

## **Effective surveillance and enforcement techniques**

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### *Effective surveillance and enforcement*

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## *I. Overview*

### **I. Overview**

#### 1. Surveillance

Detecting potential violations

- Through securities transactions on- or off-exchange
- Within securities firms (conduct of business, organization...)

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## *I. Overview*

### **2. Investigation phase**

- **First evidence** obtained from **surveillance** activity suggests a potential violation (**initial suspicion**)
- Gathering more evidence to establish whether the suspected violation has **actually occurred**
- If a violation has been established: decide on further steps

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## *I. Overview*

### **3. Enforcement phase**

- Stopping the violation by issuing
  - an **injunction** (= administrative or civil, depending on the legal system)
  - Modifying or withdrawing a **license**
- Imposing **sanctions**
  - Administrative fines
  - Removing a firm's management
  - Criminal penalty or imprisonment

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## *I. Overview*

### **4. Prevention is better than cure!**

- What “soft” instruments can regulators apply to prevent violations from occurring in the first place?
- Ensuring **adequate skills** on the part of all market participants
- Sound **infrastructure**
- Clear **rules** without loopholes

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## *II. "Soft" instruments*

### **II. "Soft" instruments to prevent violations**

1. Ensuring adequate skills of all market participants

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## *II. "Soft" instruments*

### **Interactive discussion:**

- How do you ensure that owners and management staff of licensed firms are fit and proper?
- What measures do you take to alert retail investors about fraudulent offers of securities and financial services, or misselling?

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## II. "Soft" instruments

3. How can it be guaranteed that issuers and authorized entities (banks, intermediaries and market operators) have sound infrastructures?
4. How can we be assured that supervisory laws and regulations are adequate? Please refer to
  - the Lamfalussy-procedure within the EU,
  - Laws and regulations at national level (who exercises rule-making powers in your country?)
  - Rules-based regulation, and/or
  - Principles-based regulation

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## III. Resource-planning

- III. Resource-planning: risk-based supervision**
- How can a regulator make use of his limited resources so as to best achieve his supervisory goals?
  - Identifying risks
  - Evaluating and prioritizing risks
  - Identifying those risks that can be effectively mitigated using the available resources
  - Possibly redirecting the available resources to departments dealing with high-priority risks
  - IT-support

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### *III. Resource-planning*

#### **III. Interactive discussion**

5. Discuss how risks could feed into the resource-planning processes within your authorities. Consider the different stages of the risk-based approach to supervision.

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### *IV. Market abuse*

- IV. Surveillance and enforcement in market abuse cases

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## IV. Market abuse

### I. Market abuse directive of 2003 (MAD)

#### 1. Overview

- Market abuse = **insider trading + market manipulation**
- Scope: **securities and derivatives** (= financial instruments)
- Listed on a regulated market in the EU **pursuant to the MiFID**
- **No matter whether the manipulative transaction was effected on such market or elsewhere (ATS, OTC)**
- **Excluded from the scope of MAD**
- **Derivatives traded solely on an ATS or OTC**
- **Spot markets in anything other than financial instruments (commodities, emission allowances etc.)**

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## IV. Market abuse

### 2. The Concept of market manipulation

Art. 5 MAD: “Member States shall prohibit any person from engaging in market manipulation.”

- Art. 8 MAD: “The prohibitions provided for in this Directive shall not apply to trading in own shares in ‘buy-back’ programmes or to the stabilisation of a financial instrument provided such trading is carried out in accordance with implementing measures adopted in accordance with the procedure laid down in Article 17(2).”

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## IV. Market abuse

### 3. Jurisdiction of competent authorities (Art. 10 MAD)

- (a) actions carried out on its territory or abroad **concerning financial instruments that are admitted to trading on a regulated market situated or operating within its territory or for which a request for admission to trading on such market** has been made;
- (b) actions carried out on its territory **concerning financial instruments that are admitted to trading on a regulated market in a Member State** [...].

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## IV. Market abuse

### 4. Powers (Art. 12 MAD)

- (a) have access to any document in any form whatsoever, and to receive a copy of it; [...]
- (c) carry out on-site inspections;
- (d) require existing telephone and existing data traffic records; [...]
- (f) suspend trading of the financial instruments concerned;
- (g) request the freezing and/or sequestration of assets;
- (h) request temporary prohibition of professional activity.

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## IV. Market abuse

### 5. Transaction reporting (Art. 25 MiFID)

- Applies only to shares listed on a regulated market within the EEA
- Enables regulator to quickly identify the originator of a sale or purchase order
- Problem: chains of execution
- Problem: orders routed through foreign firms (investigation then depends on effective co-operation with foreign regulators, the IOSCO MMoU being the most important tool)

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## IV. Market abuse

### 6. Co-operation with the market surveillance units of exchanges and other trading venues

- At least the surveillance units have direct access to the order book (including unmatched orders)
- Market operators have sanctioning powers vis-à-vis their members
- Exchange of information between market operators and securities supervisors
- Referrals of suspected breaches (e.g. market manipulation, money laundering...)

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## *IV. Market abuse*

### **7. Disclosure duties for issuers**

- Sales prospectus
- Financial reporting
- Ad hoc disclosure of price-relevant inside information
- Directors' dealings
- Disclosure duties under takeover legislation

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## *IV. Market abuse*

### **8. Data mining**

- BaFin receives up to 5 million Transaction reports daily
- Tools to retrieve suspicious transactions, e.g. orders prior to the disclosure of price-relevant information such as a takeover or the resignation of a CEO

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## IV. Market abuse

### 9. Sanctioning powers

- Public warnings
- Injunctions
- Administrative fines
- Criminal sanctions (often after referral to the criminal prosecutor)
- Publication of sanctions on the regulator's website ("naming and shaming")
- Ability to settle / plea-bargaining?

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## IV. Market abuse

### Practical case (insider trading):

- Listed at: Berlin, Frankfurt
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- Shares/nom val.: 440,000 shares at nom. Val. 50- DM
- Issue price: 470.00 DM
- Stock price 30.12.1994: 429.00 DM
- 28.12.1995: 130.00 DM
- 30.12.1997: 168.00 DM
- Dividends:
- 1993/94: 18.66 DM
- 1994/95: 19.00 DM
- 1995/1996: 0.00 DM
- 1996/1997: 0.00 DM

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## IV. Market abuse

Inside information - Ad hoc-Mitteilung  
disclosure on 28.6.96

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## V. Ongoing supervision of firms

### V. Ongoing surveillance of firms

- Risk classification of each firm according to its size, type of business, market share, types of clients etc.
- Risk category determines the intensity of supervision (frequency of audits etc.)
- Are inspections conducted by the regulator's staff itself or by external auditors?
- Dialogue with firms (learning process; especially necessary in case of principles-based regulation)

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## *V. Ongoing supervision of firms*

### **Firms doing cross-border business**

- Co-operation between home and host regulators is crucially important
- Supervisory colleges (only for large firms)
- Exchange of information
- CESR MiFID Protocol on the Supervision of Branches (builds on the CESR MoU on exchange of information)

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**Thank You**

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