

## *The Market Abuse Directive (2003/6/EC) on insider dealing and market manipulation (market abuse) - manipulation of a highly illiquid security*

When the Danish High Court Western Division on 13 May 2015 acquitted four defendants for violating the prohibition of manipulation in the Danish Securities Trading Act, the Supreme Court was of the opinion that the High Court had based its decision on a misunderstanding of the concept 'value in the market' as used in the Danish legislative implementation of the Market Abuse Directive (MAD).

According to the Supreme Court, which first in a separate case on 14 December 2000 and most recently in the present case, and more extensively, on 24 August 2016, ruled on the issue, the clear starting point is the most recently listed stock market price, where the price is the result of a trade between independent parties with opposing interests. Therefore, it is irrelevant how the spread between bid and tender looks like at that time. But what if the listed stock market price does not reflect the real value in the market?

Although the Supreme Court continues to assert its opinion, there have been changes in the regulation and the formulation of the crime content no longer contains the same concepts. This decision sheds light on how the Danish Supreme Court understands the concept of manipulation, and although it was decided according to MAD, it may also have relevance in respect of the Market Abuse Regulation that replaced MAD on 3 July 2016.

### **The legal background**

In connection with the application of the 2<sup>nd</sup> Stock Exchange Reform (Betænkning 1995 1290), the Danish Securities Trading Act was adopted (L 1995 1072), and a specific prohibition of manipulation was introduced into Danish securities trading supplementing a much older and less used general prohibition on manipulation in the Criminal Code. The prohibition of manipulation was quite briefly regulated and was inserted in section 39 and supplemented with a prohibition of aiding manipulation. The definition of manipulation was stated in section 34, subsection 3, and therefore it could be said that the prohibition of manipulation had a quiet existence compared to the abuse of inside information (the prohibition of insider dealing), which had been introduced into Danish

securities regulation in 1986 and subsequently amended by the implementation of the Insider Dealing Directive.

In 2000, the EU Council called for the establishment of a framework for financial markets, as there was a need to protect market integrity as a result of the financial and technical developments that provided an incentive for market abuse and the existing regulation was incomplete. This resulted in the adoption of the Market Abuse Directive 2003/6/EC (MAD) on criminal sanctions that entered into force on 12 April 2003.

MAD was to be implemented before 12 October 2004. The implementation was done in section 38 and 39 of the Danish Securities Trading Act (L 2004 1460). At the same time, the concept of manipulation was given a broader definition. The Act made a reference to the condition that the action shall be suitable for influencing the price in a direction that deviates from the listed stock market price.<sup>1</sup>

In 2009, the Larosière Group carried out a study which showed that Member States' sanctions were weak and heterogeneous and that a new legislative instrument was needed to ensure uniform rules and clarity on key concepts. On this basis, the Market Abuse Regulation 596/2014 (MAR) was applied and entered into force on 3 July 2016. Taking into account the legal framework established by MAR and its implementing measures, the Directive on Criminal Sanctions for Market Abuse 2014/57/EU (MAD II) was applied and entered into force on 3 July 2016 in parallel with MAR.<sup>2</sup> At the same time, MAD was repealed.

The overall purpose of MAR is to have a uniform interpretation and application of the rules on market abuse. As far as the prohibition of manipulation is concerned, the scope of MAD and MAR is the same, but MAR contains a number of clarifications, including that manipulation is also prohibited by the use of high-frequency trading or a derivative financial instrument.<sup>3</sup>

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<sup>1</sup> The Danish Securities Trading Act section 38, subsection 1: "Ved kursmanipulation forstås handlinger [...], der er egnet til at påvirke kursen på værdipapirer [...] i en retning, der afviger fra disses værdi i markedet..."

<sup>2</sup> As far as criminal law is concerned, Denmark has a legal reservation to the treaties, and therefore MAD II does not apply.

<sup>3</sup> The concept previously known in Danish law as "price manipulation" has been changed to "market manipulation" in accordance with the English translation of MAR. The change is due to the development that has taken place in the trading of securities, where securities are currently traded on several marketplaces, and where securities can be interdependent, so that manipulation with one financial instrument can have derivative manipulative consequences for another financial instrument. Furthermore, the change is a signal that not only price changes are relevant, but also

## The case

The question for the Supreme Court was whether there was a basis for repealing the Danish High Court Western Division's judgment and remanding the case because the High Court Western Division, in assessing whether two purchase orders deviated from the bond's 'value in the market', had applied section 38, subsection 1 of the Danish Securities Trading incorrectly.

## The indictment

On 17 October 2014, the Danish Prosecution Service indicted four defendants for violating the prohibition of manipulation:

- A limited liability company (T1) for being responsible for T2 taking actions that were suitable for influencing the price of the bond in a listed company in a direction that deviated from the value in the market.
- The director of the limited liability company (T2) for having executed purchase orders, which were suitable for giving incorrect or misleading signals about the demand for and the price of the bond and thus ensuring that the price was at an artificial or abnormal level.
- A bank (T4) for principally being responsible for T3 helping to execute purchase orders, and subsidiarily for being responsible for T3 failing to notify the Danish FSA of purchase orders, even though it could be assumed that the execution violated the prohibition of manipulation.
- The trader (T3) for principally having assisted in executing purchase orders, and secondary for failing to notify the Danish FSA of purchase orders, even though it could be assumed that the execution violated the prohibition of manipulation.

