonstrate that somebody intended to commit fraud in a financial transaction that prosecutions are often not brought in the first place because the Crown Prosecution Service is uncertain that it will be able to secure a conviction.

Consider the following hypothetical scenario. Do please attempt this activity now and read the feedback before you go on to study the rest of this chapter, since the discussion later in this chapter will build on issues covered here.

Activity 2.1

The success of Wire plc as a business depends on the success of its planned future product 'Super Bug', which is to be sold to the law enforcement community if its technology turns out to be reliable. Wire plc is quoted on the London Stock Exchange. Herc, the research director of Wire plc, enters into the transactions with Lester Bank on 5 November creating the following:

- a contract (known as a 'put option') which means that he can, at any time he chooses before 8 November, sell his holding of 200,000 shares in Wire plc to Lester Bank for 140 pence
- a contract (known as a 'call option') which means that he can buy 200,000 shares in Wire plc at any time he chooses before 8 November from Lester Bank for 120 pence.

The market value of these shares is 130 pence both at the time he buys his 200,000 shares and at the time he buys the two options.

On 6 November, Herc makes a statement during a filmed interview for a financial newspaper's website, after being pressed by the interviewer about Super Bug, that: 'Naturally I am concerned that the Super Bug technology will not be profitable and I cannot give any categorical assurances right now.' This interview is seen live by a large number of traders on the share market. The share price of Wire plc falls to 110 pence as a result of Herc's comments. Herc exercises his put option, selling his shares for 140 pence to Lester Bank on 6 November. Therefore, Herc makes a profit of 30 pence over the market value on that transaction.

On the evening of 6 November, Herc issues a press release to say he has misspoken and that he had meant to say he was 'concerned that Super Bug technology would not be profitable for the next six months, but that it would be very profitable in the next financial year'. On the opening of trading on the next day, the share price rises back to 150 pence as a result of Herc's clarification (in particular the suggestion that the new technology will be profitable). On 7 November Herc exercises his call option and acquires 200,000 shares in Wire plc under the call option from Lester Bank for 120 pence.

Has an offence under s.397(1) FSMA been committed?

Feedback: over the page.

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Feedback – and hearing the other side of the same facts...
I would suggest that on its face this factual scenario involves a clear attempt to mislead the market under s.397 FSMA 2000. Work through the elements of the offence in turn.

To begin with s.397: the offence is made out when a person makes a statement, promise or forecast which 'he knows to be misleading, false or deceptive in a material particular'. The real issue on these facts is whether or not Herc has knowledge (s.397(1)(a)) or is reckless (s.397(1)(c)). The facts of the problem do not tell us this definitively, and therefore we need to infer the existence of *mens rea*. In the real world this is a problem prosecutors usually face, unless there is evidence of actual knowledge (e.g. a phone call or an email) or a confession.

On these facts:

- the size of the transactions for a private individual,
- the unique position which Herc holds as the person who could opine so definitively on the facts,
- the rapidity with which (as a private individual) Herc exercises the options between his various media statements,
- the convenient ambiguity of his first statement, which is definitely reversed to such an extent by his second statement, and
- the occurrence of those statements so close to the dealings in securities

all, taken together, seem clearly to suggest the necessary criminal intent. In practice, putting Herc in the witness box and asking him to explain his actions in front of a jury is more likely to allow the jury to form the impression that he was acting with criminal intent. It can be shown that the first statement was false if Herc's press release is true; and it can be suggested that Herc must have known that it was false at the time he made it, unless it was a mere slip of the tongue.

Herc may argue that he did not 'know' that his statement was incorrect or misleading, but rather that he simply 'misspoke' by accident while being pressured by an interviewer during a live interview. But put together with the subsequent options trades (which had already been put in place), it seems unlikely that a jury would believe that this statement was innocent.

So on its face the scenario looks like a simple case of market manipulation. But it is important to consider whether each element of the offence has actually been **proved**.

