Stock Market Manipulation and Short Selling

Vivien Goldwasser

Centre for Corporate Law and Securities Regulation

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The Regulation of Short Selling

Introduction

In financial markets, a short sale[1] is essentially the sale of a security that the seller does not own. It is a popular investment technique. Although there are many variations of short selling,[2] the usual strategy is to sell at today's price in the expectation of being able to purchase later at a lower price. It is simply the reverse of the normal procedure and, for those able to afford the risks, provides a useful technique for profiting in a declining market.[3] The inherent risks are, however, unlimited and an investor can lose an indeterminate amount on the short sale should the market unexpectedly rise.

The practice has been described as 'controversial'[4], yet this is an under-statement for there have been 'few subjects relating to exchange practices that have been characterized by greater differences of opinion than that of short selling.'[5] The supporters of short selling tend to see it as a normal part of market operation, in which people are constantly speculating on price rises or falls. Its opponents, on the other hand, argue that short selling is inherently destabilising, 'forces liquidation, depresses prices, accelerates declines, and has no economic value or justification.'[6] The literature on the subject generally does little more than set out the contending arguments, without any serious attempt at their evaluation.[7]

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1. 'short . . . deficient . . . having partial or total lack of . . . less than the stated amount': *Concise Oxford Dictionary*; 'short . . . less than or lacking a sufficient or correct amount': *Webster's New World Dictionary*. In the United States, SEC Rule 3b-3 defines a short sale as (i) any sale of a security which the seller does not own, or (ii) any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.
2. A short sale 'against the box' is one of the most well known of the variations. It is not technically a short sale, but is very similar in nature. The term refers to the situation where a seller owns and possesses the security, but for some reason does not plan to deliver it. Short sales 'against the box' (indicating that the seller has the shares in a safety deposit box, but plans to accomplish delivery by using borrowed shares) are used primarily for hedging purposes — i.e. to hedge the risk of a long position in the same or related security — and for tax purposes — e.g., to defer tax liabilities by carrying over a profit from the year of the sale to a later year: Joseph Walker, *Selling Short — Risks, Rewards, and Strategies for Short Selling Stocks, Options, and Futures* (1991) 6. Also refer to Louis Loss, *Fundamentals of Securities Regulation* (1988) 646, n 21. The argument advanced is that where a person initially makes a sale against the box, but subsequently changes his mind, there is nothing to prevent him from covering in the open market. In such a case, he is indistinguishable from any other short seller.
3. Walker, above n 2, 3.
4. H A J Ford and Robert Austin, *Ford's Principles of Corporations Law* (6th ed. 1992) 915.
5. Loss, above n 2, 649, quoting the Report of the Commission on Banking & Currency, S.Rep.No.1455, 73rd Cong., 2d Sess. (1934) 50 — below n 95.
6. Ibid.
7. The article by Deutsch, n 16 below, is a notable exception.

Thus the dilemma of where the truth may actually lie between the two extreme views remains unresolved. The position taken by the law in Australia on the issue[8] is equally ambiguous: it is 'basically to prohibit short selling but then create a number of exceptions ... The effective result is that short selling is possible under very restrictive conditions.'[9]

There has been little recent development in this country in the regulation of short selling.[10] Priorities on the reform agenda have been directed elsewhere, particularly following the public and judicial outcry, and corporate soul searching, that resulted from the corporate collapses of the 1980s. As a result, the direction of legislative and regulatory reform in the early 1990s was characterised by the emergence of a more adequately resourced, national regulatory agency,[11] and government activity designed to address some of the perceived legislative shortcomings. A great deal of effort was expended in an attempt to revamp certain areas of general corporate and securities regulation,[12] and with respect to the latter, particular provisions, such as those relating to insider trading, were targeted.[13] In addition, calls were made for the legislation to be supplemented with codes of conduct to regulate business ethics.[14]

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8. The basic regulation of short sales is governed by s 846 of the Corporations Law.
9. Colin Howard, *Companies — What They Are and How They Work* (1989) 85.
10. The Australian Securities and Investments Commission — ASIC (formerly referred to as the Australian Securities Commission, the ASC) — released a Discussion Paper in May 1994, and a Background Report in September 1996, on short selling in the OTC fixed interest markets. In particular, it sought to assess whether it was desirable to relax the short selling provisions in the Corporations Law as they apply to such markets and, if so, on what terms. This is area outside the scope of this study. However in the course of dealing with this issue, it became apparent to ASIC that there was a broader range of concerns in the market place about the scope and operation of the short selling provisions in the Law. ASIC has not yet formed a view as to whether law reform is required to address those issues.