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consideration for the market, including that price formation in the market has taken place on an incorrect and incomplete basis, cf. Revision & Regnskabsvæsen.5.2016.46, section 8, note 69.

## The subject

The issuer of debt instruments (bonds) was in financial distress and had issued a series of negative company announcements and the trades in the bonds carried out at a low price. Furthermore, the spread between the best bid and tender was from 1.1 to 73 reflecting substantial uncertainty in the market as to the proper valuation of the bonds. In the period between 29 December 2011 and 30 December 2011, T2 and T4 had been in telephone contact and discussed the possibilities of purchasing bonds in the company, which T2 already owned a large portfolio of.

On 30 December 2011, which was the last trading day of the year, T2 assessed that the price had traded too low at a price of DKK 0.04, and therefore - on behalf of T1 and through T3 - placed a purchase order on the bond at a price of DKK 35, which was in the middle of the spread. The purchase order was canceled by the Danish Stock Exchange (Børsen), as the purchase order was considered an error. Subsequently, T2 placed a purchase order on the bond at a price of 30, which was completed, as there was a match between bid and tender.

## The City Court in Herning: Judgment of 17 October 2014

The majority in the City Court assumed that the bond was illiquid at the time of trading, and therefore there was no market for the bond or a market that could form the basis for manipulation. Since the purchase order for price 35 was within the spread, which had bid and tender between 0.04 and 73, explanations regarding the valuation of the bond could not be disregarded either. Therefore, the defendants were acquitted.

The minority in the City Court assumed that T1 and T2 should be convicted for manipulation according to the Danish Securities Trading Act, section 38, subsection 1, as the purchase order had to be assessed as an act that was suitable for manipulating the price formation. In addition, the minority noted that T3 and T4 should have realized that the purchase order was suspicious and therefore reported the purchase order to the Danish FSA.

Thus, the City Court ruled that the defendants should be acquitted for manipulation, as the bond was illiquid, and the purchase order was within the spread.

### The High Court Western Division: Judgment of 13 May 2015

On appeal, the High Court Western Division ruled that the bond had a limited bid and tender, and that there was a significant spread between the bid and tender prices. The spread had to be seen as an expression of an obviously different perception of the value of the bond. In addition, during the last months of the year, the bond was traded only a few times and at different prices and with a low volume.

Thus, the High Court Western Division assessed that the purchase order was not suitable for influencing the price of the bond in a direction that deviated from the bond's value in the market, and therefore upheld the City Court's acquittal with reference to section 38, subsection 1 of the Danish Securities Trading Act as not violated. In addition, since there was not offence, T3 and T4 were acquitted of failing to report the purchase order to the Danish FSA.

### The Supreme Court: Decision of 30 June 2016

The Danish Prosecution Service appealed the High Court Western Division's ruling to the Supreme Court on a limited appeal (kære) on the question of the application of law. In this connection, the four defendants requested a preliminary ruling to be submitted to the European Court of Justice on the interpretation of section 38 and 39 of the Danish Securities Trading Act regarding manipulation.

The Supreme Court ruled that the rules on manipulation in section 38 and 39 of the Danish Securities Trading Act were intended to implement MAD. It was the Supreme Court's opinion that the rules on manipulation in MAD according to their wording, purpose and practice did not give rise to doubts on the interpretation of EU law and consequently the Supreme Court ruled rejected a preliminary application to the European Court of Justice.

### The Supreme Court: Decision of 24 August 2016

The issue for the Supreme Court was that the Danish Securities Trading Act's provisions on manipulation (§§ 38 and 39) had been repealed from 3 July 2016, as MAR had entered into force. This meant that the Danish Securities Trading Act, subsection 1, nos. 2 and 4 were replaced by MAR article 12, para. 1, letter a, nos. 1 and 2. Although neither MAD nor MAR contains a provision which

corresponds to the Danish Securities Trading Act, section 38, subsection 1, it was the Supreme Court's assessment that the conditions in the Danish Securities Trading Act subject to MAD should be applied in respect of manipulation due to the Danish criminal rules on inter-temporary statutes that require the courts to apply the most lenient statute either in force at the time of the transactions or at the time of the court's hearing.

The Supreme Court referred to a case of illiquid securities from 14 December 2000, in which the Supreme Court first defined the concept 'value in the market' as the listed stock market price. The Supreme Court then referred to the preparatory work and considerations behind the provisions on manipulation in the Danish Securities Trading Act (L 2004 1460) and found that the amendment did not change the understanding of 'value in the market' that followed from its previous judgement of 14 December 2000.

