PacificCPE

COURSE
11452B

Classifying Financial Misconduct and Market Penalties

Understanding how financial misconduct is categorized is essential for anyone working near regulated markets. This course presents a structured taxonomy of financial market misconduct, helping you identify and distinguish between different types of problematic behavior. You'll also examine how markets themselves impose penalties on bad actors—beyond formal regulatory action. For CPAs and financial advisors, this knowledge supports better risk assessment, client advisory work, and due diligence when evaluating entities operating in complex financial environments.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall various schemes and characteristics associated with financial market misconduct.
- Identify the various financial regulations used in the U.S. to combat corporate misconduct.

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TABLE OF CONTENTS

CHAPTER 01

A Taxonomy Of Financial Market Misconduct 4

1.01 3.1 Introduction 4

1.02 3.2 Challenges In Research On Financial Market Misconduct 9

1.03 3.3 Defining Financial Market Misconduct 10

1.04 3.4 Defining Financial Fraud 18

1.05 3.5 Conclusion 20

Test Your Knowledge 23

CHAPTER 02

Financial Misconduct And Market-Based Penalties 27

2.01 4.1 Introduction 27

2.02 4.3 Financial Reporting Misconduct And Legal Redress 31

2.03 4.5 Legal Versus Market-Based Penalties For Financial Misconduct 36

2.04 4.6 Firm-Level Penalties For Corporate Financial Misconduct 37

2.05 4.8 Causes, Risks, And Moderators Of Financial Misconduct 55

2.06 4.10 Concluding Remarks 72

Test Your Knowledge 75

Final Exam Copy 106

Glossary 79

Index .....

Chapter 1: A TAXONOMY OF FINANCIAL MARKET MISCONDUCT

Chapter Objective

After completing this chapter, you should be able to:

- Recall various schemes and characteristics associated with financial market misconduct.

3.1 INTRODUCTION

What is financial market misconduct? Generally speaking, any practice that is "unfair" to market participants can be considered financial market misconduct, but a precise definition of the term is difficult to specify.[1] As such the range of activities that potentially fall under the scope of financial market misconduct is quite broad. To paraphrase the words of a cotton trader from a testimony before a Senate Committee in the 1920s, the term "financial market misconduct" is so broad that it can include any operation in financial markets that does not suit the person who is speaking at the moment.[2]

Concerns related to financial market misconduct have bedeviled market participants since the dawn of financial markets. The first recorded incident of financial market misconduct was sometime in the third century BCE, when a Greek merchant named Hegestratos took out a large loan, secured by the cargo on his boat. Hegestratos planned to sink his empty boat, keep the loan, and sell the cargo. In modern terms, this would be an instance of misrepresentation and loan fraud.

The earliest known cases of financial market misconduct in the United Kingdom was in 1814, when Charles Random de Berenger landed in Dover, and widely proclaimed the death of Napoleon. It was later discovered that De Berenger had bought UK government bonds and that his fraudulent announcement resulted in ill-gotten gains of GBP 0.5m (some GBP 70m today). In modern terms, this would be an instance of price manipulation, i.e., the deliberate attempt to interfere with the free and fair functioning of financial markets with misleading information or appearances.

Financial market misconduct started in the United States just a few years after it officially became a nation. During the late 1700s, prices of bonds issued by the US Federal government or (former) colonies were volatile, much like how emerging market debt is today. William Duer, the assistant secretary of the Treasury at the time, was privy to all the Treasury's actions, and used his insider information to trade on his own account, before selectively leaking such information to the public. In modern terms, this would be an instance of insider trading.

In more recent times, concerns related to financial market misconduct have significantly heightened or even skyrocketed, especially after the financial crisis of 2007–2009. A Google search

for the term "financial market misconduct" that we ran in December 2017 produced more than 14,300,000 hits. A related search for academic articles on the topic indicates that more than 80,400 academic papers have been published on financial market misconduct.[3]

For financial economists, the recent attention paid to financial market misconduct raises two important questions. What methodologies exist to detect financial market misconduct? How does one quantify the effects of financial market misconduct on market participants? In two related chapters, we survey the current empirical and theoretical literature on financial market misconduct in an attempt to answer these questions.

