

MALTA FINANCIAL SERVICES AUTHORITY

INVESTOR PROTECTION FROM MARKET ABUSE*



By Christopher P. Buttigieg

On Thursday 25th May, the US Courts found Mr. Jeffrey Skilling and Mr. Kenneth Lay (since deceased), executives of Enron, guilty of fraud and conspiracy¹. The fall of Enron in 2001, which was one of the first cases in a line of corporate scandals that materialized from the euphorious behavior of the financial markets of the 1990s, brought economic crime into the lime light. Wide coverage by the

media of economic crime has not only been due to the long list of cases which emerged soon after Enron. In fact, the spotlight was also drawn on the many changes that were made to the international financial services legal order with the purpose of ensuring that 'Enron' would not be repeated.

According to the 2005 PriceWaterhouseCoopers Global Economic Crime survey, in the two years prior to the said survey, a staggering 45% of companies worldwide were the victims of economic crime². The same study quotes market abuse (one form of economic crime) as being perceived as causing the highest level of intangible damage to companies.

What constitutes market abuse? What impact does it have on a financial system and how should it be controlled and regulated? This article gives a concise overview of the importance of financial markets, the meaning of market abuse and the value of regulation as a means of protecting market integrity. It also looks at some of the main features of local legislation in the area of financial markets and briefly examines the Malta Financial Services Authority's (MFSA - Authority) role in safeguarding the interests of the investing public, particularly individuals who are stakeholders in companies listed on the Malta Stock Exchange (MSE).

Role and integrity of financial markets

Within an economy, financial markets such as the MSE, have the crucial function of providing the business community with access to capital and citizens with an alternative for their savings. They also perform 'a wide range of economic and political functions'³. In fact, stock exchanges play a fundamental role in the carrying out of privatization programs and are often an essential ingredient for a financial centre's success and the development of the economy.

In view of the important role which financial markets play, it is vital for such markets to operate properly and to transmit to all interested parties a sense of efficiency, integrity and transparency. In this regard, stock exchanges should be able to provide investors with the opportunity of *'transact[ing] in a fair and informed market where prices reflect information.'*⁴

Market malpractice, has the capacity of damaging the integrity and reputation of the local financial market and as a result undermines the confidence that investors have in the MSE and the financial industry as a whole. Lack of confidence in a financial market leads to a decrease in the willingness of the investing public to actively participate in such a market. In the short term, this lack of participation could increase the cost of capital for companies, while in the long run it could have serious repercussions on the wider economy. However, *'[y]ou cannot clean something up until you know what ma[kes] it dirty.'*⁵

What is market abuse?

Market abuse, which is a mode of unfair treatment of the genuine stock market investor, comes in two main forms; **insider trading** being the prohibited use of unpublished price sensitive information and **market manipulation** being the distortion of the price setting mechanism of financial instruments or dissemination of false or misleading information.

1 Barrionuevo A. Enron's Lay and Skilling guilty of fraud, (The New York Times, 25 May 2006).

2 PriceWaterhouseCoopers, Marthin Luther University, Global Economic Crime survey 2005, (PWC 2005).

3 Lee R., What is an Exchange? The Automation, Management and Regulation of Financial Markets, (Oxford University Press 2000), pg 4.

4 Rydge J., Comerton-Forde., The Importance of Market Integrity, (SIRCA, 1st September 2004), pg.7.

5 Reingold D., Ending the Wall Street Insider's game, (Financial Times, 8th February 2006).



Insider trading: Company insiders (eg. company directors, senior management, auditors, lawyers etc) are exposed to non-public information about their company some of which could be of a price sensitive nature (*being information which a reasonable investor would be likely to use as part of the basis of his investment decision*⁶). Company insiders can profit from such information by buying or selling their shares in the said company prior to the issue of the said information and this can only be at the expense of the uninformed investor. Therefore, insider trading may be best described as *'the trading that takes place when those privileged with confidential information about important events use the special advantage of that knowledge to reap profits or avoid losses on the stock market, to the detriment of typical investors who buy or sell their stock without the advantage of inside information.'*⁷ The basic argument against insider trading is that insiders should not be permitted to use unpublished price sensitive information to make a profit to the detriment of uninformed investors.⁸

