# Market Misconduct: Prevention, Detection and Deterrence
# NICE Actimize Conference

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Thank you for inviting me back here again this year.

Today is a unique opportunity to discuss and share views on regulation, market conduct, behaviour and technology. All busy topics.

## Technology and the Human Element

A couple of years ago I read an article that carried the headline "If you're reading this, it's too late: a machine got here first". The article was about a new breed of computers programmed to trade automatically on the latest news stories. The article went on to say there was growing demand for machine-readable news: in effect newspapers for computers enabled to trade on headlines within milliseconds of the news being published.

When trading becomes automatically reactive to everything, theoretically, all news may become price sensitive to greater or lesser degrees.

The article quoted one banker, a head of institutional electronic trading, who made the pertinent point:

> Our general approach has been to blend the automation with a degree of human oversight. It's better to take an extra few seconds to be sure.

Those extra few seconds could be crucial. In recent times we have seen dramatic price movements in some stocks due to algorithmic trading that, quite frankly, looks out of control. In one case we saw a 56% price movement within 65 seconds; in another a 55% price swing within 44 seconds. Both cases are being looked at. Volatility of this kind will not often constitute manipulation but it may well reveal inadequate systems that are inconsistent with obligations to ensure market integrity.

We are far from against technology. We are heavy users ourselves in our market surveillance work and employ a range of different surveillance techniques using a number of different software applications. And we are participating in a global research program designed to develop new tools to help us understand our markets. We are committed to the development of electronic tools that will combine with our own observation, instinct and experience in identifying market misconduct.

But, to be honest, it is the human element that is far more important and telling.

Each day generates about 100 red flags, each of which is assessed on the same day and either written off or made the subject of surveillance inquiries to relevant brokers.
The rate of surveillance inquiries has increased each year and is now running at over 4,000 per year. Each one of these inquiries is generated not by any computer model or abstraction of what compliant or normal market behaviour should look like but is the result of human observation, instinct and experience.

The results of these inquiries are then whittled down and, based on our observation, instinct and experience, some will evolve into full scale investigations.

**Market Misconduct Cases**

We currently have 101 insider dealing and market manipulation investigations and cases on foot and last year we issued 76 summons for market misconduct and recently we laid 10 insider dealing charges in a case that is yet to appear before the courts. I am excluding cases we have referred to the Financial Secretary for potential action before the Market Misconduct Tribunal proceedings as well as cases before the Court of First Instance in which market contraventions are alleged. I will return to this topic later. Many of these cases remain before the courts.

In the last 5 years – since March 2007 - we have secured over 170 market misconduct convictions. This is a more than healthy number, comprising the vast majority of cases launched by the Securities and Futures Commission (SFC) since the SFC began more than 21 years ago. For the most part, these cases are dealing with price rigging or market rigging.

The most common manipulations are:

- inflating the appearance of supply or demand through by the placement of fictitious orders;
- price ramping, including marking the closing price; and
- rigged transactions including wash transactions i.e. arrangements between associates to trade together to give the appearance of active trading when in fact it is the same shares being passed around or where the trading is conducted by nominees on behalf of the same person so there is no real change in ownership.

In March this year we prosecuted two cases, one involving a wash trader who was sentenced to a suspended jail term of 18 months with 4 weeks imprisonment to serve. The other involved a broker, a responsible officer at Guotai Junan Securities, who was sentenced to 5 months imprisonment. The broker was given an order by a client to fix a higher closing price for the shares of one listed company. The broker accordingly arranged for a number of high priced buy orders to be placed within the last two minutes of trading which caused the share price to close 14% higher than its prevailing market range during the day. The reason, so we alleged, was to facilitate a higher price for a subsequent off-market transaction. The victims here included not only other market participants who were misled as to the real market price for these shares but also the off-market counter-party.

We have previously warned the industry that brokers who participate in obviously illegal manipulations or fail to ask appropriate questions in the face of highly suspicious instructions from clients will be held to account. This case shows the warning is a real one.

The fact that the broker is acting on instructions does not provide any cover or protection in the facilitation of market misconduct.