    See further n 15 and n 38 below.

    With regard to the work being undertaken by the Corporate Law Economic Reform Program, it should be noted that short selling is not a specific item on the CLERP agenda: CLERP Proposals for Reform: Paper No 6, 'Financial Markets and Investment Products'. Short selling will only be considered at a general level in relation to these proposals. Their main thrust is rationalisation of Chs 7 and 8 of the Corporations Law; harmonisation of the rules relating to financial markets (including such matters as the market misconduct provisions) and investment products; and extension and modification to some degree of the licensing provisions of the Law. Short selling will be considered only to the extent that it is affected by these broader issues: communication with Mike Rosser, Head, Securities Markets Division, Treasury, 1 July 1998.
11. ASIC. 'By the enormous increase in funding for the ASC, as compared with the NCSC, [the government has] effectively admitted that inadequate resources were made available in the past': Henry Bosch, *Bosch on Business* (1992) 11.
12. See in particular the Corporations Legislation Amendment Act (No 2) 1991 which made substantive amendments to, inter alia, the prospectus provisions; and the Corporate Law Reform Act 1992 which implemented major reforms on directors' duties, related party transactions, corporate insolvency and stock exchange settlement procedures. Further amending statutes have followed.
13. Corporations Legislation Amendment Act (No 1) 1991.
14. Refer to the Report tabled in 1989 by the House of Representatives Standing Committee on Legal and Constitutional Affairs entitled *Fair Shares For All*, AGPS 1989, otherwise known as the Griffiths Committee Report; and also the Report in the same year of the Senate Standing Committee on Legal and Constitutional Affairs entitled *Company Directors' Duties — A Report on the Social and Fiduciary Obligations of Company Directors*, otherwise known as the Cooney Committee Report.

However, little attention was focused on other areas of securities regulation. In particular, the practice of selling short has been conspicuously neglected in Australia since the late 1960s and 1970s,[15] as evidenced by the dearth of current literature both in the form of journal articles[16] and material in major texts,[17] and the absence of public debate on the issue. In 1983 short selling was described as 'little researched'[18] and this has not changed.

It is nonetheless important that the technique be understood and re-evaluated, as it has become an important trading strategy used by securities professionals, and today constitutes an integral part of the securities markets of many nations. In view of its increasing prevalence as a market strategy for selling stocks,[19] and the widely recognised need to

