EU Directive

# CRIMINAL SANCTIONS FOR INSIDER DEALING AND MARKET MANIPULATION

cep CEPC

Centrum für Europäische Politik

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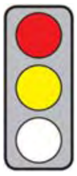
## MAIN ISSUES

**Objective of the Directive:** EU-wide minimum rules regarding criminal sanctions for insider dealing and market manipulation are introduced.

**Parties affected:** All market participants; law enforcement authorities.



**Pros:** A general prohibition along with a convincing deterrent to insider dealing would help reduce capital costs and have a positive effect on growth and employment.

**Cons:** (1) The Commission fails to prove why minimum rules for criminal sanctions really are "essential", which is a legislative precondition for harmonisation.

(2) Unclear terminology leads to considerable legal uncertainty when applying criminal law to market manipulation, which can impede pricing.

## CONTENT

### Title

**Proposal COM(2011) 654** of 20 October 2011 for a **Directive** of the European Parliament and of the Council **on criminal sanctions for insider dealing and market manipulation**.

### Brief Summary

- **Background and objective**
  - The Directive contains minimum rules for criminal sanctions for the most serious market abuse offences, namely insider dealing and market manipulation (Art. 1 (1)).
  - It complements the simultaneously proposed Regulation on insider dealing and market manipulation [COM(2011) 651] (hereinafter "Regulation"), which replaced Directive 2003/6/EC, and, amongst other things, is to bridge "gaps in the regulation of new markets, platforms and OTC instruments" (Explanation p. 3).

- **Scope**
  - The Directive applies to all "financial instruments" at the primary (issue) and secondary market (trade) which:
    - are admitted to trading on a regulated market (e.g. stock exchange); or
    - are traded on a multilateral (MTF) or organised (OTG) trading system. (Art. 2 (1) lit. a and b of the Regulation)
  - It covers all behaviour or transactions relating to financial instruments, even if the specific behaviour does not actually take place on a regulated market, MTF or OTF, but directly between the parties (over the counter, OTC). (Art. 2 (1) lit. c of the Regulation).
  - "Financial instruments" are [Art. 2 (1) in conjunction with Art. 2 (1) No. 8 of the proposed MiFIR Regulation [COM(2011) 652] in conjunction with Annex I Section C of the proposed MiFID Directive [COM(2011) 656]]:
    - tradable ("transferable") securities such as shares, (state) bonds, treasury bills, short-term bonds or certificates of deposits;
    - shares in investment funds and alternative investment funds ("undertakings for collective investment in transferable securities" – UCITS);
    - financial contracts whose value derives from basic values such as share prices, commodity prices or exchange prices ("derivatives"),
    - claims which are bundled and converted into tradable securities ("structured products", "securitisations"); and
    - emission allowances.
  - Exempted from the Directive are trading in own shares in buy-back programmes, programmes for the stabilisation of financial instruments, monetary policy measures and the management of public debts (Art. 1 (2)).
  - Actions by the EU Commission, the Member States and other public entities "in pursuit of the Union's climate policy" are also exempted from the Directive (Art. 1 (2)).

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- **Inside Information**

  "Inside information" is (Art. 2 (2) in conjunction with Art. 6 (1) lit. a-e of the Regulation)
  - precise information which has not been disclosed to the public regarding
    - financial instruments or their issuers, including any information relating to a client's pending order and which has been disclosed to the person charged with the execution of the financial transaction, or
    - derivatives on commodities and the related spot commodity contracts (which provide for the delivery of the commodities immediately upon contract conclusion),

    which if made public could have a significant effect on the course of said instruments and on the related spot commodity contracts or the accompanying derivative financial instruments,
  - other information on financial instruments or their issuers which is "not generally" available to the public and which a "reasonable investor" would regard as relevant to the decision.

- **Criminal insider dealing**
  - The Member States must in the field of insider dealing define the following conduct as a criminal offence when committed intentionally:
    - The use of inside information to acquire or dispose of financial instruments for their own account or for the account of a third party, including the amendment or cancellation of an order if placed before the receipt of insider information (Art. 3 lit. a);
    - Disclosure of inside information to third parties (Art. 3 lit. b).
  - Also punishable is:
    - the incitement, aiding and abetting to commit these criminal offences (Art. 5 Abs. 1 in conjunction with Art. 3),
    - the attempt to use (not disclose) inside information (Art. 5 Abs. 2 in conjunction with Art. 3 lit. a).
  - The sanctions must be "effective, proportionate and dissuasive" (Art. 6).

