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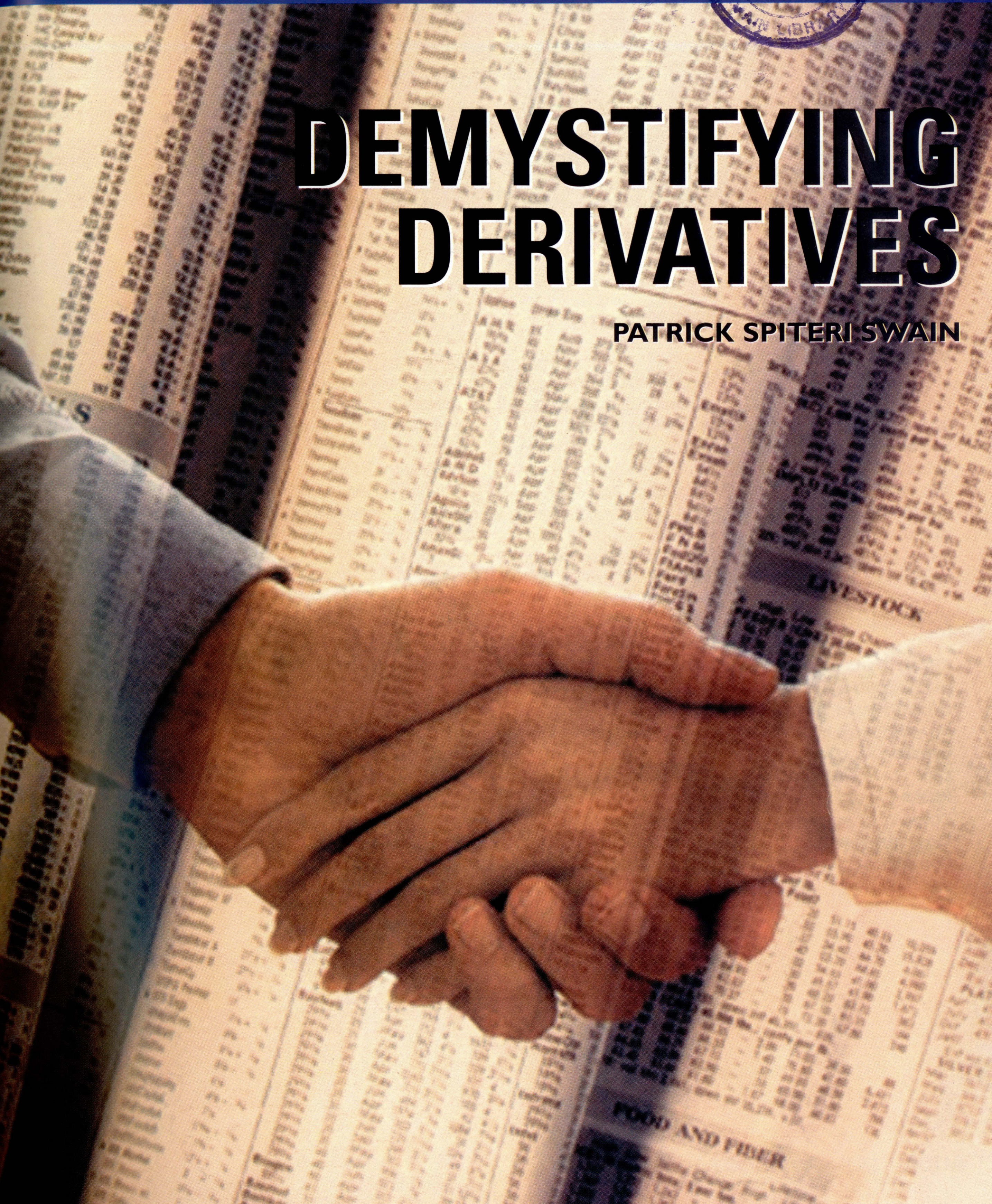

DEMYSTIFYING DERIVATIVES

PATRICK SPITERI SWAIN

1990-2005:

From insider dealing to market manipulation

by David Fabri

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SCOPE

Since 1st April 2005, the principal legislation on insider dealing and market manipulation is contained in the Prevention of Financial Markets Abuse Act[1] (PFMA). This Act has transposed the EU Market Abuse Directive (MAD)[2] and, in the process swept away the Insider Dealing and Market Abuse Offences Act of 1994[3]. The paper provides a brief introduction to the development of insider dealing and market abuse legislation in Malta. It describes aspects of the local and EU background to the new Act and reviews some of its significant features.