15. At that time there was a great deal of debate surrounding this and other stock market practices which arose out of the chaotic share market that existed at the time of the mining boom. The most recent development of major significance was the introduction, in 1985, of another exception to the prohibition on short selling in accordance with the business rules of the Australian Stock Exchange Limited (herein referred to as the ASX): see n 38 below. In April 1995, the ASX also amended its business rules to extend its reporting requirements to cover the reporting of short positions held in securities listed on the ASX (see further n 186 below). It was anticipated that the ASX would seek a broader range of amendments to its business rules and, possibly, reform of the short selling provisions of the Corporations Law.
16. See Robert Deutsch, 'Short Selling' (1983) 1 *Company and Securities Law Journal* 142; and Andrew Kedzior, 'Short Selling in Australia' (1988) 11 *Adelaide Law Review* 327. In the United States, by contrast, there has been a plethora of literature: see, for example: James Cramer, 'Profiting With Shorts: Not Such A Tall Order' (1988) 121 *New Jersey Law Journal* 6; James Cramer, 'How To Stand Tall When Shorting Stocks' (1989) 123 *New Jersey Law Journal* 13; Lars Nielson, 'Asset Market Equilibrium with Short-Selling' (1989) 56 *The Review of Economic Studies* 467; Julie Rohrer, 'A walk on the short side' (1989) 23 *The Institutional Investor* 83; David Worley, 'The Regulation of Short Sales: The Long and Short Of It' (1990) 55 *Brooklyn Law Review* 1255; Saul Hansell, 'The other side of zero; Market-neutral managers are leading pension funds into the forbidden world of short-selling' (1992) 26 *The Institutional Investor* 58; Mark Hulbert, 'A walk on the short side' (1992) 149 *Forbes* 285; Ralph Janvey, 'Short Selling' (1992) 20 *Securities Regulation Law Journal* 270; Ian Ramsay, 'Short Selling: Further Issues' (1993) 21 *Securities Regulation Law Journal* 214; Thomas Easton, 'The funds that sell short' (1996) 158 *Forbes* 92; Anon.,'The Secret World of Short-Selling' *Business Week* (New York) 5 August 1996; David Robison, 'Short Selling and Trading Abuses on Nasdaq' (1997) 27 *The CFA Digest* 8.
17. The major Australian texts in the area of corporations and securities law devote little more than a few pages to the subject of short selling. (Baxt, Ford and Black, n 25 below, is a notable exception). The leading U.S. authority remains Professor Louis Loss.
18. This comment is contained in the editor's note to the article by Deutsch, above n 16, 142.
19. This is particularly true of the United States, where short selling constitutes a fairly significant portion of total sales of exchange traded securities — see Walker, above n 2, 168. Also refer to Ramsay, above n 16, 214, 219 who, relying on the New York Stock Exchange (NYSE) Fact Book 1990, reports that in the period from 1979 to 1989 short sales on the NYSE increased over 400 percent and that in 1989, for example, short sales constituted 7.2 per cent of all reported share sales on the NYSE. It is difficult to assess the position in Australia where brokerage firms engage in short selling, inter alia, within the parameters allowed by the Stock Exchange Rules (Rule 2.11). Although brokerage firms are required to submit daily reports of their short selling activity to the ASX, *published* statistics as to the incidence of short selling in this country are not readily available. The ASX compiles monthly Short Selling Report Graphs but these are not published, nor are aggregate yearly statistics collated and published. No mention is made of the practice in the annual Fact Book published by the ASX, which in other respects provides a wide array of statistical information relating to the stock exchange and its activities. Furthermore enquiries have revealed that there is some element of doubt as to whether all short sales are in fact reported to the ASX. The doubt arises from the fact that if the seller has borrowed stock, then he is not regarded as having sold short and is therefore under no obligation to report the transaction. According to Mr. John Brien, of the ASX Sydney office, this matter is now being addressed since it clearly runs counter to short selling principles. It would appear therefore that the statistical data on short selling in Australia is unreliable.

rationalise and stream-line our corporate and securities laws,[20] and furthermore to develop in Australia harmonious and compatible laws with overseas jurisdictions,[21] this is now an opportune time to revisit the subject of short selling. Accordingly, the purpose of this chapter is to examine the legal principles and general policy considerations relevant to short selling in the securities market in Australia — drawing comparisons with the United States[22] where appropriate — with a view to explaining the operation of this significant market technique, discussing existing regulation[23] and suggesting possible reforms.

Beware the Bear? — The Historical Perspective

Despite being the target of considerable criticism, the practice of short selling has enjoyed a long and, at times, distinguished history. It is, perhaps, 'not widely realised that the selling of the island of Manhattan in 1626 was America's first short sale.'[24] Its historical origins, however, may be traced as far back as biblical times, when it is said that 'Esau sold his inheritance, which he did not possess, to his brother Jacob for a mess of potage.'[25] The common law has for long 'adopted an attitude that recognises short selling to be legal for otherwise the prohibition of the practice "... would put an end to half the contracts made in the course of trade".'[26]

Most of the attempts to regulate the practice of the short selling of shares 'have come in the wake of periods of severe market instability and this certainly was the case in Australia.'[27] The impetus for the reform of the securities markets in this country was provided by the mining boom of the late 1960s and early 1970s:

20. In recognition of the widely accepted need to rewrite the Corporations Law and to focus on simplicity, the former Federal Labor Government in 1993 embarked upon a comprehensive program for the simplification of the Corporations Law. In practice, as the process evolved, the emphasis turned to substantive change as well as simplicity. The reform program of the Coalition Government — the Corporate Law Economic Reform Program (CLERP) — announced in March 1997, has a distinct economic focus. It is part of the Government's drive to promote business and economic development, and to create a flexible and responsive regulatory regime that will help Australia move to the leading edge as a world financial centre: The Treasurer, Peter Costello, Press Release No 136, 19 December 1997.
21. It must be said, however, that it is not necessarily a sufficient argument in *itself* that the practice is permitted in other jurisdictions. Furthermore, there are variations between countries.
22. For it is in the United States where the practice has been developed and refined to its most sophisticated form, and where the bulk of the literature on the subject originates.
23. Not merely in terms of the content of the current legislative provisions, for this is traversed in the texts on the subject, but more broadly in terms of the ideological underpinning of the legislation and how appropriate, or otherwise, the provisions are in regulating the practice of short selling.
24. R M Sharp, *The Lore and Legends of Wall Street* (1989) 27. 'Peter Minuit, the first director general of the Dutch West India Company bought Manhattan Island from the Indians for U.S. $24, the equivalent of 60 gilders. There is strong reason to believe that the Indians sold something they did not own to the out-of-towner ... there is even doubt that any Indians resided on the island at all at the time': Ibid 27, 28.
25. Robert Baxt, H A J Ford and Ashley Black, *Securities Industry Law* (5th ed. 1996) 294.
26. Kedzior, above n 16, 330, quoting a passage from the judgment of Baron Alderson in the Court of Exchequer in *Hibblewhite* v *McMorine* (1839) 5 M & W 462, 467.
27. Kedzior, above n 16, 330.

> The mining boom was a period of intense speculation in mineral stocks . . . [and it] also witnessed a number of stock market disasters . . . These disasters were caused by a number of unscrupulous practices, such as the use of unsubstantiated geologists' reports in prospectuses; privileged share placements; insider trading; market rigging; and the speculative use of short selling.[28]

Largely as a result of the excesses of the mining boom, a Senate Select Committee on Securities and Exchange[29] was established in 1970 to report on the securities industry and its regulations. In so far as the Rae Committee dealt specifically with short selling, it expressed concern at the practice, briefly commented on the mining boom disaster known as the 'Antimony Nickel Affair' and noted that short selling had caused market instability.[30] Meanwhile, various states introduced legislative provisions, with admittedly somewhat different emphasis, whose purpose was to prohibit or curtail the practice of short selling.[31]

It is widely acknowledged that the 'catalyst in the creation of the short selling offence in Australia was the trading in the early 1970s in the mining stock Antimony Nickel N.L.'[32] In *Osborne* v *Australian Mutual Growth Fund*,[33] which was based on the Antimony Nickel Affair, the Fund in March 1971 instructed its brokers to purchase 100,000 shares in Antimony Nickel N.L. and the brokers contracted to do so. The contract notes sent by the brokers to the purchaser bore the endorsement that the transactions were subject to the articles and by-laws of the Sydney Stock Exchange. The selling brokers, who had sold the 100,000 shares to the Fund's brokers, were able to deliver scrip for only 38,000 shares. The buying-in procedure commenced but could not be completed because the stock exchange suspended trading and buying-in of shares in Antimony Nickel N.L. It appeared likely that the suspension would continue indefinitely.

On 17 August 1971, there having been no indication that the balance of the scrip would be delivered, the Fund purported to rescind its contract with its own brokers and the selling brokers who had failed to deliver the scrip. Within ten days, the remaining 62,000 shares were delivered to the Fund's brokers who, notwithstanding the Fund's notice, paid for them and sought in the action a declaration that the Fund was bound to accept and pay for the shares. Street J held that the Fund's notice effectively terminated any subsisting contractual obligations to deliver and accept shares. There had been such neglect by the sellers of their obligations that the Fund was entitled to assume that they no longer intended to be bound by the provisions of their contract. As a result, the Fund's brokers were left bearing the loss.

To date, there have only been two other Australian cases involving legal problems arising from short selling.[34] *Utz* v *Javor*[35] involved the sale of securities by a stockbroker on the

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28. Ibid 330, 331.
29. Herein referred to as 'the Rae Committee'.
30. Report of the Senate Select Committee on Securities and Exchange: *Australian Securities Markets and their Regulation* (1974) Part 1 Volume 1 475–6.
31. Kedzior, above n 16, 333.
32. Deutsch, above n 16, 142, 143.
33. [1972] 1 NSWLR 100.
34. These cases are discussed below and also in Robert Baxt, *The Rae Report — Quo Vadis?* 145, 146; Baxt, Ford and Black, above n 25, 295–6; Ford and Austin, above n 4, 915, 916; Kedzior, above n 16, 331–3.
35. [1973] 2 NSWLR 1.