Suppose that Herc's explanation of the facts is as follows:

> I always held about £1 million worth of shares in Wire plc as well as about £10 million in other companies – I have a large personal income from selling two of my own patents a number of years ago. So an investment of £200,000 was not unusual for me. I typically have a number of options in place in relation to all of my investments which I select very carefully in consultation with my stockbroker. The stockbroker then has complete *carte blanche* to act on my behalf in relation to those investments; furthermore, the options in this case were exercisable automatically which means that Lester Bank was required to buy and sell the shares without my speaking to them at all during the day. So, I had no involvement with the operation of those options because they were effectively on auto-pilot once they had been created. They had no connection to my work on Super Bug, which had been going on for four years already and which had at least one more year before we could possibly go into production.

> My post at Wire plc takes up only 50 per cent of my working week. I am a non-executive director. My involvement with Wire plc is usually driven by particular projects like Super Bug, and so for months at a time I can have little involvement with the day-to-day activities at the company. I work exclusively at the laboratory in Warwickshire, which is over 100 miles away from company headquarters in central London.
>
> At the time I was interviewed, I had been asked the same question about five times. I had not slept the night before due to food poisoning, and during the interview I was trying to conceal the fact that I was experiencing extreme stomach cramps. As a result, I was hardly thinking about what I was saying because I was in too much pain. I cannot be blamed for misspeaking accidentally. All I meant to say was that nothing is certain in this world and so obviously there was a chance that Super Bug might not work. Thirty minutes after the interview, I was telephoned by the Chief Executive to tell me that my statement had had a negative effect on the share price and I must therefore be interviewed again to clear up the confusion which apparently I had caused. I was too ill to be interviewed again. Therefore, I issued a press release later in the day. I approved the content of the press release, although the text was prepared by the public relations department of Wire plc in London and faxed to me at home. It was the PR department in London that sent the press release out with my name at the bottom of it.

Now, this account of the facts, if true, might make us less sure of our ground. The set of facts given originally (probably in the form which a prosecutor would like to present them) suggests that Herc was embarking on a course of criminal action, whereas Herc's own account suggests that everything is not necessarily so cut and dried. If, as he asserts, the options were exercised automatically, and if his stockbroker took control over his investment portfolio, then there might be some suggestion to be put before a jury that Herc simply benefited from an unhappy accident (his experience of the interview). Nevertheless, the fact remains that the options were created suspiciously close in time to the interview, which in turn benefited no one (not the company, not existing shareholders) except Herc. However, at criminal law it is of course necessary to cross the threshold of proving beyond reasonable doubt that Herc knew about the incorrect nature of his statement, whereas his explanation is that his physical condition meant that he spoke loosely but not recklessly or knowingly so as to mislead other people.

And all of this is before we ask the question: was anyone induced to act as a result of this statement under s.397(2)? It could be argued on Herc's behalf that no one was induced to act on behalf of manipulation because Lester Bank had entered into options contracts to buy and to sell the shares **before** the statement was made: therefore, Lester Bank cannot have been induced to act a result of it. The counterargument on behalf of the prosecution would have to be that the purpose of s.397(2) is to capture any reaction by any person to the misstatement. This interpretation would include any action by the rest of the market which causes the price of those shares to rise or fall, as opposed to an action by any individual person (such as Lester Bank). This is a feasible, natural reading of the subsection which is not limited to any particular person addressed directly by the defendant. If this second interpretation were accepted (there is no case law) then it would encompass Herc, who must

know that a misleading statement would cause the market in general to react. Herc would not fall within the narrow defences in s.397(4), and so his only defence would be that he had not acted knowingly or recklessly, as considered above.

