

# Market manipulation

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ROSS PENNINGTON

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# Market manipulation – some initial thoughts

- An 'economics' crime but not necessarily an economic one
  - The basic coherence problem – Fischel & Ross: manipulation is self-defeating in that directional pricing effects of buying activity automatically reverse by selling activity needed to profit
  - Doesn't require (or necessarily involve) a profit or loss
  - Confidence in markets is basis – public, participants, both?
- Clog on trading / liquidity?
  - Trading is a welfare-enhancing activity that underpins primary, secondary, investment and risk management markets
  - Major issues with liquidity, in part due to regulatory concern
  - A trade-off between conduct & liquidity? Benchmark reform
- Jurisprudence is sometimes difficult to reconcile
  - Difficulties are multiplied when you extrapolate across different instruments & markets – debt / derivatives aren't as simple as 'buy low, sell high' – different uses, participants & price influence
  - This reconciliation task has become easier in NZ since the High Court decision in *FMA v Warminger*
  - Issue still remains of if and how the FMCA Fair Dealing rules apply

# NZ Market manipulation laws

	Provision	Elements
<b>Criminal</b>		
<b>Fraud</b>	<b>240 Crimes Act</b>	Obtaining by deception. Requires a false representation or fraudulent stratagem that results in a pecuniary advantage to the maker or causes a loss to the recipient, with criminal intent. Could be triggered by either representations or by conduct (trading)
<b>Disclosure-based</b>	<b>264 FMCA</b>	False or misleading statement or information. This prohibits making a statement or disseminating information if the person knows it is false or materially misleading and it induces a person to trade in quoted financial products or has the effect of increasing, reducing, maintaining or stabilising the price of those products
<b>Trade-based</b>	<b>269 FMCA</b>	False or misleading appearance of trading. Doing anything that knowingly creates a false or misleading appearance with respect to the extent of active trading in quoted financial products or the supply/demand, price or value of those products

**Because of evidential difficulties of proving to the criminal standard knowledge of the relevant matters, and other elements such as causation, criminal market manipulation provisions are rarely invoked in New Zealand or overseas. Instead, actions are brought under civil equivalents**

# NZ Market manipulation laws *cont.*

Civil (Quoted Financial Products)		
Disclosure-based	262 FMCA	False or misleading statement or information. As for the criminal offence, except the fault element is expanded to a situation where D " <i>ought reasonably to know</i> " the information was false or misleading
Trade-based	265 FMCA	False or misleading appearance of trading. As for the criminal offence, except that the fault element is expanded to a situation where the person " <i>ought reasonably to know</i> " the person's act will have the relevant effect
Civil (unlisted (OTC))		
Disclosure-based	22 FMCA	Fair dealing misrepresentation. A person must not, in connection with any dealing in financial products, make a false or misleading representation in relation to (among other things) that products are of a particular value or with respect to the price of the products
Trade-based	19 FMCA	Fair dealing misconduct. A person must not engage in conduct that is misleading or deceptive in relation to any dealing in financial products

# Trade-based manipulation & the Libor context

- Key difficulty with market manipulation laws is discerning the core elements that separate manipulation from legitimate trading, and in particular the place of intent or purpose
  - Particularly acute for “trade-based” market manipulation, where there is no separate misstatement to mark out misconduct
- Note the Libor manipulation cases involved fraud based on an ‘implied misrepresentation’, since LIBOR submissions were an opinion only as to where prime banks could fund, and as such were not an example of trade-based manipulation as such
- Nevertheless, the association of market manipulation with benchmarks has persisted, and this talk concludes with some remarks about how that is playing out in NZ
- Equally, it is sobering to observe that – despite several years of continuous toil – none of the international “Ibors” has yet managed to free themselves from submission basis or ‘expert judgment’ – the current proposals to replace Libor by a secured OIS measures by 2022 (!), still face major challenges