defendant client's account. Following a significant rise in the price of the shares, and a search of the share register of the company which revealed that the defendant was not the registered proprietor of those shares at the time, the stock broker had reason to think that the shares had been sold short. The client had apparently sold the securities at a given price, intending to purchase them at a lower price, but instead the price had increased. The stockbroker, fearing the client did not own the shares he had sold, then purchased on the client's account a further 1,000 shares to replace them. The client refused to pay for these shares and the Supreme Court of New South Wales upheld his defence on the ground that the broker was not entitled to purchase shares on his behalf in anticipation of a breach of stock exchange rules. The seller had not failed to deliver the securities as required by the articles of the Sydney Stock Exchange, because the time for delivery had not yet arrived, and the plaintiff's suspicion that the defendant might not be able to deliver was not sufficient.

In *Dowling* v *Scarf*,[36] a firm of brokers sold short on behalf of a client. In order to meet their obligations to the buying broker, the selling brokers in September 1969 delivered scrip appropriated from an internal scrip 'pool'. Over a year later, in order to cover the shortfall of scrip resulting from the earlier transaction, the brokers purchased the necessary shares in the market at a considerably increased price, expending some $14,000 more than the price of the shares in September 1969. The brokers then sued the client for $14,000 damages.

Needham A-JA in the NSW Court of Appeal rejected the plaintiffs' claim, and held that they were entitled only to the price of the shares in September 1969 when the order was fulfilled. At that point, the client's obligations crystallised and there were no further rights available to the brokers. The Sydney Stock Exchange regulations conferred upon selling brokers the right to buy scrip against their principal if the principal failed to produce the scrip subject to the sale. Once the right to buy scrip against the principal was exercised, any remaining right against the seller was a right to damages or indemnity only. The provision of scrip by the selling brokers to cover the short sale was an exercise of that right. The brokers were therefore limited in damages to the loss on the value of the shares when they were provided (ie. in September 1969) to cover the short sale.

It may well be that the legislative response was an over-reaction to the problems that short selling was perceived to create. It is instructive to note that 'The Brisbane Stock Exchange in discussing short selling at the time of the Antimony Nickel corner [commented that] . . . "We believe it is wrong to judge the whole question of short selling on one isolated case . . . we believe the short seller can perform a desirable function in the market-place and we believe he should be permitted to continue to do so." '[37]

Although originally prohibited or severely circumscribed by narrowly drawn exemptions under the earlier versions of the securities industry legislation, in the mid-1980s a much broader exemption was introduced permitting short selling in accordance with the

36. (1975) 1 ACLR 248.

37. Baxt, above n 34, 145. Also see Baxt, Ford and Black, above n 25, 295 for the opposition to short selling expressed by the Commissioner for Corporate Affairs of New South Wales in the mid-1970s.

business rules of the Australian Stock Exchange.[38] The exemptions have been retained under the Corporations Law and there have been no further significant developments in this area.

As far as the historical importance of short selling in the United States is concerned, the early years of the twentieth century are the most critical to this subject. Furthermore, in the history of securities trading in that country, the regulation of short selling can only be understood in the context of the bear raid. Whereas the bull anticipates a rising market, the bear sees a declining market on the horizon.[39] A bear raid is a form of market manipulation in which short sellers force down the price of a stock, in the hope that they will 'cover the shorts' at greatly reduced prices.[40] The problem in the United States in the early part of this century was that there were a number of notorious instances 'in which the bears not only anticipated a market decline but took direct steps to cause the decline to occur.'[41] In particular, the much publicised bear raid on Northern Pacific Railroad in 1901 'involved many of the great names in business and dealt a severe blow to public confidence in securities markets. It was to provide a lesson that would often be cited as a reason for the regulation that surfaced more than thirty years later.'[42]

Indeed, there were in the United States no effective federal securities laws until 1933. Therefore, for 'the entire period of the 1920s until well into the depression, the markets were conducted without externally composed standards or requirements.'[43] The market crash of 1929, the early bear raids and other manipulative and unethical practices 'awakened the public and the financial community to the need for effective and enforceable controls'[44] and eventually culminated in the passage of the Securities Act 1933 and the Securities Exchange Act 1934. Whilst the rules relating to short selling[45] have been amended since their adoption, their purpose 'has not changed since the 1930s. That purpose is to prevent short sellers from effecting short sales in a security traded on a national securities