INTRODUCTION

Before 1990, Maltese law had no specific rule on insider dealing. Prior to the Malta Stock Exchange Act of 1990[4], no formal framework for a stock exchange facilitating the buying and selling of securities was available. The most one could find were a few patchy and ineffective rules in the Civil and Criminal codes and some very basic corporate governance rules in the then Commercial Partnerships Ordinance. With the advent of the Malta Stock Exchange, this had to change. In fact, the first definition (and regulation) of insider dealing was introduced in Maltese law by the Malta Stock Exchange Act. As an exchange relies on the public's trust and perception of fair dealing, it is easy to understand why insider dealing needed to be suitably tackled in a law establishing the Malta Stock Exchange.

Fifteen years have passed from the adoption of that pioneering Act. The 1990 provisions eventually gave way to the Insider Dealing Act of 1994. Later, in 2004, Malta became a full member of the European Union. This event signalled a silent revolution in the way we make and interpret legislation. Accession has played a very important part in our insider dealing legislation. This year, Malta transposed the MAD through the PFMA; another part of the Acquis which has now became an integral part of our domestic law.

THE TRANSPOSITION EXERCISE

The now repealed Insider Dealing and Market Abuse Offences Act had several short-comings and was not a simple law to enforce. Indeed. it failed to lead to any prosecution. The Act was revised in 2002 to ensure full compatibility with the original EU 1989 Directive on insider dealing[5]. This directive has now been repealed. Compared to the 1989 Directive, the more recent MAD presents a much more complex and ambitious blueprint. The older directive now appears simplistic and limited. The change mirrors an identifiable shift towards greater operational co-operation between member states, deeper harmonization of the securities legislation in Europe and a determination to clean up and require higher standards of conduct from participants in the financial markets. Other initiatives in a similar direction are currently underway with the recent wholesale revision of the Investment Services Directive[6], and the recent work on the new transparency and prospectus directives[7] . These measures will require further changes to our securities laws and regulations in the near future.

The Insider Dealing Directive of 1989 proved easier to transpose because it really was not such a complex document. The transposition of the new MAD presented a greater challenge. The passage of this directive through the various mandatory consultation and debate processes within the EU occasioned an impressive number of reports and detailed position papers, and the convening of many explanatory and drafting seminars and meetings. The Directive was adopted several months prior to Malta's entry into the EU, and came into force on the 12th October 2004. The Maltese transposing law came into force on the 1st April 2005, six months after the deadline fixed in the directive. Most member states have found difficulty to meet their transposition obligation. Indeed, a majority of member states missed the deadline. At the time of writing, a few member states

[1] Act IV of 2005.
[2] Directive 2003/6/EC of the European Parliament and of the Council of 28 January 2003 on insider dealing and market manipulation (market abuse) and its implementing measures.
[3] The then Chapter 375 of the Laws of Malta.
[4] Chapter 345 of the Laws of Malta now designated the Financial Markets Act.
[5] Directive 89/592/EEC coordinating regulations on insider dealing.
[6] Directive 93/22/EC of 10 May 1993 on investment services in the securities field (ISD) to be replaced by Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC (MIFID).
[7] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC (Transparency Directive);
Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC (Prospectus Directive).

still require several months before they can come fully in line by adopting the required laws and regulations. Generally, therefore, this directive has given member states, not excluding Malta, a number of drafting and juridical problems in implementing its requirements.