- **Criminal market manipulation**
  - Member States must in the field of market manipulation define the following conduct as criminal offence when committed intentionally:
    - Giving false or misleading signals as to the supply of, demand for, or price of financial instruments or related spot commodity contracts (Art. 4 lit. a);
    - Securing the price of a financial instrument or a related spot commodity contract in order to achieve an "abnormal or artificial level" (Art. 4 lit. b);
    - Any activity in the financial markets "which employs a fictitious device or any other form of deception or contrivance" to affect the price of financial instruments or related spot commodity contracts (Art. 4 lit. c);
    - The dissemination of information which gives false or misleading signals as to financial instruments or related spot commodity contracts if the persons concerned derive an advantage or profit from it for themselves or another person (Art. 4 lit. d).
  - Equally punishable is:
    - the incitement, aiding ad abetting of such criminal offences (Art. 5 (1) in conjunction with Art. 4);
    - the attempt to commit any of these criminal offences apart from the dissemination of information (Art. 5 (2) in conjunction with Art. 4 lit. a-c).
  - The criminal sanctions must be "effective, proportionate and dissuasive" (Art. 6).

- **Liability of legal persons**
  - Member States must extend liability to legal persons not only under administrative law but, "whenever possible", also under national criminal law for insider dealing and market manipulation (Recital 14).
  - The precondition for this is that such a criminal offence was committed to the benefit of a legal person by a natural person who, due to special powers, has a determining position within the legal person (Art. 7 (1) lit. a-c).
  - Legal persons must also be held liable if a person holding a determining position fails to adequately supervise or control a person under their authority who is consequently then able to conduct insider dealing or market manipulation to the benefit of the legal person (Art. 7 (2)).
  - The sanctions must be "effective, proportionate and dissuasive" (Art. 8).
  - The liability of legal persons does not preclude the criminal prosecution of natural persons or the criminal offence they committed (Art. 7 (3)).

- **Implementation and application**
  - The Member States must implement the Directive within two years after its entry into force (Art. 10 (1) sub-par. 1 in conjunction with Art. 11).
  - The Member States must apply the provisions upon the expiration of the implementation period. If the Directive enters into force later, they must apply it from the new effective date. (Art. 10 (1) sub-par. 2)

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## Changes to the Status Quo

The existing market manipulation directive (2003/6/EC) only prescribes to Member States that market manipulation must be addressed using appropriate administrative measures or by way of administrative proceedings. In future, criminal law will apply.

## Statement on Subsidiarity by the Commission

According to the Commission, different national sanctions for market manipulation can lead to offenders evading sanctions by relocating to a Member State with the least sanctions. Thus the dissuasive effect of national sanctioning rules and the enforcement of EU law to combat insider dealing and market manipulation would be vitiated. EU-wide minimum rules for criminal sanctions could "contribute to addressing this problem".

## Policy Context

In 2003, the directive regarding insider dealing and market manipulation was adopted (2003/6/EC). It defines these terms and prescribes which behaviour must be prohibited by Member States and sanctioned under administrative law. In its Communication "Reinforcing sanctioning regimes in the financial services sector" [COM(2010) 716] of December 2010, the Commission announced an examination of the question of whether or not and in which sectors the harmonization of the criminal law of Member States could contribute to an effective implementation of EU financial services rules. In September 2011, there followed the Communication "Towards an EU Criminal Policy: Ensuring the effective implementation of EU policies through criminal law" [COM(2011)573], in which the current approach of the proposed legal acts was developed.

## Legislative Procedure

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| 20 October 11 | Adoption by the Commission |
| Open | Adoption by the European Parliament and Council, publication in the Official Journal of the European Union, entry into force |

## Options for Influencing the Political Process

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| Leading Directorate General: | DG Internal Market |
| Committees of the European Parliament: | Economic and financial Affairs (leading), rapporteur: Arlene McCarthy (S&D Group, UK); Legal Affairs; Civil Liberties, Justice and Home Affairs |
| Committees of the German Bundestag: | N.N. |
| Decision Mode in the Council: | Qualified majority (approval by a majority of Member States and at least 255 out of 345 votes; Germany; 29 votes) |

## Formalities

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|---|---|
| Legal competence: | Art. 83 (2) TFEU (so-called Annex competence in terms of criminal law) |
| Form of legislative competence: | Shared competence (Art. 4 (2) TFEU) |
| Legislative procedure: | Art. 294 TFEU (ordinary legislative procedure) |

# ASSESSMENT

## Economic Impact Assessment

### Ordoliberal Assessment

EU-wide criminal sanctions against market manipulation should help to achieve a credible degree of deterrence. However, according to the economic "theory of efficient deterrence", a norm or contractual obligation can and should be deliberately disregarded if the benefits gained from doing so surpass the cost to society. Some economists go so far as to demand that the legislator allows for "efficient breaches" by imposing lenient sanctions.