38. See s 68 (3) Securities Industry Code 1980; regs. 33 and 34 Securities Industry Regulations 1981; the final exception was introduced by the Companies and Securities Legislation (Miscellaneous Amendments) Act 1985, as a result of a recommendation of the Campbell Committee (n 61 below) allowing short sales in accordance with business rules of the Australian Stock Exchange (herein referred to as the ASX). See Business Rule 2.11 (n 63 below).
39. Walker, above n 2, 9.
40. For a bear raider to be successful, he must force down the price of the stock through short sales. Once the trend is set in motion, he can cease selling and allow public sellers to accelerate the decline. As the price drops further, the bear raider repurchases the stock (covers the short) at profitable bargain prices. This has, at times, enabled raiders to gain control of a company at levels well below true value. The basic theory of a bear raid, however, is that the stock must be placed under selling pressure: at first, short sales are made at successively lower prices — later, the short seller buys at the lower prices created by the original short sales: Ibid 33.
41. Ibid. The most notorious was the bear raid on Northern Pacific Railroad in 1901: Ibid 21–3. Two more bear raids that occurred involved the Stutz Motor Car Company of America and a company called Piggly Wiggly Stores both in the1920s: Ibid 10–19.
42. Ibid 21.
43. Ibid 19.
44. Ibid.
45. The Securities Exchange Commission has promulgated three rules that together regulate short selling: Rule 3b-3, which defines the term 'short sale'; Rule 10a-1, which prohibits short selling in a falling market; and Rule 10a-2, which prohibits broker-dealers from engaging in certain activities that could facilitate an illegal short sale.

exchange when the price of that security is falling.'[46] U.S. regulation of short selling has always been predicated upon making manipulative bear raids illegal — the object of the rules is to prevent the exertion by short sellers of downward pressure on a falling exchange market, and to combat abusive short selling practices of bear raiders. However, unrestricted short selling in an advancing market is unaffected by the rules and is thus allowed.[47]

The Laws, The Rules and the Mechanics of Selling Short

When stock is sold, the seller is said to be either long or short. A long seller owns the shares and will deliver them to the buyer; a short seller does not intend to deliver his own stock, but will deliver borrowed shares. Whatever the purpose of selling short, 'the most important element is the ability to borrow the shares.'[48] The mechanics of the modern short sale have been described as follows:

> Short selling is a device whereby the speculator sells stock which he does not own, anticipating that the price will decline and that he will thereby be enabled to 'cover', or make delivery of the stock sold, by purchasing it at the lesser price. If the decline materializes, the short seller realizes as a profit the differential between the sales price and the lower purchase or covering price.
>
> An order is given to a broker to sell the stock short, and the order is executed on the floor of the exchange and recorded in precisely the same manner as any other order to sell . . . The seller is required to make delivery of the stocks he has sold within the period limited by the rules of the exchange. Since he has no shares to deliver, he must obtain them somewhere. The usual practice is for the broker executing the sale to borrow the stock on his customer's behalf. Usually it is borrowed from another broker . . . The broker uses the borrowed stock to make delivery to the person who has purchased from his customer, the short seller. Later, when the short seller covers, his broker purchases the stock in the market and delivers it to the lender. When the borrowed stock is returned, the lender repays the money which is on deposit with him and the transaction is closed.[49]

Overview of the short selling provisions — Australia

In Australia, the regulation of short selling 'takes the form of a legislative prohibition with statutory exceptions.'[50] The main legislative provision is that contained in section 846(1)

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46. Worley, above n 16, 1255.
47. Under SEC Rules 10a-1 and 10a-2, enacted in 1938 and amended in 1939, a short seller is prohibited from initiating a price decline. Short sales in which the price of the stock was rising were unaffected — quite the opposite of the bear raiders' intentions: Walker, above n 2, 33.
48. Ibid 65.
49. Loss, above n 2, 645, 646, quoting from the 1934 Report of the Senate Investigation into Banking and Currency, n 95 below. Note that today, short sales in approved securities must be made in margin accounts of 'not less than 20 per cent of the contract price of the appproved security short sold which the broker shall hold in trust until the short sale has been covered by purchase of the same number of securities from a third party. This cover may be in the form of cash or listed securities . . . or both . . .: Rule 2.18(8)(a)': Baxt, Ford and Black, above n 25, 299. The relevant Rule is now 2.11.5(1) and (3).
50. Ford and Austin, above n 4, 916. The following is not intended to be an exhaustive description of the regulations governing short sales — it is rather an outline of the salient features. For a detailed discussion, reference should be made to Baxt, Ford and Black, above n 25, 297–301; Kedzior, above n 16, 327; Deutsch, above n 16, 142.