The transposition exercise in Malta suffered a delay in its early stages when it was being completed on the basis of amendments to the Insider Dealing and Market Abuse Offences Act 1994 as amended in 2002. The Act had only been very recently revised and improved and appeared to already provide for many of the new directive's requirements. Full transposition, it was believed, could be achieved through a number of additional well-placed amendments. In practice, it became progressively more evident that the current law did not offer a sustainable platform for the substantial reforms required by the new directive. A complete and faithful transposition of the directive would effectively have entailed amendments to almost every single provision of the Act. In the light of this assessment, it was decided that it would be simpler and tidier to start again from scratch. The Insider Dealing and Market Abuse Offences Act was therefore sacrificed and has now been substituted in its entirety. It is only fair to acknowledge that the 1994 Act had anticipated several of the important new requirements of the Directive. These include extending legal sanctions also to market abuse offences[8]; the designation of one single regulatory agency for overseeing the relevant rules[9]; and a framework allowing the exchange of information with overseas regulators[10].

The directive's requirement that a single competent authority should be designated to have responsibility to administer the new rules as required by the Directive was already satisfied in the shape of the Malta Financial Services Authority (MFSA). Since 2002 the MFSA has acted as the single unified regulatory authority for all financial services, and is the agency now primarily responsible for overseeing the workings of the rules governing insider dealing and market abuse. (Before 2002, that function was exercised by the Malta Stock Exchange in its regulatory role.) The general functions and powers of the MFSA result from the Malta Financial Services Authority Act[11]. The MFSA is the competent authority for the purposes of the Investment Services Act 1994[12] and the Financial Markets Act (FMA) of 1990[13], two very important laws that govern financial markets and securities business in Malta. Under these laws, the MFSA has been assigned considerable powers to carry out investigations and to obtain information. The FMA empowers the MFSA to obtain information and records from recognized investment exchanges.

The PFMA is now the most important source of Maltese law on insider dealing and market abuse. It will certainly be playing the leading role in this area. The Act has by itself implemented almost the entirety of the new directive. Some important rules are found in other laws, including the FMA, which sets out the framework for the establishment and supervision of securities and other investment exchanges, the appointment of a Listing Authority, the issue of Listing Rules, and related matters. These two laws have complementary objectives and it is therefore no surprise that some parts of the FMA have had to be slightly revised to bring them in line with the new insider dealing and market abuse law.

A particular provision in the FMA merits being highlighted. The Act establishes a judicial remedy through the already established Financial Services Tribunal (formerly designated the Malta Stock Exchange Tribunal). The remedy seeks to compensate persons who can prove to have suffered financial loss as a direct result of market manipulation by an identified defendant. This mechanism is exceptional and can only be availed of where the defendant has already been successfully prosecuted criminally[14]. If a prior conviction has not been secured, the request for damages under the FMA provisions would fail. This remedy has been available in more or less the same form since the coming into force of the 1990 Act and was retained in the 1994 and 2002 amendments. No proceedings have ever been attempted, and this reflects the absence of any successful local prosecution for insider dealing or market abuse.

Another unusual feature of the Maltese securities regulation architecture concerns the Registry of Companies. In fact, the MFSA's wide functions also incorporates the Registry of Companies which by administering the Companies Act 1995[15] plays a central role in company securities regulation. The Companies Act of 1995, another securities-related law, can potentially play a significant role in the enforcement of insider dealing rules. This Act assigns considerable powers of intervention to the Registrar of Companies, including the right to seize company records and investigate ownership of companies. The Registrar forms part of the MFSA structure and the Registry is housed in the MFSA premises. This should guarantee a high degree of co-ordination. The joint forces of the MFSA and the Registrar in accessing and obtaining information are considerable. These levels of regulation greatly facilitate the detection and investigation of market abuse activities and supplement the principles and mechanisms

8 Article 9A of the then Chapter 375 (now Article 8 of PFMA).
9 Article 10A of the then Chapter 375 (now Article 2 of PFMA).
10 Article 10A of the then Chapter 375 (now Article 20 of PFMA).
11 Chapter 330 of the Laws of Malta.
12 Chapter 370 of the Laws of Malta.
13 Chapter 345 of the Laws of Malta, originally designated the Malta Stock Exchange Act.
14 Article 36 of Chapter 345.
15 Chapter 386 of the Laws of Malta.

introduced in the new PFMA.