The Commission, meanwhile, calls for especially severe sanctions for market manipulation in order to prevent it happening altogether. This is appropriate at least for insider trading.

In fact, insider trading can bring economic advantages if it contributes to information flowing faster into the market and therewith into prices. This improves the allocation of scarce means and increases efficiency which – despite all distribution effects – creates profits for the overall economy. However, the disadvantages associated with insider dealing outweigh the advantages. In particular external capital investors, who have no insider know-how, will not or will only for very high yields be willing to provide capital if they have to assume that the insider is only going to use his or her knowledge for their own benefit and that external capital investors are not informed in due time. It is difficult to imagine that the insider might employ believable signals for not using such knowledge. **A general prohibition of insider dealing** is therefore also of benefit for the insider, as it increases the external investors' willingness to invest. This **makes investments cheaper and has a positive impact on growth and employment**.

The proposal to address market manipulation with criminal law creates legal uncertainty. In view of undefined terms such as the dissemination of "false or misleading signals" or the employment of "false pretences" can lead to unsettling market participants. The threat of being punished with criminal law for such actions **can impede the dissemination of important information and eventually even pricing**. The fact that authorities are to decide what is an "abnormal or artificial" share price throws the doors wide open to political manipulation and is based on the very wrong assumption that there is a "real and correct" price.

## Legal Assessment

### Competency

Art. 83 TFEU transfers to the EU the competency to harmonise the substantive criminal law of Member States. Firstly, it can stipulate minimum requirements in the ordinary legislative procedure on criminal offences and sanctions for cross-border cases of very severe crime (Art. 83 (1) TFEU). Secondly, **the EU** has a so-called criminal annex competency (Art. 83 (2) TFEU), according to which it **may provide for minimum requirements under criminal law** through directives in fields where harmonisation has already been carried out. In the current case, such harmonisation was already carried out at administrative level in the Directive regarding insider dealing and market manipulation (2003/6/EC).

**Minimum requirements under criminal law must**, however, **be "essential" for an effective implementation of EU policy** (Art. 83 (2) sentence 1 TFEU). The Commission interprets this term in the sense of "necessary" and is therefore oriented towards the principle of proportionality (Art. 5 (4) TEC). As the expressed mentioning of the term "essential" is of specific nature, the proportionality examination must be subjected to stricter than usual criteria. However, it has not yet been concluded what exactly "essential" means. According to the German Constitutional Court, it must be "demonstrably established that a serious deficit as regards enforcement actually exists and that it can only be remedied by a threat of sanction" (Lisbon Decision, BVerfG, 2 BvE 2/08 of 30 June 2009, No. 362). In addition, the view is held that harmonisation should be the only remaining promising means (Calliess/Ruffert, Art. 83 TFEU No. 24).

Although criminal sanctions demonstrate "social disapproval of a qualitatively different nature" compared to administrative or civil law sanctions (Explanation P. 3), whereby the deterrent effect is increased, this does not mean that EU-wide criminal law prescriptions are necessarily "essential". Particularly questionable is whether or not there is a "lack of enforcement" at all, which can be eliminated only through the threat of punishment, or whether criminal law is the "only remaining promising means". Totally unknown is namely the number of unidentified market abuses, which to a large degree depends on the intensity of administrative investigations. However, this cannot be affected by a harmonized criminal law. **The Commission does not justify the "indispensability" of an EU-wide harmonised criminal law**.

### Subsidiarity

Different criminal law requirements in Member States incorporate the danger of cross-border market abuse not being prosecuted efficiently. This can lead to enhanced market manipulation in Member States with no or with only limited sanctions. EU-wide minimum requirements for the application of criminal law can help reduce these risks. With regard to market abuse leakage, this applies all the less the more the amount of sanctions differ from each other.

### Proportionality

See competency.

### Compatibility with EU Law

Unproblematic.

## Possible Follow-up Action by the EU

Although it has the competency, the Commission does not propose a harmonised level for sanctions. This can be imagined as the next harmonization step.

## Conclusion

A general prohibition of insider dealing reduces capital costs and has a positive impact on growth and employment. Due to the unclear terminology, the application of criminal law to market manipulation leads to legal uncertainty, which can impede pricing. The Commission fails to justify the "indispensability" of introducing EU-wide sanction rules. It is doubtful that this requirement is met.

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