2.4 The offence of creating a false or misleading impression as to the market

2.4.1 The elements of the offence

There is a further offence of creating a false or misleading impression as to the market. This offence is most closely akin to the South Sea 'bubble' which was discussed at the beginning of this chapter. It is set out in s.397(3) FSMA 2000:

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

Analysing this, we can identify the elements of the offence as follows:

- The defendant must engage in a course of conduct (which by inference must therefore be more than a single action or omission).
- The course of conduct must create a false or misleading impression.
- The impression must be as to the market in or the price of any relevant investments.
- This course of conduct must have been done for the purpose both of:
  - creating that impression, and
  - inducing another person to
    - acquire,
    - dispose of,
    - subscribe for, or
    - underwrite those investments, or
    - to refrain from doing so, or
    - to exercise or refrain from exercising any rights.

As considered above, the underlying purpose of this offence is to criminalise activities which encourage or induce other people to deal with investments, as opposed simply to criminalising the activity of intentionally or recklessly creating a misleading impression as to the market for particular investments. The requirement that this activity be done with the aim of inducing other people to acquire or dispose of investments fits most neatly with an underlying policy of securities and investment regulation that only proper and reliable information should be made available to investors.

There may be other reasons why a company would want to create a misleading impression as to the value of its securities. For example, if a company was seeking an ordinary bank loan for many millions of pounds then it might wish to make it appear that its shares were more valuable than in fact they were at the time of negotiating for that loan, in the hope

of securing a lower rate of interest. That would not be action intended to make other people deal with securities in a particular way, but rather action intended to achieve some ulterior purpose. I therefore suggest that a broad interpretation should be taken of these provisions so that a broad range of acts of market abuse are criminalised. This would also have the effect of bringing the criminal law more closely into line with financial regulation of market abuse, as we will presently see. In relation to the example of a company trying to acquire a preferential interest rate, the provision could be read broadly so that this would be a course of conduct which has as one of its many goals the creation of false impressions about the value of the company's shares. A narrow interpretation would be one which identified the underlying purpose of this provision as being to criminalise actions which were intended solely to induce people to buy or sell the company's shares, which would not cover the bank considering making a loan to the company.

There is a general aim when criminal statutes are drafted that they should identify precisely the sorts of activity that are intended to be criminalised. This relates to the idea of the rule of law, one important principle of which is certainty, especially with regard to the criminal law: people should be able to know for certain what will amount to criminal behaviour so they can avoid breaking the law. One particular consequence of this with regard to the law of finance is that a statute may be drafted before an innovation in financial markets takes place, so that new financial products are created which offend against the general purpose of the legislation without necessarily falling within its precise terms. By contrast, financial regulation is much more broadly drafted and can be adjusted by the Financial Services Authority (or other regulator) much more quickly so as to capture financial innovation within its provisions.

2.4.2 The statutory defence

A defence, or rather several related defences, to the s.397(3) offence is provided by s.397(5) FSMA 2000:

> (5) In proceedings brought against any person for an offence under subsection (3) it is a defence for him to show –
>
> (a) that he reasonably believed that his act or conduct would not create an impression that was false or misleading as to the matters mentioned in that subsection;
>
> (b) that he acted or engaged in the conduct –
>
> (i) for the purpose of stabilising the price of investments; and
>
> (ii) in conformity with price stabilising rules; …
>
> (c) that he acted or engaged in the conduct in conformity with control of information rules; or
>
> (d) that he acted or engaged in the conduct in conformity with [regulations for] buy-back programmes and stabilisation of financial instruments.

The underlying purpose of these defences is to excuse from liability people who reasonably believed that they would not create a misleading impression in the minds of people, or who were acting in conformity with regulations which explicitly approved their activities.

The defence of reasonable belief is particularly interesting. How is reasonableness to be defined? In the absence of case law, we cannot say for sure, but arguably it would make a lot of sense to look to related financial

regulation for guidance. A sensible, integrated law of finance will draw on the financial regulations governing the sorts of activity which were permissible for individuals or companies in this context as an expression of what constitutes reasonable behaviour in that same context. Otherwise, the concept of reasonableness in this context will remain something which is entirely to be decided by the courts on a case-by-case basis. The financial regulations typically will include some latitude to allow the particular circumstances to be taken into account (and so will not be unattractively rigid rules), but will nevertheless provide some guidance as to the parameters within which the notion of reasonableness in financial transactions should be understood.

