

# corporate governance

*better companies, better societies*

## Improving Market Enforcement, Preventing Fraud in South East Europe

Ensuring that capital markets are well surveilled and effectively regulated is key for countries seeking to attract investors to finance private sector development. As capital markets in South East Europe (SEE) grow rapidly, supervisory authorities must be able to appropriately identify and then halt fraud, market manipulation, and insider trading.

To address this challenge, the Global Corporate Governance Forum—with the Toronto Centre, IFC's Private Enterprise Partnership for SEE, and the World Bank's Sofia office—jointly organized the first regional workshop for strengthening the capacity of regulators to enforce regulations and prevent fraud. The Bulgarian Financial Supervision Commission, with the Financial Technology Transfer Agency (ATTF) and the International Organization of Securities Commissions (IOSCO) as cosponsors, hosted the event in Sofia on June 23 – 27, 2008.

Thirty-two experts participated, representing supervisory and stock exchange authorities from eight countries.<sup>1</sup> The diversity of representatives enriched discussions that identified common regional problems, developed solutions, and shared best practices.

During the five-day, highly interactive workshop, participants discussed how to identify acceptable outcomes, define market manipulation under current law, deal with innocent parties involved in a complex and possibly illegal trading scheme, find expert witnesses, uncover credible evidence, and secure international cooperation.



### Supervision and Sanctions to Fight Market Manipulation

*“Effective supervision by a bank’s internal department, an investment intermediary, and/or the country’s financial supervision commission is essential for preventing market manipulation and maintaining investor confidence. The other way is for the regulator to impose ex post sanctions, after conducting an investigation and detecting market manipulation. In Europe, the sanctions for market abuse range from EUR100,000 to EUR500,000, depending on the specific case. In most cases, these fines are linked to the potential profit and then multiplied by four or five times. A comparative analysis of the fines in Europe shows that the penalties differ widely among countries. The level of fines in Europe should be regulated because perpetrators could go to those countries where the penalties for market abuse are the lowest.”*

**Prof. Eddy Wymeersch**  
Chairman of the European Regional  
IOSCO Committee; Chairman of CESR;  
Chairman of the Belgian Banking, Finance  
and Insurance Commission

“It was very useful to learn about different approaches to common problems, see other points of view, and meet people confronting similar problems,” said one participant.

<sup>1</sup> Montenegro, Bosnia and Herzegovina, Romania, Croatia, Macedonia, Republika Srpska, Poland, and Bulgaria



The Global Corporate Governance Forum is an International Finance Corporation (IFC) multi-donor trust fund facility. The Forum was co-founded by the World Bank and the Organisation for Economic Co-operation and Development (OECD) in 1999.

Through its activities, the Forum aims to promote the private sector as an engine of growth, reduce the vulnerability of developing and transition economies to financial crises, and provide incentives for corporations to invest and perform efficiently in a socially responsible manner. The Forum sponsors regional and local initiatives that address the corporate governance weaknesses of middle- and low-income countries in the context of broader national or regional economic reform programs.

Donors to the Forum include the IFC and the Governments of Canada, France, Luxembourg, the Netherlands, Norway, and Switzerland.

## Effective Prevention

Combating market abuse is a top priority for financial supervisory authorities, encompassing any one or several of “the seven deadly sins.” These are: insider dealing, improper disclosure of inside information, misuse of information, manipulating transactions, and misleading behavior or market distortion. During a special session on how to combat market abuse, fraud, and insider trading, the importance of prevention as the first line of defense was discussed to ensure the highest levels of integrity.

