MARKET MANIPULATION – INCENTIVES AND ENFORCEMENT

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The relevant prohibitions

I will focus on this paper primarily on trade-based manipulations falling within two of the primary prohibitions against market manipulation, ss 1041A and 1041B of the *Corporations Act* 2001 (Cth) and on recent enforcement activity. I will not address manipulations involving fictitious or artificial transactions, which are relatively rare and would fall within the scope of s 1041C of the *Corporations Act*, or information-based market manipulations involving the making of misleading statements or false rumours, which are primarily addressed by s 1041E of the *Corporations Act*. I will also not address manipulation involving market power, such as the "squeeze" which has historically been seen in commodity markets, which would be difficult to implement unless a financial product has limited liquidity.

Section 1041A of the *Corporations Act* prohibits a person taking part in, or carrying out (whether directly or indirectly and whether in the jurisdiction or elsewhere) a transaction that has or is likely to have, or two or more transactions that have or are likely to have, the effect of *creating* an artificial price for trading in financial products on a financial market operating in the jurisdiction or *maintaining* at an artificial level (whether or not it was previously artificial) a price for trading in financial products on a financial market operated in the jurisdiction. The concept of an "*artificial*" price" in the section functions to distinguish trades falling within the prohibition from genuine trades and requires a comparison of the price at which the transaction occurred with a notional "genuine" price in the market. In *Director of Public Prosecutions (Cth) v JM* [2013] HCA 30; (2013) 94 ACSR 1; 298 ALR 615,[1] the High Court took a broad view of that section, treating the prohibition as extending to transactions not involving the genuine forces of supply and demand. The Court expressed the view (at [72]) that the section is contravened if a person creates an artificial price for entering into a transaction and noted that a sole or dominant purpose of creating or maintaining an artificial price is not necessary to such a contravention but can provide evidence that a transaction is likely to have the prohibited effect. However, a contravention of the section should not be established merely because the sale or purchase of financial products on a financial market leads to a change in the price at which those products are traded on that market, if the trader's purpose in undertaking that transaction was a legitimate one.

Section 1041B prohibits a person doing, or omitting to do, an act (whether in the jurisdiction or elsewhere) if that act or omission has or is likely to have the effect of creating or causing the creation of:

- a false or misleading appearance of active trading in financial products on a financial market operated in the jurisdiction; or

[1] For commentary, see R Bowley, "DPP v JM: High Court Clarifies the Meaning of 'Artificial Price' Under s 1041A" (2013) *BCLB* [647].

- a false or misleading appearance with respect to the market for, or the price for trading in, financial products on a financial market operated in the jurisdiction.

The decision in *Director of Public Prosecutions (Cth) v JM* confirms that there is a significant degree of overlap between ss 1041A and 1041B, which will both be available in respect of trades with a price effect. Other conduct with a price effect, including the placing of orders that did not give rise to transactions, would typically fall within the scope of s 1041B.

The publication of Enforcement Outcome reports by the Australian Securities & Investments Commission ("ASIC") provides more visibility of enforcement activity and outcomes than has previously been the case. The recent reports reveal relatively few actions in respect of market manipulation, which are significantly less common than insider trading actions. These reports indicate that:

- In January–June 2012, there were no enforcement outcomes in respect of either market manipulation or insider trading and there were then 4 pending criminal market manipulation matters, 8 pending criminal insider trading matters and 1 pending civil insider trading matter.[2]

- In July–December 2012, there was 1 criminal outcome for market manipulation by contrast with 8 criminal outcomes for insider trading, and were then 2 pending criminal market manipulation matters by contrast with 8 pending criminal insider trading matters.[3]

- In January–June 2013, there was 1 administrative remedy imposed in respect of market manipulation[4] by contrast with 6 criminal outcomes for insider trading and 1 publicly announced pending criminal matter in respect of market manipulation[5] and 4 pending criminal matters for insider trading.

- In July–December 2013, there was 1 criminal outcome[6] and 1 (or possibly 2) enforceable undertaking(s) in respect of market manipulation, by contrast with 7 criminal outcomes for insider trading, and 3 pending criminal market manipulation matters by contrast with 11 pending criminal matters for insider trading.[7]

It does not follow that there are "too few" actions in respect of market manipulation, which turns on a concealed assumption as to the extent of conduct that would warrant such actions.