Activity 2.2

Reconsider the facts involving Herc set out in Activity 2.1. Would he be caught under the s.397(3) offence?

Feedback: page 25.

2.5 Conclusion: it is difficult to prosecute market manipulation under the criminal law

So far in this chapter we have looked at how the criminal law on market manipulation might be applied and we have seen that in practice prosecutors may struggle to enforce this law. Two main general issues arise:

- First, the legislation needs to be interpreted and applied in its broadest possible sense if it is going to be able to keep pace with the various sleights of hand which will be used in a constantly moving marketplace. The use of derivatives contracts (like the options used in the learning activities) is an example of how market innovation can facilitate fraud as well as ordinary investment.
- Second, the proof of these offences in practice will be very hard because it will be difficult to **prove** definitively the state of mind of a person simply from the pattern of their investments. Indeed, the scenario in Activities 2.1 and 2.2 is in some respects easier than that which would typically face prosecutors, in that it involves a company director – he has an obvious connection with the company at the centre of the suspect dealings. In the real world, transactions might be undertaken by someone with no obvious link to a company insider. If we consider the difficulties facing a prosecutor, there will be rumours about suspiciously large trading volumes in particular securities, but it is unlikely that there will be what detective novelists refer to as a 'smoking gun' in the form of emails or recorded telephone conversations explicitly admitting or proving guilt. Therefore, prosecutors will have to rely on drawing inferences from the circumstances and from relationships between individuals, and putting together enough circumstantial evidence so that they are confident that a jury will draw the inference that criminal activity took place. That is why, I would suggest, these particular offences of market manipulation make it an offence simply to make a misleading statement with the effect of influencing some other person to act; the defendant does not have to take a personal benefit nor be an insider, provided that the other elements of the offences are satisfied (although if some personal benefit were taken, that would probably be useful circumstantial evidence in making out the offence).

2.6 FSA regulation of market manipulation

Essential reading

- Hudson, Chapter 3, 3.17–3.20; Chapter 12 generally.

In Section A of this course, we looked at the law on insider dealing. We saw that the criminal law on insider dealing had come to be seen as ineffective and had therefore been complemented and to some extent in practice replaced by civil regulation by the Financial Services Authority (FSA).

Similarly, even though there is a criminal offence relating to market manipulation (as considered above), the activities which fall under that criminal jurisdiction are also within the FSA's jurisdiction to regulate market manipulation as part of its general power to regulate 'market abuse', which includes the power to impose civil penalties on perpetrators.

As is discussed in Chapter 3 of the set textbook, there is an overlap between the criminal law and financial regulation in that they are both concerned with the control of market abuse, although the two codes have slightly different objectives (as discussed in the textbook at paras. 3.17–3.20).

In the following discussion of FSA regulation of market abuse, we are mainly interested in two issues:

- How do the regulations on market abuse compare with the criminal law on market manipulation?
- How far can the regulatory principles help as a guide in interpreting the criminal law (given the paucity of case law)?

2.7 Market Abuse Directive

Essential reading

- Hudson, Chapter 14, 12.02–12.07.

2.7.1 The architecture of the regulatory rulebooks: EU and UK

As with much financial regulation in this area, there are EU Directives which give rise to the high-level principles that are then implemented by UK regulation (in this instance introduced by the FSA). For more information on this regulatory structure, see para. 1.23 *et seq.* of the textbook, and the file on my website (www.alastairhudson.com) introducing financial regulation in the UK.

2.7.2 EC Market Abuse Directive

The Market Abuse Directive (2003/6/EC) creates a new framework for regulating market abuse across the EU, over and above the criminalisation of market manipulation. It has been implemented in the UK primarily by the enlargement of the FSA Handbook (which contains the financial regulations in the UK). As with all such Directives, the Directive contains the over-arching policy goals of the legislation, with the detail being contained in Commission Technical Regulations.