MAD requires that the regulatory agencies assigned responsibility for monitoring market abuses in the member states be properly equipped and resourced. This will enable them to perform their functions within their own jurisdiction and to adequately assist regulators from other member states interested in pursuing cross-border investigations. Article 12 of the directive therefore requires member states to ensure that their respective competent authorities have a number of specified powers considered essential to detect and punish market abuses. These include such new extraordinary powers as freezing of funds and the ability to collect telephone records. None of the laws mentioned earlier had ever expressly granted similar powers. In order to accommodate the variety of legal cultures and administrative procedures found throughout the recently enlarged European Union membership, the directive accepts that these powers may be exercised indirectly through the medium of some other public authority. This authority may be the Attorney General, the Police or the courts. Should a member state fail to place its national authority in a position to adequately assist other EU regulators in combating cross–border cases of market manipulation, it may find itself sanctioned for inadequate or incorrect transposition of EU law.

Indeed, intensive cross-border collaboration between regulators from different member states is a major pillar underlying the EU financial services regulatory framework and action plans. It is a major objective pursued by Committee of European Securities Regulators and its enforcement working group known as CESR-Pol. The MAD envisages extensive collaboration between regulatory agencies from different member states where financial services wrong-doing straddles their borders. More generally, EU Directives in this area have progressively increased the expected level and quality of information-sharing and other forms of supervisory assistance between member states. Article 16 of the directive returns to this important theme, imposing strict obligations of assistance and co-operation which now cannot be qualified by such considerations as cost-sharing or equivalence of confidentiality or regulation.

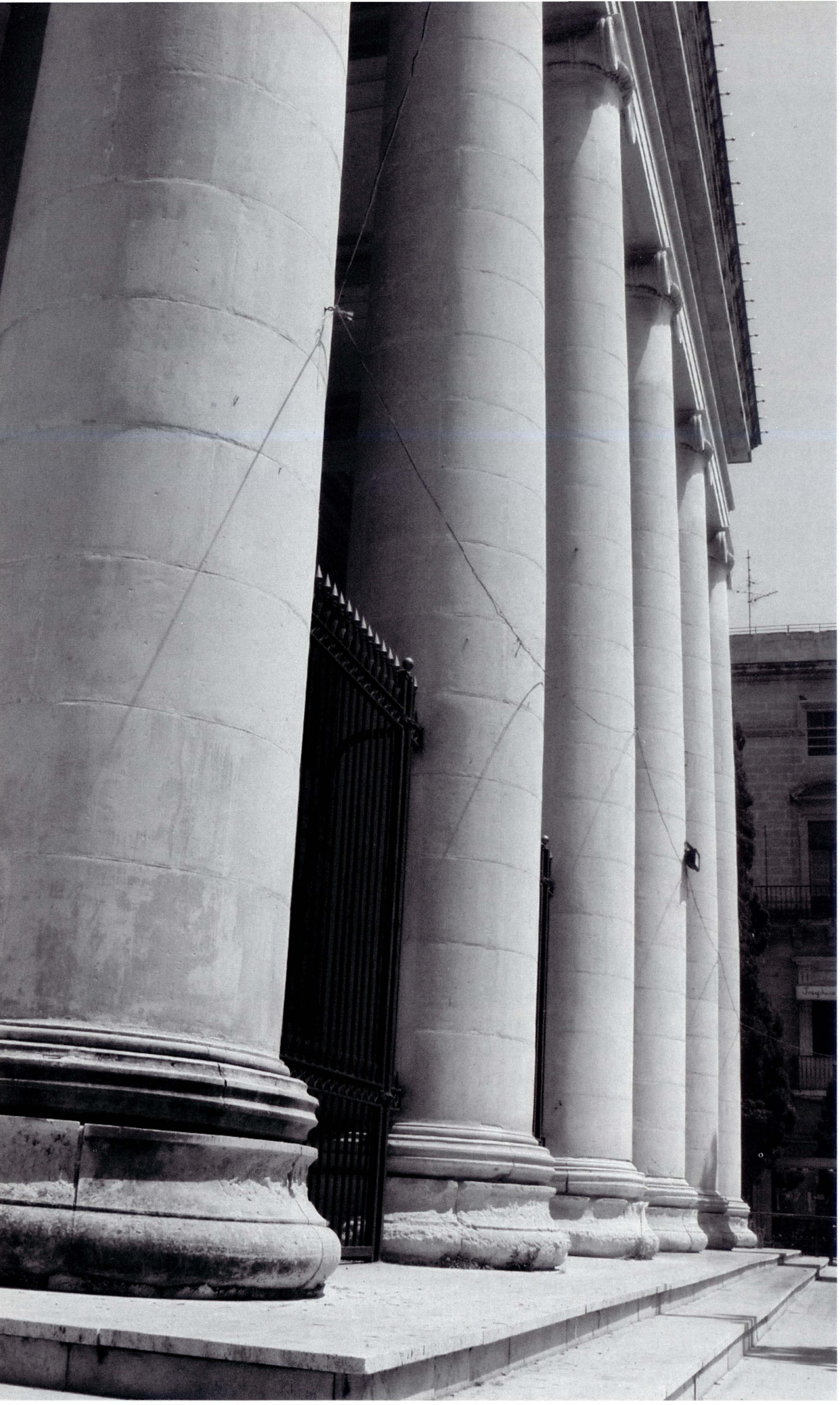
The various pieces of legislation which regulate and describe the powers of the MFSA already create an extensive network of supervisory and investigative powers which may be utilized both to tackle domestic issues and to assist foreign regulators. Article 10A of the Insider Dealing and Market Abuse Offences Act, inserted in 2002, had enhanced these powers. The Act already allowed the MFSA and the Registrar to co-ordinate their efforts, and to exchange information with other regulatory and enforcement authorities in Malta and overseas. In this way, the requirements of Article 12 and 16 of the directive had already been adequately catered for in the now repealed Act.