**Summary or Indictable Prosecution ?**

Like these two cases, most of the 170 or so charges have or are being prosecuted in the Magistrates Court and this is probably the right venue for many of them given the size, impact and amount of money involved in each case. There is a maximum three year jail term for these offences in the Magistrates Court so, as the March cases demonstrate, loss of liberty is not a theoretical possibility but a strong likelihood on conviction.

But we do not think the Magistrates Court is the right venue for all of these cases especially those involving more complex or serious misconduct, large amounts of money and/or involve transactions that seriously misled the market.

The decision to prosecute these cases as indictable offences is made by the Director of Public Prosecutions (DPP). The DPP's normal practice is to make a decision on the appropriate venue for trial based on an assessment of the likely sentence if the defendant is convicted. If the defendant is likely to receive a sentence of imprisonment of more than three years – the maximum for such cases in the Magistrates Court – then that will indicate an indictable prosecution should be commenced.

The problem with this approach is only a small number of manipulation cases have been prosecuted on indictment. There is settled sentencing range for this kind of misconduct, no consistent precedent bank of manipulation cases to indicate the court's likely sentencing disposition and there is little experience in handling these cases in the DPP's office.

The impression is that a normal fraud involving say $2 million will inevitably lead to a trial in the District Court but a manipulation involving this amount - and many of our cases involve more - will not be seen as sufficiently serious to warrant prosecution in the District Court.

We believe the assessment of where a manipulation case is tried should be made on the basis of complexity and seriousness taking into account the impact of the conduct on the investing public and the need for stronger deterrence given the problems of detection and proof. We will continue to advocate this position with the DPP and believe more of these cases should be prosecuted on indictment given the serious impact of manipulation on the investing public and market integrity.

**Criminal or MMT ?**

Let me now turn to the issue of how we determine whether we should institute criminal proceedings or, instead, refer the case to the Financial Secretary for potential proceedings before the Market Misconduct Tribunal (the MMT).

In this respect, the SFC and DPP are in firm agreement. The Securities and Futures Ordinance has earmarked insider dealing and market manipulation as criminal offences for a reason: they should be prosecuted as crimes where there is sufficient evidence to establish the case to the criminal standard of proof and a prosecution is not otherwise inconsistent with public policy (see the DPP's The Statement of Prosecution Policy and Practice). This is also consistent with public policy that criminal offences should be prosecuted as such.

There is some confusion here between criminal prosecutions and MMT proceedings. The confusion is due, I think, to the fact they are, in many ways, two sides of the same coin. Both procedures are dealing with the wrongdoer and both apply deterrent sanctions, albeit with different degrees of severity and using different standards of proof.

The similarity is observable in the way in which the Securities and Futures Ordinance (SFO) applies a double jeopardy rule. The SFO provides that if a market misconduct case is brought before the MMT, then the parties involved cannot be prosecuted criminally for the same misconduct. In effect, the commencement of MMT proceedings confers an automatic statutory immunity from prosecution for the same misconduct. The rationale for this immunity is the rule that a person cannot be punished for the same misconduct twice, in other words, double jeopardy. The source of the rule is grounded in well-established legal principles as well as common sense notions of fairness.

In other words, the legislation recognises that the MMT is involved in the application of deterrent or quasi-deterrent sanctions and a person should not also face punishment for the same conduct through the criminal process.

As a Bills Committee paper (Paper No 12/01) on the establishment of the MMT stated, the purpose and function of the MMT is “to inquire into and punish all forms of market misconduct” albeit using these powers calibrated to the civil rather than the criminal, standard of proof (see also Luk Ka Cheung v Market Misconduct Tribunal HCAL 49/2008, 18 November 2008 (Hartmann JA and A Cheung J).

Accordingly, the SFC gives priority to criminal proceedings over MMT proceedings where the conduct in question can be established to the criminal standard of proof and it is in the public interest to prosecute the case. The SFC will not commute what is otherwise a criminal offence into a civil contravention.

By the same token, if the evidence in question does not support the laying of criminal charges but nonetheless the evidence is sufficient to establish market misconduct using the lower, civil standard of proof, then the SFC will refer the case to the Financial Secretary to consider initiating MMT proceedings.