# Trans-Tasman differences

- On the face of it, significant:
  - Aus: “Artificial price” formulation under section 1041A, like UK, EU and Canada
  - NZ: Market manipulation and Fair Dealing both of the ‘fraud on the market’ variety, like the US, based on misleading the market
- Broader context also:
  - No general unconscionability prohibition
  - Absence of general conduct rules, such as prohibition on conflicts of interest
    - Contrast s 912A Corporations Act and ss 12CA – 12CC ASIC Act
- In reality, though, the differences at least in relation to market manipulation may be cosmetic
  - Venning J in *Warminger* relied heavily on *North v Marra* ‘sole or dominant purpose’ test as the font of New Zealand law
  - Note also FMA’s conduct expectations & Guidance Note jurisprudence

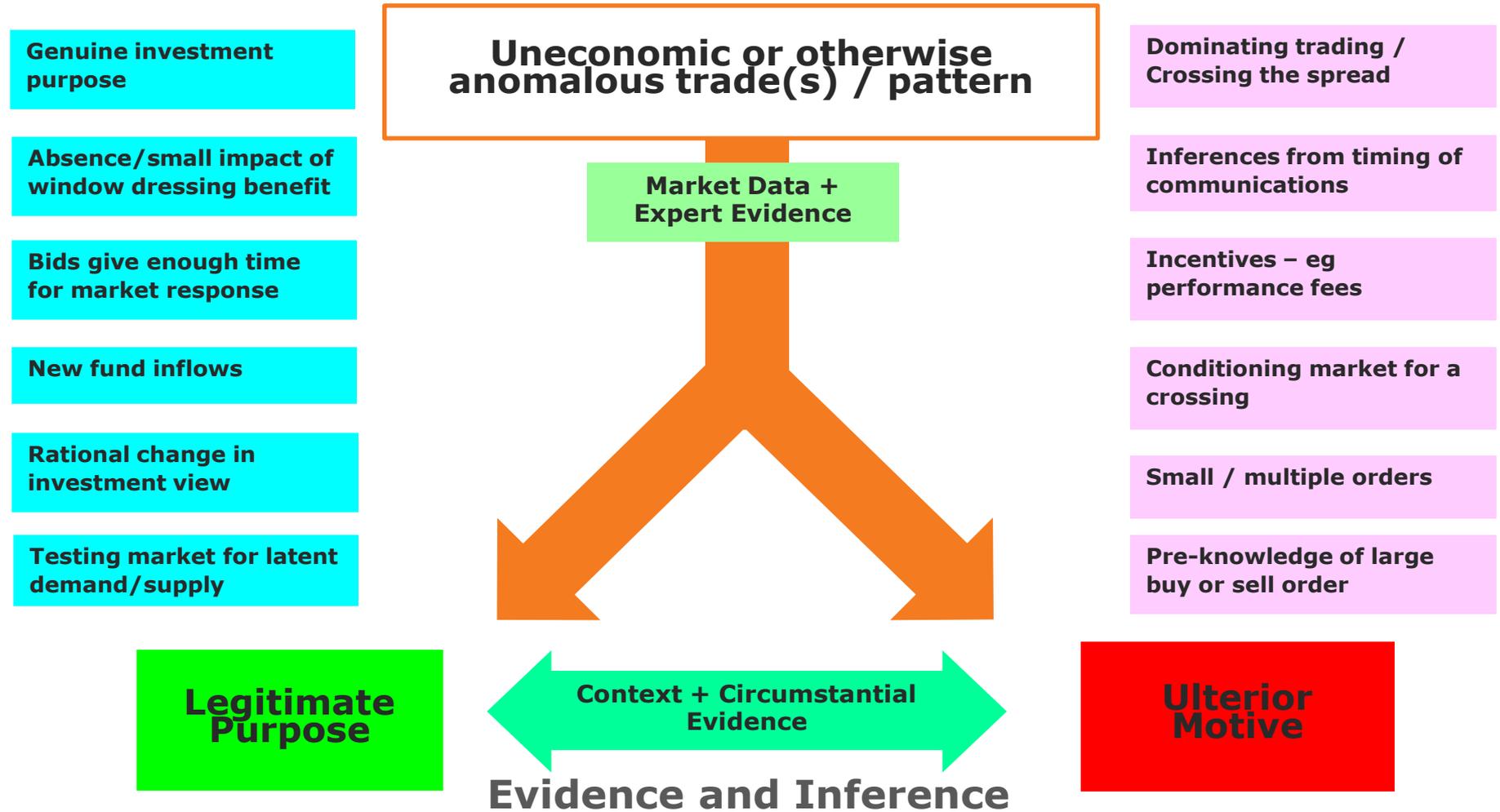
## Warminger: NZ's first MM case

- *Warminger*, decided under the predecessor to s 265 FMCA, is the first case on market manipulation in NZ
  - Civil proceeding, FMA brought 10 causes of action, succeeded on 2
  - Penalties have been assessed and appeals withdrawn
  - W was found to have manipulated the market by increasing and maintaining the offer quote & price, creating a misleading appearance, to 'window dress' or benefit off-market crossings
- Key take-outs:
  - The civil balance of probabilities standard applies, but – because of the seriousness – strong evidence is required to satisfy it
  - MM is established by trading having or likely to have prohibited effect of creating a false and misleading appearance in the market – because every trade has the potential to impact on price, the purpose of the trade may be the key factor which distinguishes culpable manipulation from trade made for genuine reasons
  - Evidential focus was on market data (the investigative trigger), but the context was also important in determining purpose

## Warminger: Intent, purpose and legitimacy

- The effects/service test & question of legitimate trading are inter-related & essentially involve the same inquiry:  
*"if the trade was for a genuine purpose or for a legitimate reason then it is not likely to have the effect of creating or causing the creation of a false or misleading appearance of trading and the FMA could not establish that Mr Warminger would or ought to have known that it would be likely to have that necessary effect"*
- Venning J drew heavily on the test in *North v Marra* about the purpose of trading
  - Noted that this approach continued in *DPP v JM*, despite the shift from 'intent' to an effects-based test