Market manipulation: Insider trading is not the only form of market abuse. In fact manipulation of the market is also considered to fall within the scope of the definition of market abuse. Market manipulation involves the creation of a false impression of trading activity or price movement or market information which leads to a reduction of market efficiency due to the fact that trading decisions are not being made on financial fundamentals⁹. There are various ways in which one can manipulate the market and while it is not the purpose of this article to go into detail of the various forms of manipulative practices, it is worthwhile noting that there are two main forms of market manipulation. That is, transaction based manipulation, being transactions or orders to trade which give or are likely to give false or misleading signals to the market, and information based

manipulation, which takes place through the dissemination of false or misleading information in the media¹⁰.

Why regulate market abuse?

The investing public and market participants are generally known to keep to high standards when transacting on the market. This notwithstanding, without proper supervision and enforcement, the actions of a small minority would damage investors and harm the MSE's reputation. One of MFSA's roles is to ascertain that the local financial market conveys a sense of genuineness, which is a tool to ensure proper investor confidence. Market integrity may be promoted by ensuring that the MSE and the companies who have their securities listed thereon are subject to adequate transparency rules and that the MFSA has the necessary information/power to monitor properly the market, and to detect, investigate and prosecute instances of market malpractices.

The Prevention of Financial Markets Abuse Act, 2005

On the 1st April 2005, the Prevention of Financial Markets Abuse Act (henceforth referred to as 'the PFMA') came into force. The PFMA regime, which replaced previous applicable legislation in this area, has the purpose of inter alia safeguarding the integrity of financial markets and to enhance investor confidence in such markets¹¹.

The PFMA prohibits market abuse, provides for the monitoring and investigation of instances of market malpractice and affords the MFSA, which is the Authority vested with the function of enforcing the said legislation, with the required enforcement powers to address instances of market abuse. It also establishes a number of transparency requirements which apply to companies whose securities are listed on the MSE. Such listed companies are in fact obliged to promptly inform the investing public of any unpublished price sensitive information concerning such companies¹² [this requirement supplements the already existing listing rules applicable in this field]. Moreover, the Act enhances investor protection by making persons who are found guilty of market abuse, liable to pay compensation to any person suffering a loss from such action¹³.

The PFMA also deals with financial journalism. In fact, while it does not impede the media from reporting on financial matters, it nonetheless subject journalists, like all other citizens, to market abuse sanctions if the information that they disseminate was known to be/could reasonably be expected to have been known to be either false or misleading. In other words, journalists who in good faith receive and pass on erroneous information would not be guilty of breaching the PFMA. Moreover, the PFMA regime includes a number of provisions to ensure transparency in

6 Art 2 (1), Prevention of Financial Markets Abuse Act, 2005 - (PFMA).

7 Newkirk T.C., & Robertson M. A., *Insider Dealing a U.S. Perspective*, (Speech on the 16th International Symposium on Economic Crime, Jesus College, Cambridge, England, 1998).

8 Haddock D., *Insider Trading*, (Concise Encyclopedia of Economics).

9 Aggarwal R. J., *Stock Market Manipulation – Theory and Evidence*, (University of Michigan Business School, March 2003).

10 Ferrari G. A., *The European Market Abuse Directive*, (Common Market Law Review 41: 711 – 741, 2004)

11 Art 3, PFMA.

12 Art 9, PFMA.

13 Art 24 (9), PFMA.

the publication of investment recommendations by requiring inter alia disclosure of the source's identity. In this regard, when quoting third party recommendations regarding the price of issuers of financial instruments, journalists are obliged to disclose such third party's identity¹⁴.

Market monitoring / investigation

The PFMA also sets a number of reporting requirements which together with the requirements emanating from other legislation which regulates the activities of stock exchanges and investment services, ensure that the MFSA is provided with timely information that it requires in order to be able to monitor trading on the MSE. The Authority, in fact, avails of a trades monitoring function which enables suspicious transactions to be flagged.