Compared to the 170 or so criminal convictions we have secured, there have been relatively fewer cases handled by the MMT. That is not the result of any aversion to the MMT but a direct result of the application of this policy and the fact we have been successful, in the forensic sense, in establishing the necessary evidentiary thresholds to initiate criminal prosecutions far more frequently than not.

**Section 213**

Let me turn briefly to our use of section 213 of the SFO which permits the SFC to make applications to the Court of First Instance where a person has contravened the law. Under this provision, the court can order interim and permanent injunctions and, in effect, make orders reversing the consequences of alleged contraventions for the benefit of those who are on the adverse end of them.

We have been in court this week in relation to two of these cases, one involving allegations of insider dealing and market manipulation and the other involving allegations the market was misled by false information. In both cases we are seeking orders to unwind the relevant transactions. In both cases, the defendants are not within the jurisdiction so criminal proceedings cannot be commenced. However, unlike criminal prosecution or MMT proceedings, these cases are not concerned with punishment or deterrent sanctions against the wrongdoer. Instead, they are directed to the consequences of wrongdoing.

The jurisdiction invoked here is a new one. Section 213 has been in the legislation since it was enacted but it has not been used very often. We are determined to give effect to the language and the purpose of the provision. Its use raises several novel questions but in one sense the jurisdiction is an old one, akin to the well established equitable jurisdiction of the court to disaffirm or repudiate contracts induced by fraud (see Alati v Kruger (1955) 94 CLR 216 at 223).

In the case of insider dealing, insiders who possess inside information, by their conduct, represent to the market generally and to corresponding buyers and sellers, in particular, that they are legally competent to trade when in fact they are not: they are prohibited from doing so. In effect they misrepresent their status, position as well as their competence i.e. ability to trade. All of these matters would give rise to remedies for misrepresentation in a face to face transaction. The falsity of the insider's representation is not detectable because all traders are anonymous yet the representation is as false as any false statement in a fraud case. In the case of market manipulation, the falsity of the representations arises from the false appearance of real market activity.

In one of these section 213 cases this week, the Court had indicated it does not think there is any jurisdiction in the Court of First Instance to find contraventions where the relevant contravention is both a criminal offence and market misconduct without, in effect, either a conviction or an MMT determination in place.

We have not seen the reasons for this ruling. But it is one we are likely to challenge as it appears to us that the Court of First Instance must have jurisdiction to determine when the law has not been complied. The Court of First Instance certainly has this jurisdiction in actions brought by applicants other than the SFC (see section 281 and section 305 of the SFO).

But if we are wrong, it will mean that orders under section 213 dealing with the consequences of misconduct on the investing public must be relegated procedurally until such time as we have secured either a criminal conviction or an MMT determination (assuming any fine or disgorgement order made by the Court or the MMT has not used up all the available money that might be used to pay a reasonable restitutionary order).

Given the SFC is able to initiate criminal proceedings and the Government has indicated that it proposes to give the SFC direct access to the MMT, it will be easier for the SFC to achieve these threshold determinations if that is what is required.

The rationale for us pursuing cases seeking both deterrent and remedial sanctions is our firm view that as the champion of market integrity and fairness, as well as the agency with a statutory mandate to protect the investing public, we have an obligation not only to bring cases against wrongdoers but also to attack and remediate the consequences of wrongdoing.

The investing public should not have to bear the full price for market misconduct and the interim injunctions we have obtained recently are designed to ensure that doesn't happen.

**Closing**

The investing public – both retail and institutional – are entitled to expect the regulator will tackle market misconduct robustly. In doing so, we get a clearer picture of the damage caused by market misconduct.

Often the damage caused by market misconduct is diffuse, across a wide spectrum of market participants and investors. The damage to each person is invariably not worth pursuing individually given the legal costs involved but in aggregate the amount may be and is often very significant. More importantly, the deterioration in market confidence caused by misconduct that is not rectified is even more costly.

We will continue to pursue wrongdoers and we will continue to attack the consequences of wrongdoing.