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Same rules, different enforcement: Market abuse in Europe ☆

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ABSTRACT

We present and analyze a novel set of enforcement data from the European Securities Market Authority during the period following the European Union's harmonized rule setting on securities market abuse. The data show significant differences in the intensity of enforcement across Europe. The empirical tests are highly consistent with the view that the intensity of enforcement is the most statistically robust and economically significant predictor of market abuse detection. In particular, the data identify three important arms of enforcement: the number of supervisors, which enhances detection; formalized cooperation, which facilitates surveillance; and imprisonment, which facilitates deterrence. We discuss research, practitioner implications, and policy implications for securities regulation across several key European countries.

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"The Debate Over Wall St. Enforcement

How much enforcement is enough to adequately oversee Wall Street and the major banks? Make regulations too onerous, and firms won't pursue potentially worthwhile investments for fear of huge legal bills if they are accused of violations. Too loose, and banks and brokers will run amok like schoolchildren when the teacher leaves the room, which is what happened in the years leading up to the financial crisis in 2008."

[New York Times, October 27, 2014.][1]

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[1] http://dealbook.nytimes.com/2014/10/27/the-debate-over-wall-st-enforcement/?_r=01

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1. Introduction

It is widely understood that there are important differences in securities laws across countries (La Porta et al., 2006), just as there are important differences in the enforcement of securities laws across countries (Jackson and Roe, 2009). This empirical evidence shows that both the design and enforcement of securities laws have important implications for the success of market activities, such as facilitating new listings and other capital raising activities. However, this evidence on rule design versus rule enforcement highlights the fact that we do not know exactly how important the enforcement of securities laws is in the context of a legal environment that possesses the same set of market abuse rules.

Put differently, in past years what actually constituted market abuse in securities laws has been inconsistently defined across countries, thereby making analyses of what works in detecting market abuse rather intractable. Recently, however, European Union directives have given rise to more harmonized market abuse definitions and rules (Cumming et al., 2011; Aussenegg et al., this issue). The recent release of market abuse statistics and enforcement data from ESMA (2012) provides a unique setting in which to analyze the importance of enforcement in detecting market abuse cases. This paper represents a first look at such data.

Academic, practitioner, and policy literature are consistent in highlighting the importance of analyzing factors that lead to differential detection of market abuse. There is a comprehensive debate about the effects of insider trading and market abuse on the well-functioning of financial markets (e.g. Manne, 1966; Leland, 1992). While the evidence on the social utility of insider trading is mixed, the conclusions about market abuses are rather obvious: Frauds harm the integrity of financial markets and disrupt the mechanism of efficient allocation of financial resources (La Porta et al., 1997, 1998; Easly and O'Hara, 2004; Djankov et al., 2008; Aitken et al., 2015), and more generally market misconduct affects firm financing policies and real outcomes (Giudici et al., this issue; Chen et al., 2015; Depken et al. 2010; Duran and Lozano-Vivas, 2015; Farag et al., 2016; Helwege, 2010; Li et al., 2016; Ma et al., 2016; Persakis and Iatridis, 2015; Shehzad and De Haan, 2015; Stenfors, this issue). Some firms are more prone to misconduct and fraud (Chaturvedula et al., 2015; Chen et al., 2013; Imisiker and Tas, 2013; Li et al., 2017) and take steps to protect against fraud (Boubakri and Bouslimi, 2016; Tennant, 2011). The 2008 to 2010 LIBOR manipulations established the biggest fraud activity in European financial markets to date. Record sanctions have been imposed and will probably continue in the ongoing process of settling all detected fraudulent acts. Despite the benefits of deterring fraud (Becker, 1968; La Porta et al., 2000; Djankov et al., 2003; Shleifer, 2005), there are costs to enforcement (Jackson and Roe, 2009). Our paper adds to this literature by studying a unique setting where rules are harmonized while enforcement is not. We make use of data to ascertain the precise marginal benefit of additional enforcement activity with respect to improved detection.

Our empirical analysis focuses on fraud in European financial markets. We utilize a unique data set provided by the European Security and Markets Authority (ESMA, 2012) on frauds detected by national competent[2] authorities between 2008 and 2010. This data allows us to elaborate on the criteria that affect fraudulent acts and their detection across time and countries. The data reveal several consistencies. First, increasing the resources for supervisory authorities strongly and reliably supports fraud detection. Our conservative estimates show that a 1-standard deviation increase in the number of supervisors (persons who work in the national banking and insurance supervisory authorities) is associated with an increase in detected fraud cases by 71%. Second, differences in enforcement rules pertaining to surveillance give rise to large differences in fraudulent acts. In particular, the application of formalized cooperation agreements between the supervisory and legal authorities is associated with a reduction in detected fraudulent cases by approximately 59%. We interpret this as a deterring effect caused by the threat of more efficient supervision and quicker reactions to committed infringements. Third, differences in enforcement rules relating to deterrence give rise to large differences in fraud. The data indicate that a one-year increase in the minimum imprisonment sanction reduces detected fraudulent cases by 10%. The legal obligation to publish the sanctions of market manipulators also has a strong effect on fraud deterrence. The economic significance of each of these effects is calculated relative to the average number of cases across countries and years. They are robust to unobserved heterogeneity and different estimation techniques.

In this paper, we examine detected fraud, not actual (unobserved) fraud. There could be differences between detected fraud and actual unobserved fraud across countries due to differences in national culture, for example. We do not find any cultural determinants of detected fraud across countries in our sample. Nevertheless, the data do indicate that countries with more capital market activity are more likely to detect market abuse. Similarly, the data highlight that the legal quality in a country, with respect to the protection of shareholders and lenders, mitigates infringement activity. Also, the data suggest that enforcement authorities are more vigorous in detecting and reporting fraud when minimum pecuniary fines are higher.

There are a number of policy implications from our analyses. Legal enforcement of market abuse comes in three primary forms: the direct expenditure on enforcement officers, the quality of surveillance through information sharing and cooperation, and the rules pertaining to deterrence. The ESMA data examined herein show that each of these three mechanisms is extremely important for detecting and deterring fraud. The examined data reveal effective mechanisms for politicians and regulators to fight fraud in financial markets and to increase investors' confidence in the existence of sound capital markets.

[2] ESMA uses the term competent authorities explicitly. It strengthens the notion that the national supervision and enforcement authorities are equipped with particular competences. We refer to the three terms (competent, supervision, and enforcement authority) synonymously in this paper.

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