Price manipulation

Three generalisations can be made by way of introduction to trade-based price manipulation, subject to the usual difficulties as to generalisation:

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[2] ASIC Report 299, *ASIC Enforcement Outcomes January-June 2012.*
[3] ASIC Report 336, *ASIC Enforcement Outcomes July–December 2012*.
[4] ASIC 13-099MR (Pearson).
[5] ASIC Report 360, *ASIC Enforcement Outcomes January-June 2013*.
[6] ASIC 13-309MR (Tang).
[7] ASIC Report 383, *ASIC Enforcement Outcomes July-December 2013*.

- First, a legitimate trade will often be executed in a manner that will minimise its price impact, unless there is some other good reason that the trade is not price-sensitive, for example, where it seeks to acquire a pre-bid stake in a takeover or establish or unwind a hedging transaction within a short time frame; on the other hand, trades undertaken with a manipulative purpose may be structured so as to increase price impact, for example by trading in periods of limited liquidity or placing trades in a manner that will accelerate existing price movements.

- Second, a trade-based manipulation will only succeed if the manipulator's trading causes the price of the security to rise and the manipulator is able to sell at a price higher than its purchase price and transaction costs. This can occur through liquidity effects or through information effects, if other traders perceive a manipulator's trades as indicating that a particular stock is attractive or unattractive.[8]

- Third, a trade-based manipulation may be difficult to implement in a highly liquid market, if any price change caused by manipulative trades would be offset when those trades are unwound. However, a manipulator can avoid that difficulty if it can achieve a market effect from trades in smaller volume, which do not need to be unwound before trades in larger volume are executed at an artificial price or some another advantage, such as a change in the conversion ratio of converting securities or avoiding a margin call, is achieved at that price.[9]

The enforcement actions to which I will refer below suggest that price manipulation is still the most common form of market manipulation, or at least the most common subject of enforcement activity. The incentives for price manipulation are straightforward. For example:

- If a person wishes to dispose of his or her shares in a company, it is in his or her interest that the share price of that company's shares remain firm or increase, rather than decrease, prior to the disposal.[10]

- A decline in the price at which shares are trading may trigger an event of default under loan covenants or a margin call where those shares have been lodged with a broker; or release an underwriter from underwriting obligations. An issuer or underwriter to a rights issue might seek to prevent a decline in the price at which shares in the issuer are traded, since investors will not take up a rights issue if the market price for shares in the issuer is less than the subscription price in the rights issue.[11]

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[8] DR Fischel & DJ Ross, "Should the Law Prohibit 'Manipulation' in Financial Markets?" (1991) 105 *Harv L Rev* 503 at 512-519; S Thel, "$850,000 in Six Minutes – the Mechanics of Securities Manipulation" (1994) 79 *Cornell LR* 219; CR Korsmo "Mismatch: The Misuse of Market Efficiency in Market Manipulation Class Actions" (2011) 52 *Wm & Mary L Rev* 1111 at 1140–1143.

[9] Fischel & Ross note 8 above at 519; Korsmo note 8 above at 1145–1146.

[10] For example, *US v Mulheren* 938 F 2d 364 (2d Cir 1991).

[11] In this context, civil proceedings brought in the United States after the dotcom boom alleged that underwriters of initial public offerings in technology companies had allocated shares to investors on the basis of informal agreements that those investors would purchase shares in the after-market, so as

- If a first company has a substantial holding of shares in a second company in its investment portfolio, it will be in the first company's interests that those shares are trading at a higher rather than a lower price at the first company's balance date; this is reflected in trades referred to as “window dressing”.