- Rejected the approach in the UK (*Winterflood*) that the FCA does not have to prove purpose, observing  
*purpose is not an element of the section [118 FSMA], but it is still a relevant consideration when considering whether there had been manipulation*

# Warmingier – evidential framework



# Manipulation as Fair Dealing misconduct

- The MM provisions in Part 5(3) FMCA apply only to “quoted financial products” on licensed markets
  - ie NZX markets, ASX 24 & ICE Futures
- As such, does not *directly* affect OTC debt & derivatives markets, or related benchmarks such as BKBM
- This raises the question whether manipulation actions can be brought under Part 2 FMCA (Fair Dealing)
  - Never been considered in any case, but no clear reason in principle why manipulation would not be FD misconduct
  - Elements of s 19 FMCA involve engaging in conduct that is misleading or deceptive in relation to any dealing in financial products, which is similar in substance to MM under s 265 FMCA
- On the basis that this is at least a significant possibility, the key question becomes whether the *Warminger* purpose test should also apply, as the Fair Dealing provisions lack a formal intent element

# Intent required for Fair Dealing?

- Intent is not a formal element in Fair Dealing prohibitions
  - Effects-based test – is the market misled?
  - Similar to position in UK (*Winterflood*) and Aus (s 1041A)
  - But commentators argue intent/purpose is an inherent element of trade-based MM under and may be the hallmark of it
- The argument from principle
  - Like the QFP prohibition (s 265 FMCA), s 19 requires conduct (here trading or bids/offers) that is “misleading or deceptive”:
    - Must prove (in the absence of actual misstatement) market would be misled by the trading itself. Since all that a traded price represents is the actual price agreed between market participants for a particular financial product, and all a bid/offer represents is the price at which a participant is prepared to buy/sell, there needs to be some other factor that identifies the trades as conveying misleading information, thereby becoming manipulative or distortive
    - Intent may be inferred from conduct, so MM cases focus on whether apparently anomalous trading has a legitimate economic purpose or rationale, which is inseparable from the purposes of the trader
- In all cases *in practice*, focus is on legitimacy or otherwise of the trader’s purpose; ruling in *Winterflood* is not ‘self-aware’