*“Market manipulation is considered to be illegal. Yet, there is a very subtle distinction between manipulation and acceptable market practice; hence, proving such a case is fraught with many difficulties. The problem: what are the criteria to identify market manipulation?”*

**Alan Cameron**

Former Chairman of the Australian Securities and Investments Commission

## Combating Fraud and Other Market Abuses: Success Factors

### Market Abuse

- Efficient law—if not statutory, greater use of rules and regulations promulgated by ministries
- Efficient investigation—concentrate on the most problematic issues
- Preventative sanctioning—prevention is better than the cure

### Market Manipulation

- Effective surveillance system
- Reliable control system
- Price and volume restrictions
- Liquidity

### Insider Trading

- Protect inside information from unauthorized access
- Awareness of employees—educate, highlight the risks, and monitor
- Dealing culture—train employees about market principles and reputational risk
- Internal regulations—adopt binding procedures or a code of best practices

### Disclosure Duties for Issuers

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

## ‘Good Rules – Essential for Effective Enforcement’

Stefan Pankoke, senior advisor with Germany’s Federal Financial Supervisory Authority, stressed the need for effective surveillance and enforcement techniques. Surveillance may yield evidence of a potential violation. After that, more evidence must be gathered to establish whether the incident is a violation. If it is, the regulator must stop the violation by issuing an injunction, withdrawing a license, or imposing administrative or criminal sanctions.

## DID YOU KNOW?

In Bulgaria, the Financial Supervision Commission (FSC) organizes weekly press conferences. FSC decisions are publicly available on their web site ([www.fsc.bg](http://www.fsc.bg)) as is the list of licensed firms. The commission started education campaigns for retail investors, judges, the police, and others. In Romania, the Supervision Commission presents information on the business TV channel.

## Eight Steps to Identify Insider Trading

- Review documents (transaction/order/financial records)
- Examine the broker's client advisory activities, including phone records
- Establish relations with external entities providing services to issuers (e.g., law firms, financial advisors, agencies handling public relations and investor relations)
- Interview issuers to determine whether they communicate with their investors or participate in shareholder meetings
- Launch explanatory proceedings by collecting information from such sources as the tax office
- Engage police in the investigation
- Coordinate the activities—organizing interviews with suspects and witnesses
- Formulate an outcome

## What 'Soft' Instruments Can Regulators Apply to Prevent Violations?

**Skills:** Adequate skills for all market participants

Many retail investors are not aware of or understand the rules and regulations designed to protect their investments against fraud and misuse

**Management:** Integrity of owners and management staff of licensed firms

**Infrastructure:** Sound structure and operations for issuers and authorized entities (e.g., banks, intermediaries, and market operators)

**Rules:** Clear and adequate supervisory laws and regulations without loopholes

**Reporting:** Procedures to alert retail investors about fraudulent offers of securities and financial services

## Steps to Achieve Efficient Surveillance

Alan Cameron, the former chairman of the Australian Securities and Investments Commission, pointed out some of the red flags that may indicate market manipulation. A firm may engage many brokers to handle transactions but doesn't provide any information about the strategy motivating those transactions. Purchases and/or sales may be concentrated at the opening or close. The broker orchestrating the trades may be registered abroad.

In presenting a case study of market manipulation that he resolved while he was ASIC's chairman, Cameron outlined the following steps:

### Develop a Plan

- Define your goal
- State clearly what you would like to achieve
- Outline available options to achieve the goal
- Analyze the options' pros and cons

### Analyze Stakeholders

- Identify those stakeholders who are needed to achieve your goal
- Assess their influence
- Consider the position they may take on your plan – a stakeholder may support, be neutral or oppose your effort
- Evaluate stakeholders' needs, wants, and vested interests to gain their support

### Persuade Stakeholders

- Establish your credibility
- Find common ground
- Provide evidence of the proposed change's needs and benefits
- Connect emotionally
- Five essential elements of communicating change effectively:
  - **SENSE** – Use clear language
  - **CREDIBILITY** – Use research and experts
  - **BALANCE** – Build trust
  - **TRANSPARENCY** – Disclose information
  - **COLLABORATION** – Seek feedback

# Investigatory Powers and Techniques to Press Market Manipulation Cases

Ilona Pieczynska-Czerny, director of enforcement for the Polish Financial Supervision Authority (PFSA), noted that financial market participants need to know that the securities regulator closely cooperates with the police to deter or penalize wrongdoing. Such cooperation provides the regulator with intelligence and assistance during an investigation. For the police, the regulator is a good source to detect problems early.