Stockbrokers also have a role to play in safeguarding the integrity of the Maltese market. In fact, such entities are, in terms of the PFMA, required to bring suspicious transactions to the attention of the MFSA¹⁵. Reports on suspicious transactions are also made by the MSE which has retained the responsibility for real-time monitoring of trading on the Exchange.

The MFSA is further vested with a number of investigatory powers. These powers, which include the power to demand access to documentation and telephone records and to summon persons for hearing, allow the Authority to gather the essential evidence and to take all the action required to fully investigate instances of alleged market abuse and to determine the validity of such suspicions.

Enforcement

Market abuse is an offence of the PFMA and persons found guilty of prohibited use of unpublished price sensitive information or market manipulation may be subject to a fine imposed by the MFSA or to prosecution by the Maltese Courts¹⁶. Notwithstanding the various investigations of suspicious transactions undertaken so far, to date, nobody in Malta has been found guilty of the prohibited use of inside information or of manipulating the value of Maltese listed equities. Seen against the historical background of the regulation of market abuse in other financial centres such as London, the regulation of this area in Malta is relatively recent. The investigation and prosecution of market abuse process can best be said to be still on a learning curve.

Conclusion

In Malta, a share ownership culture as a means of investing one's extra income is on the increase, as at the 30th June 2006, the number of MSE individual accounts reached a high of 64,000. In order to safeguard this trend, the local financial services regulatory infrastructure must be adequate to properly preserve the integrity and efficiency of financial markets which in turn, is the basis for investor

confidence. The protection of our financial market from market abuse cannot be belittled. In this regard, having a proper legal framework is only a first step towards ensuring market integrity, but the effectiveness of a regime which has the purpose of controlling market abuse can only be judged by results.

The investigation and prosecution of market misconduct is sacrosanct in order to send a clear message that manipulative behavior is not acceptable. The MFSA has a zero tolerance policy with respect to market abuse and in this regard, since the coming into force of the PFMA in 2005, the MFSA has installed adequate procedures to ensure proper market monitoring and has conducted thirty two reviews of suspicious transactions twenty two of which were investigated further. However, while indications of presumed market misconduct might abound, proving an alleged abuse is another matter which inter alia depends on the Regulator's ability to gather tangible evidence of misconduct. Experience has shown that this is not easily forthcoming.

In implementing the new market abuse regime the MFSA is taking a gradual approach. The first challenge was that of setting up appropriate systems and procedures for the monitoring and investigation of market abuse. Public awareness followed. By issuing guidance notes and circulars and through a number of public presentations the MFSA tried to ensure that interested parties understand their responsibilities in this area. Through co-ordination with other regulators, members of the International Organization of Securities Commissions (IOSCO) and the Committee of European Securities Regulators (CESR), the MFSA is currently sharing experiences on how suspicions of market abuse are investigated and sanctioned.

*'Lax enforcement leads to a calculus that the probability of reward exceeds the risk and the penalties of being caught. Reversing that calculus would have a tremendous deterrent effect.'*¹⁷ It is one of the MFSA's priorities to reverse the 'calculus'. A well disciplined regime in the world of financial markets can only be achieved through sustained commitment.

Christopher P. Buttigieg is a qualified accountant who holds a Masters in Financial Services from the University of Malta and a Masters in European Law and Society from the University of Sussex. He is currently a Manager within the Securities Unit of the Malta Financial Services Authority and the Secretary General of the Chevening Alumni Association of Malta.



* The views expressed in this article are the author's own and do not necessarily represent the views of the Malta Financial Services Authority.

14 Regulation 4 of the Prevention of Financial Markets Abuse (Disclosure and Notification) Regulations, 2005 [L.N. 108 of 2005].

15 Art 11, PFMA.

16 Arts 22, 24, PFMA.

17 Reingold D., (FT, 8th February 2006).