There are several reasons *why* such a survey is of interest. First, financial market misconduct is systemic and pervasive in scale. For example, Dyck, Morse, and Zingales (2010) find that in the US, as many as one in seven publicly traded companies engage in financial market misconduct in any given year. They estimate the probability of a large firm in the US engaging in misconduct in any given year to be 14.50%.

Studies that estimate the incidence or frequency of financial market misconduct in other countries are more limited. One recent survey by the Association of Certified Fraud Examiners (ACFE) does estimate the incidence of financial fraud (which is just one particular type of financial market misconduct) in other countries. ACFE examined 2,410 confirmed instances of financial fraud in 114 different countries over 10 months from January to October 2015. The results of this survey are summarized in Table 3.1 and shows that financial fraud is widespread, affecting almost all the countries in the world.[4]

TABLE 3.1 FREQUENCY OF FRAUD BY COUNTRY.

Notes: This table is based on the results of the 2016 Global Fraud study by the Association of Certified Fraud Examiners (ACFE). The report is available on ACFE's website at http:\www.acfe.com. The report confirmed 2,410 instances of financial fraud over the months of January 2015 to October 2015. This table depicts the frequency of fraud cases by geographic region. Column 1 indicates the geographic region. Columns 2 and 3 indicate the number and percentage of fraud cases in each region. Finally, Column 4 indicates the median loss (in US dollars) for fraud cases in each region.

Region	Number of cases	Percent of cases	Median loss (USD)
United States	1,038	48.80	120,000
Africa	285	13.40	143,000
Asia-Pacific	221	10.40	245,000
Latin America	112	5.30	174,000
Western Europe	110	5.20	263,000
Eastern Europe	98	4.60	200,000
Southeast Asia	98	4.60	100,000
Canada	86	4.00	154,000
Middle East	76	7.70	275,000

Figures 3.1 and 3.2 (also from the 2016 ACFE Global Fraud Study) depict the incidence of financial fraud by industry, firm size, and firm type. Figure 3.1 indicates that fraud affects firms in all industries, but that most cases occur in the financial services industry. In addition, Figure 3.2 indicates that while private sector firms experience higher incidence of fraud, firms in all sectors of the economy, regardless of their ownership status, suffer from such misconduct. Thus, financial market misconduct impacts all economic agents and entities in the economy. Finally, the ACFE Global Fraud Study also shows that fraud affects firms of all sizes and the percentage of cases hardly varies by firm size.

FIGURE 3.1 FREQUENCY OF FINANCIAL MARKET MISCONDUCT (FRAUD) BY INDUSTRY.

Notes: This chart is based on the results of the 2016 Global Fraud study carried out by the Association of Certified Fraud Examiners (ACFE). The report is available on ACFE's website at http:\\www.acfe.com. The report examined 2,410 instances of financial fraud over the months of January 2015 to October 2015. This figure depicts the percentages of cases by industry.

