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.

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

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
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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 invepante tifcerm i anc3(sb3(sd)--7( )]TJ T*(t)-7(h t)a7(do)11(es 0 Td [