White Collar Crime - Switzerland

Front running qualifies as management fraud

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Introduction

In a recent ruling the Zurich District Court qualified the exploitation of advance knowledge of an upcoming client transaction to one's own advantage (ie, so-called 'front running') as management fraud. The court found an asset manager working for insurance companies and pension funds and his accomplice guilty because they took positions in securities to capitalise on upcoming client transactions and then sold these securities at a gain. Specifically, the asset manager passed information to his accomplice regarding upcoming large purchase transactions which he was going to execute for his employer on behalf of insurance companies and pension funds. The accomplice then bought the same securities for his custody account and later sold them over the counter at manipulated prices to the insurance companies and pension funds represented by the main defendant and via the stock exchange to independent third parties. The two defendants shared the profit of more than Sfr3 million on these transactions.

No violation of insider rules and prohibition of price manipulation

The events underlying the case before the Zurich District Court occured before October 1 2008. In the version of the law valid at that time, the insider rules as defined in Article 161 of the Penal Code applied only to the exploitation of advance knowledge of the impending issue of new securities, an alliance between companies, or similar circumstances of comparable importance. Front running was not included.

According to the version of the insider provision that has applied since October 1 2008, front running does not usually constitute a criminal offence, since individuals who engage in front running often do not qualify as 'insiders' as defined by the insider penal provisions. Insiders include only the members of the board of directors, the executive board and the auditors, as well as the persons mandated by a company, members of a public authority and public officers and the assistants of these individuals. Neither an asset manager who works on behalf of an institutional investor – such as the main defendant in this case – nor other employees of financial service providers qualify as insiders. In addition, front running does not always involve a substantial impact on the price of shares. Under the insider rules, only the exploitation of a fact whose disclosure can be anticipated to have a significant influence on the market price of shares traded on the Swiss stock exchange is punishable. Front running often exploits price fluctuations that are likely to occur but are relatively small and can therefore not be classified as significant.

In the case before the district court, the price of the securities was driven up specifically in favour of the defendant and to the detriment of the portfolio under management as the transactions were executed aggressively. The defendants also placed limited sales orders that were far removed from the current price but were then executed due to a lack of other offers and were serviced by corresponding purchase orders for the client's portfolio. Although the price of shares traded on the stock exchange was manipulated in this case, the prerequisites of price manipulation pursuant to Article 161*bis* of the Penal Code were not fulfilled. Article 161 imposes punishment only for the dissemination of misleading information or fictitious purchases, and does not cover real transactions with a manipulatory background such as front running.

Even after the recent Federal Council proposal to revise the provisions on stock exchange offences and market abuse, front running is unlikely to meet the new criminal provisions for insider trading and price manipulation. which should be transferred from the Penal Code to the Federal Law on Stock Exchanges and Securities Trading. However, the proposal includes a recommendation to introduce either a special rule or a general clause which would make front running punishable by the market supervision authorities.

Zurich District Court arguments

To date, front running in Switzerland has been managed mainly through supervisory regulations and various professional codes of conduct. For example, front running by securities traders violates their duty of loyalty and their duty to exercise proper care (in particular, the best execution of client orders). The Swiss Bankers Association's guidelines to guarantee the independence of financial analysis also prohibit front running.

The recent Zurich District Court ruling represents the first time that front running has been subject to criminal penalties. The court qualified the front running by the defendants as multiple management fraud as defined in Article 158 of the Penal Code, and as constituting the aiding and abetting of management fraud. According to the court, the main defendant in his capacity as portfolio manager and a member of the management (ie, authorised officer) of an asset management company met the conditions for a perpetrator of management fraud. He qualified as a manager because it was part of his remit to manage third-party assets – that is, to manage the assets of the injured insurance companies and pension funds – in their best interests. He therefore had the required measure of independence, which is confirmed by the fact that he took decisions to trade in specific equities at his own responsibility. That the general investment policy was mainly decided by his line managers does not change this. According to the court, the main defendant violated his contractual duties of loyalty by failing to execute the share transactions for the portfolios managed by him at the best possible conditions and paying excessive prices after he deliberately manipulated the price.

The court assessed the damage to be equal to the gain earned by the defendants minus the gain generated by sales of shares by the defendants to third parties. The decision can be interpreted to mean that the gain earned on sales of shares by the defendants to third parties was deducted because the injured parties were not involved in these transactions and, therefore, they did not suffer any losses on these sales. The loss therefore relates to the fact that the share transactions executed on behalf of the injured insurance companies and pension funds were settled at worse conditions.(1) It can therefore be assumed that the defendants would also have been punished if they had sold their shares to third parties only.

The main defendant, who pleaded guilty, was sentenced to a conditional prison sentence of 21 months. His accomplice, who did not plead guilty, was sentenced to a prison sentence of three years for front running and other offences, part of which will be imposed.

Comment

The judgment is not yet final, and it remains to be seen if the Zurich Superior Court will confirm the judgment of the Zurich District Court.

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Endnotes

(1) The difference between the actual purchase price paid by the injured parties and the hypothetical purchase price which could have applied if the transactions were to have been carried out immediately.

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