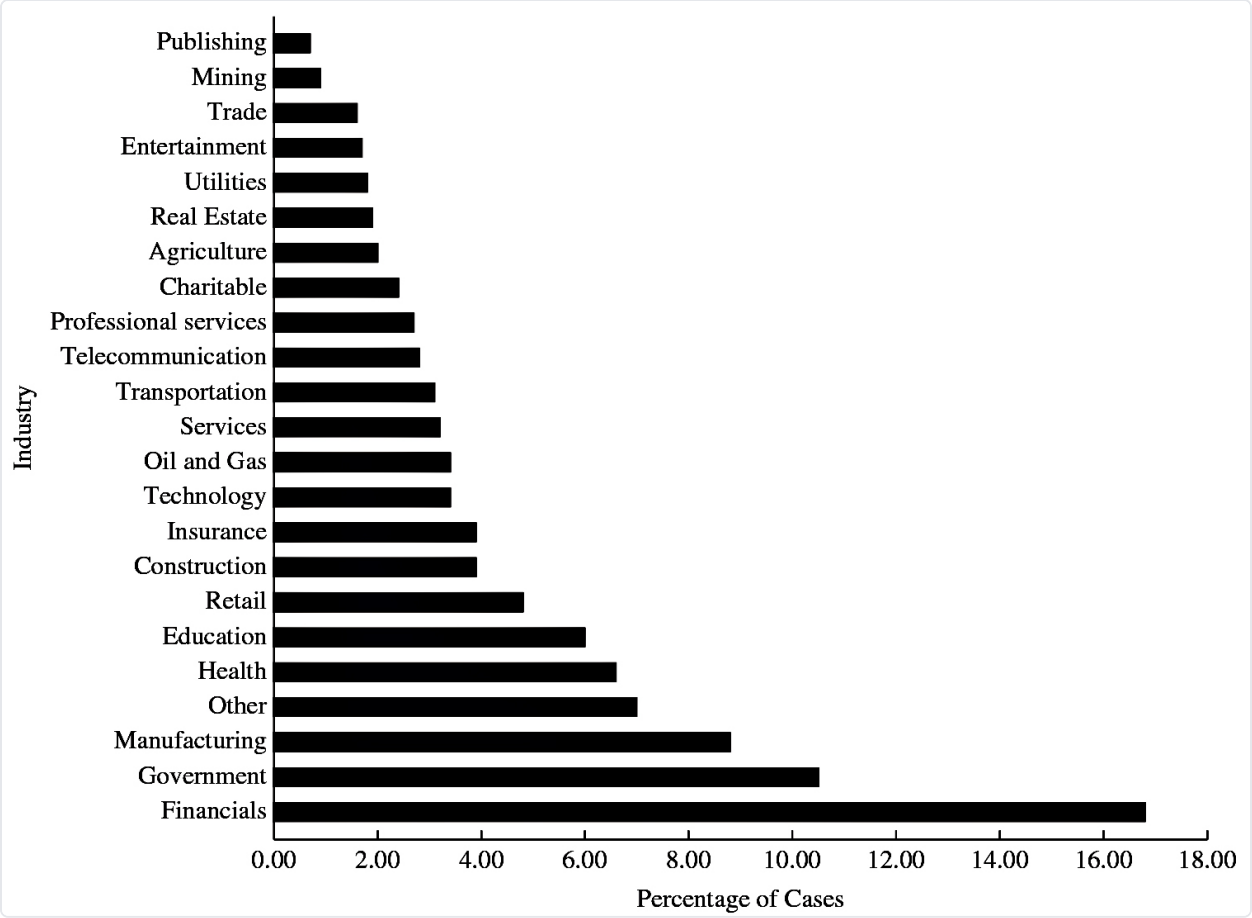
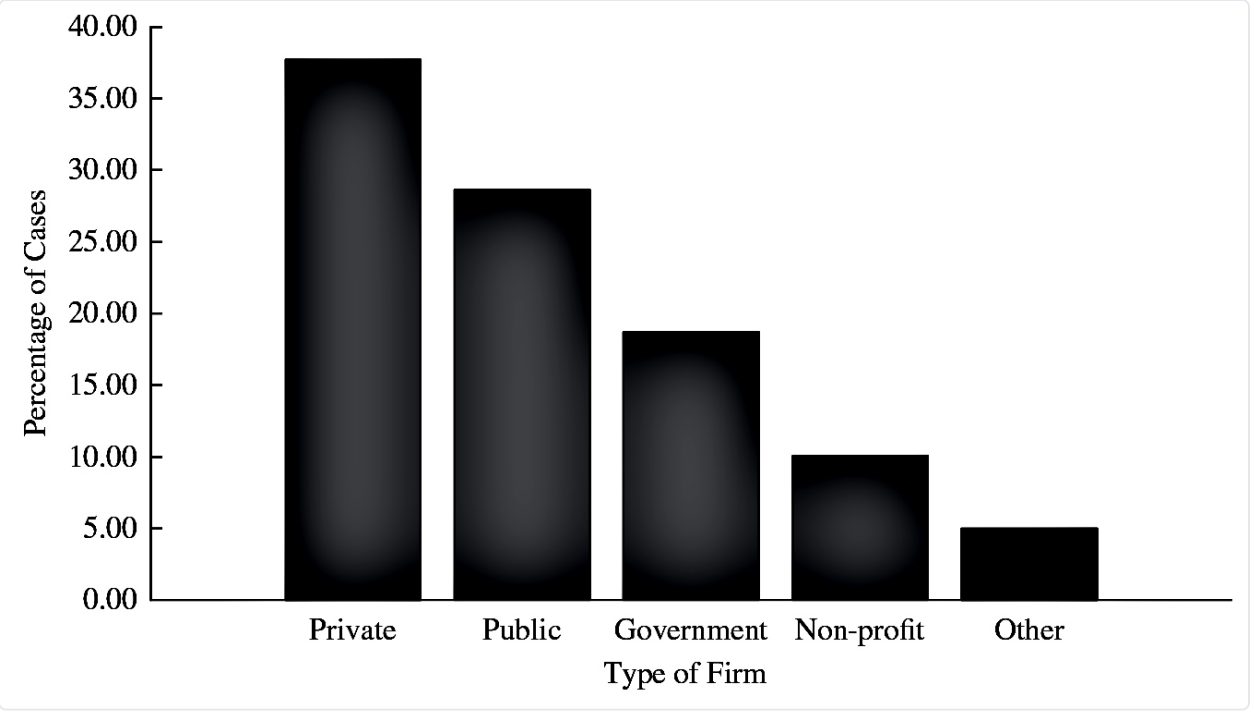