The key steps in dealing with cases involving market manipulation include using the following investigatory powers and techniques:

## **Before launching a formal procedure, examine records for:**

- Transactions
- Orders
- Finances

## **Decide how to obtain the information:**

- Telephone interview (at the preliminary stage, only to confirm some information)
- In-person interview (the challenge is to choose the right witness)
- Email

## **Distinguish between witnesses and interviewees:**

- Witnesses testify during administrative proceedings
- Interviewees testify voluntarily at explanatory proceedings

## **Hearing of witnesses or interviewees:**

- Usually NOT taped
- Interviewees are not informed about the hearing's subject in the request
- Witnesses or interviewees with ties to one another are questioned on the same day
- Witnesses or interviewees are not allowed to contact anyone when providing testimony
- Witnesses are asked to sign the minutes upon completion of each segment
- Cross interrogation permitted of witnesses or interviewees

“Do not inform defendants about the subject of the interview in the request; ‘surprised’ and unprepared people might tell you things you would normally never hear. Let them talk and ask open-ended questions,” said Martin Pachuki, deputy director of enforcement at PFSA.

## **DID YOU KNOW?**

The European Securities Regulators Committee advised the EU Commission on how to form an international body to set standards and monitor credit rating agencies (CRAs). This body would develop and monitor compliance with international standards in line with steps already undertaken by IOSCO. By requiring full public transparency and acting in a “name and shame” capacity, the new body could enforce compliance through market discipline. This body should be formed of senior persons representing investors, issuers, and investment firms, all of whom have a global perspective. See the Website: [www.cesr-eu.org](http://www.cesr-eu.org) .

## **Are Credit Reporting Agencies Important?**

Although credit ratings are legally no more than opinions, investors rely heavily on them, assuming that the ratings process is sufficiently sound, independent, and reliable. But this is not always the case. Regulators have raised concerns about the agencies’ inherent conflict of interest since they are paid for their ratings services by the companies or entities whose securities they are rating.

## The Response: Administrative vs. Criminal Proceedings

In Poland, the introduction of administrative proceedings for market abuse and manipulation cases brought efficiency to the country’s financial market. As of September 2008, there were only 15 pending cases dealing with market abuse.

For these administrative proceedings, the preponderance of evidence is sufficient to justify imposing sanctions. The defendant, though, has the right to provide evidence to counter the regulator’s charges. The penalties are proportionate to the nature of the infringement and could be as much as 10 times

the value of the infringement’s benefit. PFSA collects evidence, prepares a report for the commission, and recommends a fine, Pieczynska-Czerny explained.

The PFSA may appear in the criminal court as the public prosecutor. PFSA has the same rights as an “injured person,” meaning that the defendant cannot ask the court to reject the agency from participating in the prosecution. The agency also supports the prosecutor by providing testimony and conducting searches of the business premises or private homes. PFSA also has the right to appeal the court’s decision.

Administrative	Criminal
Carried out under the administrative code	Carried out by public prosecutor
More flexible and faster (only one debate and the decision is taken there)	Takes years; difficulties in proving the form of intent
Less demanding in legal context	Very strict and formal in legal context
Non-contradictory	Contradictory
For dissemination of false information excluding journalist	For transactions and orders

## Action Planning: Identifying Enforcement Challenges, Defining Solutions

“Action planning” was the highlight of the five-day training program. Before the workshop began, every participant had to identify enforcement challenges from their work. During the workshop, these situations were analyzed to develop solutions. With the help of the program leaders, each participant developed and presented an individual action plan

on how best to resolve the problems. The topics discussed included: identifying market abuse and manipulation; implementing effective surveillance and inspections; strengthening the department’s internal work; managing pension funds and social insurance brokers; and, improving the notifications, REITS, and prospectus.