It is also possible to identify more complex incentives for manipulation, although it is perhaps not surprising that such cases are less commonly reported. For example:

- In a contested takeover, the directors of a target company have an interest in seeing that the price of its securities on market is higher than the bid price, to reduce the likelihood that shareholders in the target company would accept the bid,[12] while the bidder has a converse interest in seeing the decline of the price of shares in the target company on market. Even in the absence of an existing offer, management may be concerned that a fall in a company's share price may make it vulnerable to such an offer. It is also in the interests of a takeover bidder which has made a scrip offer that its shares trade at a higher rather than a lower price, maximising the attractiveness of the offer to shareholders in the target company.[13]

- The manipulation of share prices might allow an investor to derive profits on the futures market, or affect the price at which options to subscribe for shares are exercised or the number of shares issued on the conversion of preference shares.[14]

Form of regulatory actions

There are many examples of criminal prosecutions for (alleged) trade-based price manipulation in the case law. For example:

- In *Brown v The Queen* [2006] WASCA 145; (2006) 202 FLR 98; 58 ACSR 290, a shareholder in a listed company traded on both sides of the market, making more than one bid on the market simultaneously through different brokers, gave instructions to the brokers so that his own bids would increase over each other and did not inform the brokers that he was placing bids through other brokers. He was found to have contravened s 998 of the *Corporations Law* (the predecessor to s 1041B) at trial and an appeal in respect of penalty was dismissed.

- In 2009-2011, two client advisers with stockbroking firms were each given suspended sentences in respect of market manipulation in a listed company’s

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to increase the market price of those companies and create an appearance of market momentum: *In Re Initial Public Offering Litigation* 471 F 3d 24 (2d Cir 2006), discussed in Korsmo, note 8 above at 1140–1141.

12 For example, *Crane Co v Westinghouse Air Brake Co* 419 F 2d 787, 792-799 (2d Cir 1969), cert denied 400 US 822 (1970).

13 For example, *Davis v Pennzoil Co* 264 A 2d 597, 603 (1970); *Schlick v Penn-Dixie Cement Corp* 507 F 2d 374, 378-381 (2d Cir 1974); *North v Marra Developments Ltd* (1981) 148 CLR 42 (contravention of predecessor to CA s 1041B).

14 For example, *Fame Decorator Industries Pty Ltd v Jeffries Industries Ltd* (1988) 28 ACSR 58; 16 ACLC 1235 (sale of shares at low price to affect conversion ratio for convertible notes); *ASC v Nomura International Plc* (1999) 29 ACSR 473 (cross-market manipulation).

shares.[15] Those advisers and a third client adviser were also banned from providing financial services for periods of between 2 and 5 years (see below). The daughter of the chief executive officer of a listed company was sentenced to a term of 21 months imprisonment, but released on a recognisance release order, after pleading guilty to 10 counts of market manipulation in contravention of s 1041A involving purchases of more than 5.9 million shares in the company in accounts held in her name and in the names of companies related to her father, who was a major shareholder in the company, and her husband.[16] Her husband was previously sentenced to 22 months imprisonment, with a minimum period to serve of 6 months, following pleas of guilty to 5 counts of market manipulation.[17]

- In *R v Chan* [2010] VSC 312; (2010) 79 ACSR 189, a client adviser in a broking firm was sentenced in respect of contraventions of s 1041A, involving late trades and trades at higher prices than existing bids for the securities in a listed company, Bill Express, purportedly purchased for individual clients of the broking firm but in fact purchased on behalf of associates of that company. He was also banned from providing financial services for 5 years.[18]

- In 2011, a former director of a listed company pleaded guilty to four charges of market manipulation under s 1041B and a charge of making a false or misleading statement to ASIC, in relation to trading in that company using an online share trading account in his own name and under an alias, which were alleged to have the effect of creating a false or misleading appearance of active trading in the securities. A monetary fine was imposed and, as a result of his conviction, he was disqualified from being involved in the management of a corporation for five years.[19]

- In November 2013, a trader who pleaded guilty to two market manipulation charges relating involving 100 separate trades, conduced through 11 separate online accounts, was sentenced to 2 years imprisonment, although he was to be released after 4 months on entering into a recognisance and subject to a good behaviour bond.[20]

- In December 2013, a director of two ASX listed companies was charged with market manipulation and failure to disclose interests in those companies, which was alleged to have taken place first to support a rights issue by one of the companies; then to reduce a margin position in relation to shares in the company; and subsequently to increase a claim in the liquidation of the margin lender.[21]

These matters are typically the subject of criminal proceedings rather than civil penalty actions, with civil penalty proceedings in this area being even rarer than in the area of insider trading.. This seems to reflect an enforcement philosophy that the

[15] ASIC 09-19 AD (Musumeci and Wade).
[16] ASIC 11-30AD (Tamara Newing).
[17] ASIC 10-58AD (Geoffrey Newing).
[18] ASIC 09-147AD (Chan).
[19] ASIC 11-192AD (Tang).
[20] ASIC 13-309 MR (Tang).
[21] ASIC 13-327MR (Choiselat).

conduct is too serious to be addressed by monetary penalties and banning orders alone.