FIGURE 3.2 FREQUENCY OF FINANCIAL MARKET MISCONDUCT (FRAUD) BY FIRM TYPE.

Notes: This table is based on the results of the 2016 Global Fraud study carried out by the Association of Certified Fraud Examiners (ACFE). The report is available on *ACFE's website at http:\www.acfe.com. The report examined 2,410 instances of financial fraud over the months of January 2015 to October 2015. This figure depicts the median loss and percentage of cases by firm type.*



Second, the impact of financial market misconduct on market participants can be economically large. In 2002, the US Government Accountability Office (henceforth the GAO) analyzed the stock market reaction of financial statement restatements.[5] They found that on the initial restatement announcement, stock prices of the restating companies fell almost 10% on average and the restating companies lost about $100 billion in market capitalization (See US Government Accountability Office 2002).

More recently, Karpoff, Lee, and Martin (2008) show that firms that engage in financial market misconduct in the US on average lose 38% of their value (i.e., market capitalization) as a reputation penalty when such misconduct is revealed. In general, Dyck, Morse, and Zingales (2010) estimate that financial market misconduct destroys on average one-fifth of firm value, giving rise to an average cost of financial market misconduct in large corporations in the US estimated at $380 billion per year. In yet another study, Gee and Button (2015) estimate that a typical firm loses 5.6% of its annual revenue due to financial market misconduct. Applying this percentage to the corporate revenues for all the countries in the world yields a figure of nearly $3.7 trillion lost worldwide due to activities related to financial market misconduct.

Incredible as these numbers are, they only reflect direct losses suffered by firms when they engage in financial market misconduct. These estimates do not include indirect costs of financial market misconduct, such as losses due to erosion of trust among market participants, or their reluctance to participate in financial markets if misconduct becomes widespread. Guiso, Sapienza, and Zingales (2008) study one such indirect cost and argue that when investor trust in markets is low (i.e., when

the likelihood of financial market misconduct is high) people do not participate in the stock *market.* The resulting lack of investor demand for *equity* in such countries makes it difficult for firms to float their stock and raise capital.

Finally, our survey can perhaps even help those who have engaged in financial market misconduct. As an example, consider the typical case of a firm that faces an allegation of financial market misconduct. Ex-post, that is after misconduct is discovered (or proven), the risk of potential litigation for the firm can be much like the "Sword of Damocles," hanging over its future operating decisions. Under these circumstances, it may be helpful for existing (or new management) at this firm to quickly quantify the extent of its potential losses and damages (using some of techniques outlined in this chapter), thereby ascertaining the extent of litigation risk stemming from the alleged misconduct.