# Intent in Fair Dealing – *Warminger* direction

- *Warminger* judgment is consistent with this view:
  - **Australian authorities:** Law in Australia (*North v Marra*) has not changed in substance (ref *JM*) despite the intervening move from intent under s 998 to the effects-based test in s 1041A
  - **'Fraud-on-the-market' basis:** Key focus of s 265 is on trading that has the effect of misleading the market, which has the same core elements as the prohibition in section 19
  - **Structure/focus of the judgment:** It is apparent from the way that Venning J considered the various elements of the section 11B prohibition that the presence or absence of the objective 'knowledge' element in section 11B(b) was only incidental to the core findings about the relevance of purpose/legitimacy
  - **Treatment of UK authorities:** Referring to *Winterflood*, Venning J finds that absence of intent as a formal element does not mean that purpose is irrelevant in judging manipulation
  - **References to Fair Trading Act:** Venning J draws a link between the objective test for D's conduct under s 265 and the relevant FTA (now Part 2 FMCA) test for misrepresentation

# Identifying market manipulation

- MM laws divide into (1) disclosure-based and (2) trade-based categories, which can be further divided as follows
  - **Legally presumed manipulation:** activities such as wash trades and matched orders which are presumed by law to be MM
  - **Factually presumed manipulation:** trading patterns such as spoofing and layering which, when detected, clearly involve manipulation because there is no legitimate economic rationale
  - **Circumstantial cases:** the remaining cases fall into a residual category which is more nuanced but normally involve uneconomic or otherwise abnormal trading as the key factual trigger. In these cases:
    - D will seek to demonstrate that the trading had a genuine investment purpose or other legitimate economic rationale
    - which P will seek to rebut on the facts or by reference to actual or circumstantial evidence of manipulative intent (eg ulterior motives)
- In the third category, circumstantial evidence is likely to come to the fore, including a number of common indicia of manipulation from which inferences about legitimacy may be drawn

# Common indicia of manipulation

- Unusual volume or trading behaviour
  - Dumping (aggressive selling), Ramping/facing (aggressive buying, esp above the ask), Domination of trading
- Ulterior motive / separate benefit
  - A very common feature in MM actions
  - Examples include avoiding margin calls, supporting a takeover, or influencing the benefit under a separate contract
- Marking the close
  - Buying a security near end of trading to alter its closing price
  - Various motives for this can exist, including 'window dressing'
- Specific intent evidence (including transcripts)
  - Agencies will often look for email, IM or phone transcript evidence of an intent to set price at a particular level or move it a particular direction
  - Can be problematic in isolation if the impugned transaction had a legitimate purpose and would have had the same price effect without the price motivation (compare *Donaldson & SEC v Masri*)

# Indicia of market manipulation *cont.*

- Illiquidity
  - A common background factor because it makes markets more susceptible to manipulation, although a weak factor of itself
  - Bid/offer spread in illiquids itself conveys market information and (without 'ulterior motive') manipulation likely to be self-defeating
- Shareholders/insiders
  - Manipulation cases commonly involve shareholders or other corporate insiders, who may have an incentive to support the price of relevant (particularly illiquid) stocks or may have separate contracts keyed to stock prices (e.g. converts or stock options)
- Evasion or chicanery
  - Destruction of evidence is not consistent with innocent purpose
  - Other subterfuge such as use of fictitious or multiple accounts can also create an inference of concealment and manipulation
- Note about combination
  - Few of these circumstantial factors are likely to be conclusive in their own right, but their presence may move the practical onus