Use of administrative remedies

ASIC has also used banning orders under s 920A of the *Corporations Act* as a means to address market misconduct by employees of financial intermediaries. The use of banning orders raises somewhat different issues from criminal and civil penalty proceedings since such orders are made to protect the public and are not primarily punitive in intent, although deterrence is a relevant factor and they may obviously have adverse effects on the persons against whom they are made. Banning orders have frequently been made as an initial regulatory response in matters that have given rise to subsequent criminal proceedings.

For example, banning orders were made against a trader who purchased securities at higher prices than the previous trading price in order to manipulate the securities price upwards and against a broker who assisted a client in placing orders to maintain an artificial price for trading in company shares; and against a broker who circulated an email stating that there was a run on a cash management trust operated by a major financial institution and, once the market became aware of it, that institution's share price could halve.[22] In 2013, a stockbroker was banned for 3 years where ASIC found he had created a false or misleading appearance of active trading by placing orders as part of an on-market buyback of units in a listed fund, which were placed late in the day and caused the closing share price of the fund to be relatively high, creating a false or misleading appearance in the price for trading in the stock.[23] On the other hand, a banning order made in respect of off-market crossings was overturned by the Administrative Appeals Tribunal on the basis that those transactions did not give rise to a false or misleading appearance of active trading on a financial market where they were executed off-market and did not give rise to a misleading appearance as to price where persons who had access to information concerning the trades would know that special crossings could properly be executed at process other than current market prices.[24]

Enforceable undertakings

ASIC can accept an enforceable undertaking under s 93AA of the *Australian Securities and Investments Commission Act* 2001 (Cth) in relation to an alleged breach of the insider trading or market misconduct provisions, although it would be expected that power would rarely be exercised in a serious case where the available evidence was sufficiently strong to support a criminal prosecution or civil penalty proceedings. A later breach of an enforceable undertaking would expose the licensee to liability to pay the amount of any financial benefit attributable to that breach to the Commonwealth, to compensate any other person who has suffered loss or damage as a result of the breach and to any other order which the Court may consider appropriate. For example, in the second half of 2013, ASIC accepted

[22] *Donald v Australian Securities and Investments Commission* [2000] FCA 1142; (2000) 104 FCR 126; 35 ACSR 383; *Musumeci v Australian Securities and Investments Commission* [2009] AATA 524; (2009) 109 ALD 677.
[23] ASIC 13-099 MR (Pearson).
[24] *Rosenberg v Australian Securities and Investments Commission* [2010] AATA 654; (2010) 117 ALD 582.

enforceable undertakings from National Australia Bank where conduct of trading personnel of a contractor had led to a spike in the ASX 200[25] and from UBS in relation to potential misconduct in relation to information provided in submissions for the Australian Bank Bill Swap rate (BBSW).[26]

High frequency trading, Market Integrity Rules and infringement notices

There has been recent regulatory scrutiny, and resulting amendments to the ASIC Market Integrity Rules, directed to opportunities for market manipulation arising from changed market structure, and particularly automated order processing ("AOP") and high–frequency trading ("HFT").

