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Financial market misconduct and agency conflicts: A synthesis and future directions☆

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ABSTRACT

This paper reviews recent research on the causes and consequence of different forms of financial market misconduct and potential agency conflicts and the impact of regulating financial market misconduct. We examine regulatory responses to financial market misconduct and highlight the presence of complementarities in financial market misconduct regulation and enforcement. We feature papers that make use of natural experiments, rule changes, and market design changes. Further, the interdisciplinary nature of financial market misconduct research is highlighted, and potential avenues for future research are discussed.

1. Introduction

Financial market misconduct and potential agency conflicts come in many forms. Insider trading (trading on material non-public information), financial restatements, and options backdating are some of the more common forms of misconduct. But the scope of misconduct is much wider and includes various other types of manipulative trading. For instance, there are a variety of specific forms of insider trading other than insider tipping such as front-running (brokers trading on the information in and in advance of a client's trade), violation of client precedence, and trading ahead of research reports. There are a variety of forms of price manipulation,

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including marking the open, marking the close, portfolio pumping with misleading end-of-the-month/quarter/year trades designed to influence marks to market, intraday ramping/gouging, market setting, pre-arranged trades, influencing or rewarding the employees of others, intimidation/coordination, and domination and control of market segments. Apart from price manipulation, volume can be manipulated through churning and wash trades. Further, market manipulators may engage in spoofing, which includes giving up priority, switches, and layering of bids/asks. Financial misconduct also encompasses false disclosure, which includes the dissemination of false and misleading information, and parking/warehousing (hiding the true ownership of securities). Other types of misconduct include broker–agency relationships such as improper trade through, improper execution, improper member use of exchange name, improper sales materials and telemarketing, and improper dealing with customers. Financial misconduct further includes numerous classes of agency problems, including, for example, conflicts of interest among investment banks in taking firms public, and more broadly, a variety of conflicts between equity holders and bond holders. Lawsuits may mitigate the effect of some of these conflicts, but at other times, they may exacerbate some of these conflicts.

Financial market misconduct is not merely an interesting scholarly area of study, but also one with meaningful practical industry and public policy implications. Dyck et al. (2010, 2014) and Karpoff et al. (2008a) show that fraud costs firms 20–38% of a firm's value, which aggregates to hundreds of billions in lost value per year in the US. Dyck et al. (2010, 2014) expect up to 14% of firms engage in fraud. Cumming and Johan (2013a) report SEC investigations among 2–5% of listed companies per year in the US. A broad cross-section of investment practitioners surveyed by CFA Institute (2014) cite market fraud, the integrity of financial reporting, and misselling as significant ethical issues facing global markets. Financial market misconduct is therefore widely recognized as being both common and costly, and hence is an important scholarly area of research in corporate governance and corporate finance, as well as microstructure, law and finance, and a number of related interdisciplinary fields.

The purposes of this paper are to review recent research on the causes and consequence of different forms of financial market misconduct, the impact of regulating financial market misconduct, and to suggest future directions of research. The review highlights the importance of papers that make use of natural experiments, rule changes, and market design changes to study the causes and consequences of financial market misconduct. Some insights drawn from the review include evidence that there are complementarities in different forms of manipulation, and evidence that there are complementarities in the regulation of different forms of manipulation. Further, the interdisciplinary nature of financial market misconduct research is highlighted herein, and we discuss how the array of interdisciplinary angles offers many interesting avenues for future financial market misconduct scholars.

This paper proceeds as follows. Section 2 describes research on the presence and determinants of financial market misconduct. The consequences of financial market misconduct are reviewed in Section 3. Section 4 presents research on the regulation of financial market misconduct. Section 5 discusses interdisciplinary approaches to financial market misconduct work and offers suggestions for future research. Concluding remarks follow in Section 6.

2. The presence and causes of market misconduct

2.1. The presence of market misconduct

What constitutes financial market misconduct? Insider trading, accounting fraud, and dissemination of false information are commonly understood forms of misconduct. But there are many other types of misconduct that compromise the integrity of markets and that are formally banned in many countries and exchanges around the world (see Table 1, and Cumming et al., 2011). Authorities commonly use computer surveillance algorithms to search for this type of misconduct (Cumming and Johan, 2008).

It has been long understood that uninformed speculators/manipulators can make profits from insider trading or the release of false information, as long as other investors attach a positive probability to the manipulator being an informed trader (Allen and Gale, 1992). In equilibrium, therefore, we expect a positive amount of manipulation (Allen and Gorton, 1992). Early empirical work has established that there is significant stock-price run-up and an increase in trading volume before takeover bids (Jarrell and Poulsen, 1989). But the pre-announcement run-up is largely, but not exclusively, attributable to insider trading (Meulbroek, 1992). It is difficult to sort out whether or not pre-announcement run-up is attributable to rational anticipation versus insider trading. King (2009) argues that insider trading is consistent with large abnormal turnover and abnormal returns on days when insiders are active, limited reaction to the announcement due to the price discovery ahead of the announcement; market anticipation by contrast is consistent with abnormal trading ahead of returns with rising serial correlation closer to the announcement date, and a significant market reaction upon announcement. Cumming and Li (2011) further distinguish between abnormal returns and market anticipation by examining the number of acquisitions previously made by firms (firms with a history of takeovers are more likely to be in the market again) and toehold positions (toeholds are potentially signaling a future takeover). Cumming and Johan (2008) explain that in practice, surveillance authorities look for patterns of activity that are otherwise difficult to explain by the manipulator. With a one-off manipulation, the manipulator likely has an alternative plausible explanation (or "APE" as it if often called in industry).

How often is financial market misconduct observed? Dyck et al. (2010, 2014) estimate that on average one out of seven large publicly traded US firms engages in fraud and destroys on average one fifth of their value, giving rise to an average cost of fraud in large corporations to be estimated at $380 billion per year. Karpoff et al (2008a) show that firms lose on average 38% of their value as a reputational penalty when fraud is revealed, well over 7.5 times the sum of all penalties imposed through the legal and regulatory system. Cumming and Johan (2013a) show that in the US, detected[3] fraud rates differ substantially by exchange, and yet investors

[3] The detected fraud statistics in Table 2 are litigated cases. These statistics are not the proven cases with judgments. See Cumming and Johan (2013a) for further details.

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