2.7.3 FSA Market Abuse Rulebook

The FSA regulation of market abuse is concerned with the imposition of 'civil penalties' as opposed to criminal offences. (A similar jurisdiction exists in the USA, as was illustrated by an investigation into Goldman Sachs by the US regulator, the Securities and Exchange Commission (SEC), in April 2010.) The principles considered in this chapter are drawn from the EC Market Abuse Directive as implemented by Part 8 of the Financial Services and Markets Act 2000 and the FSA Market Abuse Rulebook ('MAR') focusing particularly on the Code on Market Conduct (referred to as 'MAR 1'), which is found in Chapter 1 of MAR.

2.8 Market manipulation in the Market Abuse Directive

We now look at the specific provisions of MAR which relate to market manipulation (as opposed to insider dealing). We start by looking at the definitions in the Market Abuse Directive (MAD) and then consider the more detailed implementation of those expressions in the FSMA 2000.

2.8.1 'Market manipulation'

'Market manipulation' is defined in MAD, Art.1(2) as constituting:

> (a) transactions or orders to trade:
>
> - which give, or are likely to give, false or misleading signals as to the supply of, demand for or price of financial instruments; or
>
> - which secure, by a person, or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level,
>
> unless the person who entered into the transactions or issued the order to trade establishes that his reasons for so doing are legitimate and that these transactions or order to trade conform to accepted market practices on the regulated market concerned;
>
> (b) transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance;
>
> (c) dissemination of information through the media, including the Internet, or by any other means, which gives, or is likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading. In respect of journalists when they act in the professional capacity such dissemination of information is to be assessed […] taking into account the rules governing their profession, unless those persons derive, directly or indirectly, an advantage or profits from the dissemination of the information in question.

2.8.2 The scope of the market abuse provisions

Essential reading

- Hudson, Chapter 12, 12.10–12.35.

Let us now look at the definitions of 'market abuse' in the FSMA 2000. What will emerge from this is that the definitions of market abuse are similar to the offences of market manipulation but are expressed in different language (and as all lawyers know, differences in expression are all the difference in the world). You should consider each in turn, and consider how it could be used to interpret the definitions of the offences connected to market manipulation set out earlier in this chapter.

2.8.3 Causing a false or misleading impression: 'manipulating transactions'

Among the many categories of 'market abuse' in s.118 FSMA 2000, s.118(5) FSMA 2000 provides:

> The fourth is where the behaviour consists of effecting transactions or orders to trade (otherwise than for legitimate reasons and in conformity with accepted market practices on the relevant market) which –
>
> (a) give, or are likely to give, a false or misleading impression as to the supply of, or demand for, or as to the price of, one or more qualifying investments, or
>
> (b) secure the price of one or more such investments at an abnormal or artificial level.

The difference from the criminal offences is that the regulation measures behaviour against standard market conduct, as opposed to focusing solely on whether the behaviour of other people has been altered. Regulation is concerned to ensure an even standard of market behaviour among all participants as opposed to prosecuting individuals for criminal offences.

2.8.4 Employing fictitious devices or contrivances: 'manipulating devices'

Section 118(6) FSMA 2000 provides:

> The fifth [category of market abuse] is where the behaviour consists of effecting transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance.

This provision is closer to the criminal offences, although it is focused on deception and contrivance, whereas s.397(1) extends only as far as recklessness. A fictitious device would include a misleading statement (for example to the media), but is not limited to that.

2.8.5 The dissemination of information giving a false or misleading impression: 'dissemination'

Section 118(7) FSMA 2000 provides:

> The sixth is where the behaviour consists of the dissemination of information by any means which gives, or is likely to give, a false or misleading impression as to a qualifying investment by a person who knew or could reasonably be expected to have known that the information was false or misleading.

This provision is similar to the criminal offences, although it is focused on deception and contrivance, whereas s.397(1) extends to recklessness as well as covering 'knowledge'.