In 2009, the Financial Services Authority (UK) has expressed the view that "layering" or "spoofing" could constitute market abuse, in the nature of manipulation, under s 118 of the *Financial Services and Markets Act* (2000) (UK), and emphasised that market participants had the obligation to exercise adequate control over activities taking place on direct market access platforms.[27] ASIC Consultation Paper 145 *Australian Equity Market Structure: Proposals* (November 2010) identified the issue of changes in technology on market misconduct. A Consultation Report issued by the Technical Committee of the International Organization of Securities Commissions (IOSCO) in July 2011 noted a concern:

> "… whether technological advantage offers HFT firms the possibility of engaging in abusive practices on a larger scale than would previously have been possible. Momentum ignition, quote-stuffing, spoofing and layering are some examples of existing trading practices which may have an abusive and manipulative purpose, and that may benefit from the edge of HFT-style technology and the complex and fragmented nature of modern financial markets."[28]

IOSCO's comment recognises that these matters are neither novel forms of manipulation nor unique to HFT and the challenge raised by HFT may be more one of the potential scale of the activity and of difficulty in detection, where manipulation may take place by order messages or trades entered for short times in small volumes and large numbers, which would need to be identified within a market where the number of order messages and trades has itself increased through HFT activity.

ASIC Report 331, *Dark Liquidity and High-Frequency Trading* (March 2013) similarly noted that trading practices such as, inter alia, "layering" or "spoofing",

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[25] ASIC 13-365MR.
[26] ASIC 13-366MR.
[27] FSA, *Market Watch*, Issue No 33, August 2009; S Tregillis, "ASIC's Agenda for Market Integrity", Paper delivered at the 2011 Supreme Court Corporate Law Conference, 23 August 2011; M Prewitt, "High-Frequency Trading: Should Regulators Do More" (2012) 19 *Mich Telecomm & Tech L Rev* 131 at 147–148; CR Korsmo, "High Frequency Trading: A Regulatory Strategy" (2014) 48 *U Rich L Rev* 523 at 548–549.
[28] *Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity and Efficiency* (July 2011), p 28. IOSCO defined "momentum ignition" as the initiation of a series of orders and trades (possibly combined with false rumours) in an attempt to ignite an upward or downward price movement; "spoofing" as the use of displayed limit orders to manipulate prices; and "layering" as a strategy that layers the order book with multiple bids and offers at different prices and sizes, generating a high volume of orders which may have an extremely short duration and high cancellation rates

"quote stuffing", abusive liquidity detection and "momentum ignition" [29] could be considered predatory and pointed to an international consensus that these forms of trading were forms of market manipulation.[30] This conduct is not necessarily unique to HFT; however, it is possible that the speed of HFT may allow profits to be made from it which would be more difficult to achieve from more traditional trade-based manipulations and the volume of trades may also mask the conduct.[31] Conduct such as "spoofing" or "layering" or "quote stuffing" may well fall within the scope of s 1041B of the *Corporations Act*, so far as an order placed without any real intention to execute it is likely to create a false or misleading appearance as to the market for the relevant financial products; the position in respect of small orders entered with a purpose of liquidity detection may be more controversial, where those are intended to trade but also arguably have a collateral motive.

ASIC Consultation Paper 202, *Dark Liquidity and High-Frequency Trading: Proposals* (March 2013) proposed the amendment of the Market Integrity Rules to address manipulative trading practices through trading algorithms, and an Appendix to that Consultation Paper set out proposed guidance by ASIC on manipulative trading which expressed the view that:

> "Using the above strategies [layering, quote stuffing, quote manipulation and spoofing], whether through an automated order processing system as part of algorithmic trading, high-frequency trading or any other means of trading would be considered by ASIC to be contravention of the Market Integrity Rules and the Corporations Act. This list should not be considered an exhaustive list and may be added to as further developments are made, and misconduct identified, in our market."

Rule 5.7.2 of the ASIC Market Integrity Rules (ASX Market) (Chi-X Market) and r 3.1.2 of the ASIC Market Integrity Rules (ASX 24 Market) were subsequently amended to require market participants to have regard, in considering whether orders would create or be likely to create a false or misleading appearance of active trading or the price for a financial product, to factors relevant to HFT including the frequency with which orders are placed, the volume in each order and the extent to which orders were made are cancelled or amended relative to the orders executed.