### Preparing a Successful Action Plan

- Set a narrowly defined, manageable, and concrete challenge. Don’t be overly ambitious.
- Analyze the situation considering the relevant macro, micro, and internal factors, timing, urgency, and problem’s importance.
- Concentrate first on identifying the problem before crafting the solution.
- Define the preferred outcome.
- List possible solutions that will lead to the outcome desired. Select the best solution and save the others for a contingency plan. Address possible objections of senior management and build internal support.
- Analyze the stakeholders. To be understood, you must first understand. Make sure you understand what you can offer, who your key stakeholders are, and what you need to obtain from each.
- Classify the stakeholders according to their power in helping or hindering your plan. Choose a communication/persuasion/negotiation strategy for each group of stakeholders.
- Detail the activities, resources, and timing for each step in the plan.

Even the best plans are of little use if they are not implemented properly. Implementation is about following the plan, closely completing each step, monitoring the results, and adhering to timelines and a budget.

Prepare a contingency plan: What if the plan fails? Does this failure call for a change of course or an adjustment of the original?

*“Most projects fail because they don’t include enough milestones to monitor completion of the implementation plan’s major tasks. You should not run towards the goal, and forget about the milestones, because the darkest part of the tunnel is right at the middle.”*

**Gerry Lewis**  
Consultant

## International Cooperation Central to Cross-Border Transactions' Success

International cooperation is essential in preventing market manipulation given the increasing interdependence of national economies. Such cooperation should be proactive, going beyond what is strictly the securities sector to include accounting, auditing, and money laundering issues, advises Carlo Biancheri, former director of international relations at CONSOB (the Italian securities regulator).

"The consolidation of the world stock exchanges and mutual recognition will continue in the future and only the big international players, working in cooperation to ensure cross-border access to

information and capital, will form the new landscape of financial markets," said Wymeersch.

Solving international fraud cases requires cooperation worldwide. Why? The reasons include: the existence of subsidiaries based in different jurisdictions; major subsidiaries registered in off-shore centers; cross-listing of financial instruments; the parent companies and their subsidiaries using different auditors; the application of different accounting standards; and, raising funds outside the parent company's jurisdiction.

### IOSCO Memorandum

By 2010, all IOSCO members are expected to have signed the IOSCO Multilateral Memorandum of Understanding (MMoU) concerning consultation, cooperation, and the exchange of information. This is the first global MMoU among securities regulators to include detailed provisions on the regulators' responsibilities and facilitating an investigation into securities market crimes.

### 'Hot Money'

This refers to funds that are moved quickly by the owner from one investment to another to take advantage of changing international exchange rates and thereby earn high short-term returns.

Under the EU Memorandum of the Accounting Directive, companies must provide information about the use of special purpose entities (SPEs) even if they are not consolidated. SPEs should appear in the notes of financial statements.

### DID YOU KNOW?

#### Who is Accountable for a Company's Wrongdoing?

- Under the EU Transparency Directive, the Directors should issue a responsibility statement that, "to the best of their knowledge, the annual financial statements, prepared in accordance with the applicable set of accounting standards, give a true and fair view of the company's consolidated assets, liabilities, financial position, and profit or loss."

*The EU Directive sets higher requirements for auditors' professional ethics, qualification and control.*

- In the United States, under the Sarbanes Oxley Act of 2002, CEOs and CFOs must certify that each periodic report containing financial statements fairly presents the company's results. This law imposes prison sentences of up to 20 years and/or fines of up to US\$5 million for any CEO or CFO who willfully signs a false certification of a periodic report.

*In the United States, the control over auditors is regulated by the Sarbanes-Oxley Act.*

### LEARN MORE

**Global Corporate Governance Forum**  
2121 Pennsylvania Ave., NW  
Washington, DC 20433 USA  
Tel: +1 (202) 458-1857  
Fax: +1 (202) 522-7588  
cgsecretariat@ifc.org  
www.gcgf.org

### NEXT ISSUE:

Brazil's Institute of Corporate Governance has been a major success, inspiring other institutes on how to advance corporate governance in the board rooms. Their efforts come with several challenges.