2.8.6 Failure to observe standard of behaviour reasonably expected of a person in that market: 'misleading behaviour and distortion'

Section 118(8) FSMA 2000 provides:

> The seventh is where the behaviour (not falling within subsection (5), (6) or (7) [the three preceding types of behaviour]) –
>
> (a) is likely to give a regular user of the market a false or misleading impression as to the supply of, demand for or price or value of, qualifying investments, or
>
> (b) would be, or would be likely to be, regarded by a regular user of the market as behaviour that would distort, or would be likely to distort, the market in such an investment,
>
> and the behaviour is likely to be regarded by a regular user of the market as a failure on the part of the person concerned to observe the standard of behaviour reasonably expected of a person in his position in relation to the market.

The focus in this provision is on the contravention of ordinary norms of market behaviour (among regular users of the market), whereas the criminal offences focus on the intention to create, or recklessness as to the creation of, a misleading impression about the value of securities. There is also a much broader reference in this provision as to the distortion of the market, as opposed to the focus in s.397 on the misleading effect on one particular person.

Activity 2.3

Reconsider the facts involving Herc set out in Activity 2.1. Would the FSA have grounds for taking regulatory action against Herc?

Feedback: page 25.

Activity 2.4

Go back over the criminal law and regulatory provisions that we have covered in this chapter. Make sure you are familiar with the material. In particular, make notes on:

a. What sorts of activity constitute 'market abuse'?
b. How do the definitions of 'market abuse' differ from the definitions of 'market manipulation' in criminal law?

No feedback provided.

Reminder of learning outcomes

By this stage you should be able to:

- identify the sources of law for the criminal offences in relation to market manipulation:
  - making misleading statements
  - creating a false or misleading impression as to the market
- analyse each offence and identify its key principles
- identify the sources of financial regulation relating to market manipulation
- analyse the relevant regulatory provisions to identify their key principles

- compare the regulatory provisions with the criminal law
- identify and compare the policy reasons for, and the desirability of, the regulatory provisions and the criminal law
- apply the principles of the law on market manipulation to factual problems, and present an argument identifying the application of those principles to the facts
- evaluate the effectiveness of the criminal law and of regulation in relation to market manipulation
- exercise critical judgment in relation to these issues.

Feedback to activities

Activity 2.1

For feedback, see page 16.

Activity 2.2

The arguments in relation to this offence are very similar to those in relation to s.397(1). It must be demonstrated here that the statement was made 'for the purpose of' creating a misleading impression, whereas Herc would argue that it was a mere mistake. It is difficult to prove definitively one way or another on these facts. You should go through each of the elements of the offence, as before, and consider how best to interpret that provision.

Central issues here are again (a) whether the creation of the options in advance of the misleading statement prevents there being any inducement to the bank to sell the options contracts to Herc, and (b) whether Herc can be demonstrated to have had the necessary knowledge. As regards (a), the interpretation necessary for a successful prosecution would have to be that the inducement need not be active on any one person in particular, but rather that it is intended to mean that anyone in the market generally reacting to the statement is enough to satisfy the provision. As to (b), Herc may argue that he did not 'know' that his statement was incorrect or misleading, but rather that he simply 'misspoke' by accident while being pressured by an interviewer during a live interview, as considered in relation to the Activity 2.1. There is also the availability of the defence of reasonable belief on behalf of Herc. The facts of this problem are, however, insufficient to establish whether or not he had such a reasonable belief.

Activity 2.3

As we have mentioned above, s.118 in its various provisions will tend to avoid the difficulties caused by the narrow definitions in drafting in the criminal offences in s.397 of FSMA 2000. The focus of the regulation is on upholding norms of market behaviour rather than punishing proven instances of manipulation. Taking the scenario in the activity as an example, many of the issues as to whether or not Herc had committed an offence would be removed if it were enough that he had intended to distort the market as a whole (as opposed to affecting the behaviour of any given person).

Activity 2.4

No feedback provided.