There are not yet any Australian reported cases, so far as I am aware, of intentional conduct involving manipulation in respect of HFT or algorithmic trading, although I will refer below to numerous infringement notices issued in respect of

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[29] ASIC Report 331, *Dark Liquidity and High-Frequency Trading* (March 2013), paras 378-395. ASIC defined these terms in a broadly similar way to IOSCO, noting that "layering" or "spoofing" involves submitting multiple orders at different prices on one side of the order book away from the bid, then submitting an order on the other side of the order book where the trader intends to trade and, after the execution of the latter order, removing the multiple initial orders from the order book; "quote stuffing" involves entry of small variations in position in the order book so as to create uncertainty for other participants, slow down the order process and hide a trader's strategy; abusive "liquidity detection" or "ping orders" involve the entry of small orders aimed at triggering a reaction by other participants in order to gain information about their positions and expectations; and "momentum ignition" involves the entry of aggressive orders to start or accelerate a trend, in the hope that others will join to allow the trader to unwind its position at a profit.

[30] See Securities Exchange Commission (US), *Concept Release on Equity Market Structure* (January 2010); Technical Committee of IOSCO, *Regulatory Issues Raised by the Impact of Technology Changes on Market Integrity and Efficiency* (October 2011).

[31] Korsmo note 27 above at 556-557.

system failures by intermediaries in this context. There is a US example of regulatory action taken by the Financial Industry Regulatory Authority (US) in November 2010 against Trillium Brokerage Services LLC and several of its employees in respect of the use of a high-frequency trading strategy involving entry of layered orders to generate selling or buying interest in stocks, and induce other traders (or their algorithms) to execute against limit orders entered by Trillium.[32]

There is also significant regulatory activity reflected in the issue of infringement notices by the Markets Disciplinary Panel, in respect of breaches of ASIC's Market Integrity Rules in respect of automated order processing systems.[33] While failures of such systems do not necessarily result in manipulative conduct, they weaken a safeguard that would otherwise be available against such conduct and increase systemic risk.

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[32] See Tregillis note 27 above; Korsmo note 27 above at 555.

[33] Examples of infringement notices in this area include ASIC 13-005MR Susquehanna Pacific Pty Limited (alleged breach of r 5.6.1 of the ASIC Market Integrity Rules (ASX Market) 2010, arising when the firm's information technology department inadvertently disabled the price filter for its AOP system relating to exchange traded funds, during an upgrade of that system, permitting an order to be entered at an incorrectly calculated price, which was executed in the closing single price auction and reduced the price of the relevant fund by over 99%); 13-129MR Merrill Lynch Equities Australia Limited (alleged breach of MIR r 5.6.3(a) which relates to the organisational and technical resources required of a trading participant which uses its system for AOP, arising from changes to Merrill Lynch's system which had inadvertently allowed certain orders of an associated entity to be automatically routed to ASX without review by its trading desk or testing by a price filter, and an incorrect order caused a decrease in the price of a company by nearly 86%); 13-208MR Instinet Australia Pty Limited (paid a penalty of $130,000 in respect of an infringement notice relating to a failure to have in place an appropriate automated filter in its AOP system to address wash trades or trades where there was no change in beneficial ownership; in alleged breach of MIR 5.6.1(a)); ASIC 12-234 MR Commonwealth Securities Ltd (CommSec) (alleged breach of MIR r 5.5.2 which requires an AOP participant to maintain the necessary organisational and technical resources to ensure that trading messages submitted by the trading participant do not interfere with the efficiency and integrity of the market or the proper functioning of a trading platform, arising from failure to have automated filters in place which would identify transactions involving no change of beneficial ownership, where they arose from connected accounts with different account numbers, in alleged); ASIC 13-298MR ABN Amro Clearing Sydney Pty Ltd (alleged contraventions of MIR 5.6.1, 5.6.3 and 5.9.1, relating to the requirement for automated filters and the AOP system not interfere with the efficiency and integrity of the market or the proper function of the trading platform; that the trading participant have appropriate organisational and technical resources in place, and that the market participant not do anything which results in a market for a product not being fair and orderly, arising from failure to activate a system to check pre-trade limits for a client using AOP, with the result that orders in excess of those limits were submitted on ASX). Note that compliance with an infringement notice issued by the Markets Disciplinary Panel is not an admission of guilt or liability and a party that complies with such a notice is not taken to have contravened s 798H(1) of the *Corporations Act*.