3.2 CHALLENGES IN RESEARCH ON FINANCIAL MARKET MISCONDUCT

Our review reveals that researchers interested in financial market misconduct face several challenges that are perhaps unique to this topic. First, there is the issue of data. Regulators often collect enormous amount of data about financial markets.[7] However, this data is often not available to researchers. In some instances, regulators post data only periodically, often with a lag. In other cases, regulators aggregate data, so it cannot be attributed to a particular entity. In still other cases, regulators fear that sharing detailed information may reveal proprietary methods that criminals may then use to develop more sophisticated misconduct techniques or to avoid detection of misconduct. While these concerns are understandable, this limited information exchange constrains not only the detection of misconduct but also the development of new misconduct detection technologies.

Second, in any study of financial market misconduct, prevalent laws are important as they influence the conduct of financial market participants. In fact, it is difficult to make progress on many issues related to financial market misconduct without understanding the enormous variation in laws across markets and time. On the one hand, such variation in laws poses difficulties for studies on financial market misconduct as what may be deemed as misconduct during one period/jurisdiction, may be an accepted practice in another. On the other hand, variation in laws can also help as researchers can use variation to identify the causes of misconduct, and the effect of enforcement on misconduct. This rich variation in laws and regulations is only now beginning to be *exploit*ed by financial economists, and seems a likely fruitful area for further work.[8]

Finally, a study of financial market misconduct is inherently cross-disciplinary in nature, perhaps much more so than other areas of finance. Many questions in the area of financial market misconduct cannot be addressed appropriately within the confines of individual disciplines and must draw from the body of knowledge in areas as diverse as finance, economics, law, mathematics, statistics, decision sciences, 6. Henry (2008) finds that the total cost of litigations for Fortune 500

companies in the US equals one-third of their profits in a *given year. Typically, a firm under investigation for financial market misconduct identifies potential litigation costs and regulatory fines as a key future risk factor in its annual reports. For example, several large global banks identified* litigation risk and *regulatory fines as a key risk factor in their annual reports for 2008–2010, after they faced allegations of manipulating* interest sociology, and so on. Cross-disciplinary work of course presents challenges and frustrations of its own. For one thing, researchers wishing to draw on the body of knowledge in diverse disciplines must learn the set of rules and assumptions that are particular to each of these disciplines. In addition, it is difficult enough to keep abreast with the ongoing developments in any one discipline. When one conducts cross-disciplinary research, however, one also needs to stay current in multiple areas.

3.3 DEFINING FINANCIAL MARKET MISCONDUCT

As we attempt a comprehensive review of the current empirical and theoretical literature on detecting and quantifying financial market misconduct, a key challenge for us is the issue of scope.

In particular, how does one define financial market misconduct, and what activities and practices fall under its domain? The range of potential financial market misconduct is limitless and its scope so wide that regulators often resort to use of computer surveillance algorithms to search for such activities (Cumming and Johan 2008). The US Seventh Circuit Court of Appeals aptly summarized this issue in its decision in Cargill v. Hayden wherein it stated that: “The methods and techniques of manipulation are limited only by the ingenuity of man.” Financial market misconduct comes in many different forms and includes several classes of activities, and at first sight, a comprehensive review does not even seem possible.

Consider, for example, the bevy of allegations of financial market misconduct levied against financial intermediaries in the aftermath of the financial crisis of 2007–2009. A non-comprehensive list of such misconduct includes rating agencies providing favorable ratings to lenders to help them sell risky mortgages (Acharya and Richardson 2009), banks selectively moving risky mortgages off their balance sheets (Keys et al. 2010), instances of lenders issuing mortgages while allegedly willfully disregarding the borrower’s ability to repay the mortgage (Agarwal et al. 2014), and banks rigging an important interest rate benchmark (Gandhi et al. 2018). Each of these practices were commonplace prior to the financial crisis of 2007–2009, and can be classified as financial market misconduct. Each of these activities is also quite unique, and requires the use of distinct empirical techniques to detect and quantify its extent.

However, it seems that new data combined with novel analytical and computational techniques can help resolve the issue of limitless scope of potential misconduct activities and indicate that the number of misconduct techniques is perhaps more limited. For example, recently, the Fixed Income, Currencies, and Commodities Markets Standards Board (FMSB) – established in 2015 as a private sector response to the conduct problems revealed in global wholesale fixed income