Therefore, it was the Supreme Court's assessment that the concept 'value in the market' must be understood as the most recently listed stock market price, where the price is the result of a trade between independent parties with opposing interests, i.e. a trade where the seller wants to achieve the highest possible price and the buyer wants to buy as cheaply as possible. According to the Supreme Court, no emphasis can be placed on the fact that in assessing whether an action is suitable for influencing the value in the market, there is a large spread between the bid and tender prices. The explanation is that the spread does not represent a decision to transaction but only indicates a willingness to do so.

Further, the Supreme Court stated that a transaction may deviate from the latest stock market price achieved in a previous transaction if that stock market price is not a fair expression of 'the value in the market'. This may be the case if, after the most recently listed stock market price, general changes have occurred in the market, such as interest rate changes, or an issuer via company announcements (or similar) have provided information that has an impact on the value of a security. On the other hand, the Supreme Court emphasized that a price which is stated in a sales order, but which does not lead to a trade, does not in itself show that the most recently listed stock market price is not true.

The Supreme Court held that the High Court Western Division had failed to apply the correct understanding of the statute and consequently failed to use the most recently listed stock market

price from 28 December 2011 in assessing the value of the bond in the market when the purchase orders were placed as it should have done.

Thus, the Supreme Court judged that the High Court Western Division had misinterpreted the concept 'value in the market' as applied in the Danish Act, and therefore set aside the High Court Western Division's judgment and remanded the case to the High Court Western Division for reconsideration.

#### The High Court Western Division: Judgment of 9 November 2017

On 9 November 2017, the High Court Western Division ruled on the case again. In accordance with the Supreme Court's decision of 24 August 2016, this time the High Court stated that in assessing 'value in the market', the clear starting point is the most recently listed stock market price, where the price is the result of a trade between independent parties with opposing interests. Further, the listed stock market price may be deviated if it is not a fair expression of 'the value in the market'.

In regard to its decision, the High Court took the listed stock market price on 27 and 28 December 2011 into account and assumed that the bond's value in the market on 30 December 2011 corresponded to a level between price 1 and price 5. Therefore, it was the High Court's assessment that the purchase orders at price 35 and price 30 very significantly exceeded the value of the bond in the market and that the purchase orders were suitable for influencing the price in a direction that deviated from the value in the market.

Thus, the High Court Western Division stated that the purchase orders constituted intentional manipulation and were covered by section 38, subsection 1, nos. 2 of the Danish Securities Trading Act. On the other hand, the purchase orders were not covered by section 38, subsection 1, nos. 4 as the purchase orders did not secure the price at an artificial or abnormal level. Moreover, the High Court found that the purchase orders were covered by MAR article 15, cf. article 12, para. 1, letter a, nos. 1 and para. 4.

Therefore, the High Court Western Division punished the four defendants for violating the prohibition of manipulation as:

- T1 (the company) was responsible for T2 taking actions that were suitable for giving incorrect or misleading signals about the bond's value in the market. Punished with a fine of DKK 100.000.
- T2 (the director of the company) executed the purchase orders, which were suitable for giving incorrect or misleading signals about the bond's value in the market. Punished with a conditional sentence for 30 days.
- T4 (the bank) was responsible for T3 failing to notify the Danish FSA about T2's purchase orders. Punished with a fine of DKK 25.000.
- T3 (the trader) failed to notify the Danish FSA about T2's purchase orders, even though T2 indicated his desire to achieve a large increase of the bond's value in the market. Punished with a fine of DKK 10.000.

### New practice

In a recent case, which was judged on 6 February 2020, the Supreme Court stated that the listed stock market price of a bond could not be considered a fair expression of the bond's value in the market. Therefore, the Supreme Court found that there were special circumstances which meant that the valuation of a debt had to take place on a different basis. As the Danish Tax Authorities' estimated value of the bond did not differ significantly from an assessor's assessment of the bond's value in the market, the Supreme Court ruled that there was no basis for assuming that the Danish Tax Authorities' estimates were based on an incorrect or deficient basis or that the estimate was unreasonable.

It seems that the Supreme Court has continued its opinion from the judgment of 24 August 2016. Although the stock market price is usually an expression of the value in the market, this does not mean that an older stock market price where the value of a security is very uncertain can be chosen. Instead, the stock market price must be deviated if the stock market price is not a true expression of the value in the market.

## Conclusion

New practice shows that the Supreme Court's judgment of 24 August 2016 under MAD continues to have an impact on cases regarding manipulation after the application of MAR.

As MAR does not contain a provision which corresponds to the previous Danish Securities Trading Act, section 38, subsection 1, on the concept of 'market price', it is no longer a condition for being convicted for manipulation that an action is suitable for influencing a price in a direction that 'deviates from the value in the market'. However, the Supreme Court's emphasis that manipulation affect the 'market price' understood as the most recent transaction entered into on the market is probably still relevant. Equally, the Supreme Court's contention that the most recent transaction may lose its relevance if new circumstances become known to the market, in which case such 'stale prices' may be disregarded.

Since the Danish Securities Trading Act, section 38, subsection 1, nos. 2 and 4 has been replaced by MAR article 12, para. 1, letter a, nos. 1 and 2, the Supreme Court's judgment of 24 August 2016 will continue to have an impact on behavior that constitutes manipulation.

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