An important issue arising from the directive requirement regards "*administrative measures*". National competent authorities are required to put in place these measures in order to be able to pursue and punish administratively any identified perpetrators of insider trading and market abuse offences. Article 14 of the directive requires the

introduction of "*effective, proportionate and dissuasive*" administrative sanctions against market abuse offences. This article operates "*without prejudice to the right of member states to impose criminal sanctions*". An initial reading of the directive may give the impression that a member state could choose to punish insider dealing and market abuse offences through the workings of criminal law, and stop there. The correct reading instead is that even though criminal law sanctions are in place, a member state is still obliged to adopt appropriate administrative measures and sanctions. Prior to the PFMA, Maltese law punished these offences very severely but only as criminal offences.

The mandatory introduction of administrative measures to deal with the market abuse part of the directive has probably caused the most difficulty, not only in Malta but also in other EU states. The old law only dealt with market abuse offences as criminal offences and punished them accordingly. This would not be sufficient for the MAD. The clear implication is that criminal law sanctions have been deemed insufficient (and possibly also inefficient), but member states were allowed to decide whether they should also use the criminal law. The PFMA chose to retain both procedures. Accordingly, the new administrative sanction shall now have to co-exist with the criminal sanction.

The problem is that the same wrongdoing or omission may now amount both to an administrative contravention and to a breach of the criminal law. Once it may refer to the same wrong-doing, the risk of overlap and the application of the so-called "double jeopardy" rule may have to be considered. Article 22(5) of the new Act states that the imposition of an administrative penalty does not preclude the institution of criminal or civil proceedings. It also provides that where in respect of a specific act of default, which also amounts to a breach of a criminal provision, an administrative fine has already been imposed by the competent authority, no criminal proceeding may be taken in respect of the same act or omission.



rules and sanctions also apply to other persons who, though not actually engaging in dealing, may have encouraged or advised others to do so in an illicit manner, particularly on the strength of inside information.