# Some academic comments

- Common theme that MM definitions (esp “artificial price”) are too broad and lack a strong conceptual basis
- Fischel & Ross
  - “Price pressure effects are symmetrical. If purchases increase the demand and thus the price, sale will have the opposite effect.”
  - Inability to credibly define the prohibited conduct reflects conceptual confusion
  - Concept of an artificial price is “hopelessly overbroad” and “meaningless”
- Nelemans
  - EU and Australian prohibitions may be overinclusive and “lack a clear normative distinction between legal and illegal behaviour”
  - Case law does not set precedent to protect informed traders
- Huang

“All the existing economic methods used to define an artificial price have proven conceptually problematic and practically unreliable. Experts may arrive in different conclusions depending on the methods used and the assumptions made. This makes the concept of “artificiality” either inappropriate to, or unhelpful in, the determination of what constitutes manipulation.”

# Cases – the good, the bad, the anomalous

## Cogent authorities

- *North v Marra + JM* – purpose test
- *Warminger* – same view, evidence requires more than mere suspicion
- *SEC v Masri* – also backs purpose test, on ‘but for’ basis; i.e. if trades would have happened regardless of intent about price, market isn’t misled & there is no manipulation

## Anomalies/doubtfuls

- *Winterflood* – incoherent for reasons given
- *Stephenson* – ramping gilts into UK QE, a self-serving & low quality ‘judgment’
- *Donaldson* – problematic case of ‘specific intent’ where legitimate trades would have had same price result
- *Fenwick* – note dissent re fundamental feature of open market transactions

## OBVIOUSLY ILLEGAL

### GREY AREA

*Key focus area for compliance: to give benefit of doubt / margin for error*

### LEGITIMATE TRADING

*Operating presumption that trading is socially beneficial, supporting liquidity, price discovery and asset allocation*

*Purpose becomes relevant where there is a fact trigger, eg uneconomic or anomalous trading*

**Support by robust compliance framework and conflicts management**

**Genuine commercial purpose**

**Profit and risk management**

**Principal positions**

**Permissible price discovery**

**Market making**

**Uneconomic trades + Ulterior motive (purpose/legitimacy test)**

**Dominating trading**

**'Conditioning' market**

**Incentives, conflict of interest**

**Asymmetric conditions**

**Wash trades**

**Schemes (eg layering/spoofing)**

**Specific intent evidence**

**Collusion**

# Impacts & Initiatives

- BKBM – *traded* interbank benchmark
  - Reduced participation as a result of regulatory uncertainty
  - FMA + Industry engagement to drive conduct expectations
  - Legitimacy of hedging through the rate set, with controls designed to manage the inherent conflict of interest
- NZFMA Closing Rates
  - Daily pricing service for debt & derivatives market
  - Process updated for IOSCO compliance – Bloomberg AllQ grab
- FMA Conduct Guidance
  - FMA is expected to issue wholesale guidance, drawing on the *Warminger* purpose test & conduct/conflict management
- Liquidity v conduct?
  - Both are critical to market confidence and neither is served by open-ended or discretionary rules that impinge trading
  - Potential trade-off more apparent than real if there is clarity both in the law and in regulator's conduct & legitimacy expectations

## *In Memoriam, Libor (1986-2021)*

So. Farewell Then  
Libor.

You were the  
London Interbank  
Offered Rate.

Three hundred and fifty  
Trillion  
Dollars, pounds, yen

That's how much  
Money they say  
You benchmarked.

But really  
No one traded you.

Not good for a  
Benchmark  
Is it?

You were a fraud  
Like traders  
Who committed  
Fraud using you.  
(Allegedly.)

It was done for you  
Big Boy.  
But now you  
Are done for.\*

- Joseph A. Cotterill (FTAlpha)

\* An actual 'fixing' quote from a Libor bank:  
"Done...for you big boy"