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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.

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, 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, Dyck et al., 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, Dyck et al., 2014 expect up to 14% of firms engage in fraud. Cumming and Johan, 2013a, Cumming and Johan, 2013b 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 mis-selling 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.

Section snippets

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...

Consequences of financial market misconduct

Research on the consequences of financial market misconduct can be grouped into four types of papers. These papers are summarized in Table 4. First, there are papers that examine the managerial consequences to financial market misconduct. Karpoff et al. (2008a) show that, among individuals identified as responsible for financial misrepresentation in the US, 93% lose their jobs, 28% face criminal penalties, and jail sentences average 4.3 years. Bereskin et al. (2014) show that there is a greater ...

Regulation of insider trading

Regulations banning insider trading were adopted in many countries around the world from the 1960s through the 1990s, but they appear to have been ineffective. Early evidence from Seyhun (1992) shows that US regulations pertaining to insider trading had no impact on insider trading activities and profits, but enforcement activities were effective in reducing insider trading activities (see Table 5). In Garfinkel (1997), the 1988 Insider Trading and Securities Fraud Enforcement Act (ITSFEA) in...

Future directions

Research on financial market misconduct is a growth area of research. Fig. 1 clearly shows that research on "financial market misconduct" (and corporate fraud and insider trading) has grown at roughly double the pace as that on corporate finance in general from 2000 to 2015. Similarly, research on "financial market manipulation" has at almost double the past as research on "market manipulation" in general. A strong divergence in these research streams is notable since the global financial...

Conclusions

This paper reviewed recent research on the causes and consequence of different forms of financial market misconduct. We also examined the impact of regulating financial market misconduct. We provided data from Google Scholar that clearly show that financial market misconduct and fraud have been growth areas of research, particularly since the financial market crisis. Despite the massive growth in research in this area, we highlighted a large number of gaps in the literature and directions for...

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