One can possibly distinguish the two forms of sanctions in accordance with these respective criteria:

Administrative fines would be characterized:

- by the relatively smaller amounts (only up to LM 40,000 or whatever and not including imprisonment),
- by the role of the Competent Authority which alone imposes the fine
- by the possibility of an appeal to the Financial Services Tribunal
- by the non-intervention of the Attorney General in the process

Criminal sanctions would be distinguished:

- by the requirement of the Attorney General's approval to authorize proceedings
- by the non-involvement of the Competent Authority
- by the applicability of the criminal law, procedure and relative appeals
- by the possible imposition of much higher punishments (up to Lm400,000 and including imprisonment) than are foreseen for administrative fines

Another novel requirement of the Directive now incorporated in the new Act is the duty to report suspicious transactions. Clearly borrowed from its money-laundering precedent, this mechanism is found transposed in Article 11. A uniform format for such reports is available. Article 36 of the FMA had already regulated what a recognized investment exchange, like the Malta Stock Exchange, should do when it suspects or become aware of insider dealing or market abuse. In the PFMA, this provision has been broadened and is now subject to a formalized procedure.

Another major issue that arises in this context is how the law should deal with market abuse offences committed by ordinary persons, that is persons who are not licence-holders and not directly subject to the normal regulatory reach of the supervisory authority. (Supervised persons would include stockbrokers and directors of listed companies.) The PFMA is now clear that even ordinary investors caught abusing the financial market may henceforth become subject to administrative measures including possible substantial fines. In this respect, the PFMA adheres to the directive. Henceforth, a person, including a private individual, who deals (buys or sells), on a regulated market[16] is considered an active participant in that market and thereby deemed to have voluntarily accepted any applicable rules (and sanctions) for wrongful acts involved in trades on such markets. Some of these rules are now found in the PFMA. The

The MAD also seeks to increase transparency and early disclosure of price-sensitive information. Evidently, the chances of insider trading or market abuses are reduced if proper and timely disclosure is made by public issuers. This places all investors on a level-playing field and militates against the dangers of selective or abusive use of confidential information. Similar rules founded on the same objective are already well-established in the Listing Rules issued in terms of the FMA. The new requirements

16 The Malta Stock Exchange is the only regulated market in Malta.

of the PFMA should be seen as complementing the rules already set out in the current Listing Rules. In fact, the duty to inform the public of inside information as soon as possible was already found in the Listing Rules. However new rules have had to be added, particularly to satisfy the new rules referring to reporting of transactions by managers and the new obligations governing "*persons who produce or disseminate research*".

The new Act introduces new obligations on persons who publish or broadcast information relating to specific financial instruments. The legal requirements are really quite basic and should provoke no controversy or hardship. The law requires that such information be published fairly and objectively and with such verification and caution that proper journalists are expected to take. At this point, it would be interesting to dwell briefly on the position of journalists and similar media persons under this Act. The word "journalist" has been avoided in the drafting as it is devoid of a precise legal meaning. The new Act does not attempt to define the word "journalists", which in fact is not defined in any of our financial legislation. Nor is there a definition in our Press Act which is the main legislation to affect the work of journalists. As a consequence, one would have to look at any issue that may arise on a case by case basis.

The local problem is compounded by the consideration that journalists are not regulated or licensed or authorized in any manner. There is no law which specifically regulates their profession and there is no proper structure for self-regulation. Journalists require no specific qualifications or credentials, and one cannot refer to an identifiable binding rule-book, a breach of which could lead to possible suspension or withdrawal of the authority to describe oneself and to work as a journalist. No self-regulatory body for journalists exists. What we find is a voluntary Institute grouping members of this category, but many journalists and columnists are not even members. Although the PFMA makes no reference to "journalists", there is no doubt that some of its provisions are extremely relevant to persons who may contribute comment and analysis in the media on financial instruments[17].

The requirements of Article 13 of the Directive imposing professional secrecy are already provided for in Maltese law through the Professional Secrecy Act 1994, whereas Article 8 which refers to buy-backs had to be transposed by special provision.

Conclusion

The transposition of MAD has doomed Chapter 375 of the Laws of Malta to legal history: another law to fall "victim" to Malta's EU membership. It has had a brief, historically significant and yet unspectacular existence. Indeed, it did not lead to a single prosecution for insider dealing (since 1994) or market abuse (since 2002). On this ground alone, one cannot describe the 1994 Act as having been a success. Its laborious and obtuse drafting style may have proved its worst failing. It is not sorely missed and is indeed already forgotten. On the other hand, it is still too early to judge the effectiveness of the recent new 2005 PFMA or to identify its possible strengths and weaknesses.