of the Corporations Law, which prohibits the sale of securities unless the seller at the time has, or believes on reasonable grounds that he or she has, a presently exercisable and unconditional right to vest the securities in the purchaser.[51] A number of exceptions to this broad prohibition are then listed:

1. Odd-lots: a broker who is a member of a securities exchange and who specialises in dealing in odd lots (defined as a parcel less than one marketable parcel) may short sell those transactions.[52] Such sales are permitted on the basis that they are unlikely to prejudice the solvency of the dealer or move the price of the security.[53]
2. Arbitrage transactions: a sale of securities as part of an arbitrage transaction is outside the prohibition.[54] Arbitrage is the near simultaneous purchase and sale of the same or exchangeable security in the hope of showing a profit through a difference in markets. Arbitrage transactions are excluded from the prohibition because they are thought to serve a useful purpose by bringing into parity two prices which represent the same economic equivalent.[55]
3. Unfulfilled conditions: securities may be sold by a person who, at the time of short selling securities, has already contracted to buy those securities, but has not completed the purchase.[56] This exception applies where the only conditions on the right to have the securities vested in the short seller are:
   (i) payment of the purchase consideration;
   (ii) receipt by the short seller of a proper instrument of transfer; or
   (iii) receipt by the short seller of title documents to the securities.
4. Sellers who are beneficiaries of a trust, or for whom securities are held by a nominee, and who have a presently exercisable and unconditional right to call on the trustee or nominee to vest the securities in them, are not within the prohibition. Nor is a seller whose securities are charged or pledged to another person to secure the repayment of money.[57]
5. Three day deliveries: a limited right to short sell is permitted where arrangements are made before the sale that will enable delivery of securities of the class sold to be made to

51. Securities are defined under s 92(1) to include government debentures, stocks and bonds, corporate shares and debentures and prescribed interests (now referred to as managed investment schemes). The parameters of the prohibition are therefore broad.
52. Section 846(3)(a). Section 761 defines 'marketable parcel' in relation to securities that are listed for quotation on the stock market of a securities exchange, as a marketable parcel of those securities within the meaning of the relevant business rules or listing rules of that securities exchange.
53. ASIC Discussion Paper: *Short Selling*, May 1994, 14. The 'odd-lots' exception has been of little significance since 1995 when, following the introduction of electronic trading, the ASX abolished requirements about trading in marketable parcels: Baxt, Ford and Black, above n 25, 297.
54. Section 846(3)(b).
55. Baxt, Ford and Black, above n 25, 297. Also see ASX Business Rule 2.11.2.
56. Section 846(3)(c). This provision has attracted criticism: see Baxt, Ford and Black, above n 25, 298–9. Such sales are not required to be reported anywhere, with the result that the statistical data on short selling activity in this country is incomplete.
57. Section 846(2)(a) and s 846(2)(b) respectively.

the buyer within three business days after the sale.[58] The concession is not available where the seller is an associate of the body corporate whose securities have been sold short.[59] In addition, if the short sale is made on the stock market of a securities exchange, the 'price must be 'not below' the price at which the immediately preceding ordinary sale was effected, or equal to that immediately preceding sale price.'[60] The stock exchange must be notified immediately of the short selling nature of the transaction.

6. Stock Exchange regulated short sales: arguably the most important exception (to which reference has already been made) resulted from a recommendation of the Committee of Enquiry into the Australian Financial System.[61] It was introduced in 1985 and allows short sales which are in accordance with the Business Rules of the ASX.[62] Subject to certain safeguards, securities which have been designated by a securities exchange as being 'approved' for short selling are outside the prohibition. At the time of the sale, the seller must not be an associate of the body corporate that issued the securities, and the sale must be effected in accordance with the business rules of the securities exchange. Under Business Rule 2.11,[63] which establishes the requirements for short sales of approved securities under the ASX Business Rules:

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58. Section 846(3)(d)(ii).
59. Section 846(3)(d)(i).
60. Section 846(3)(d)(iii). This provision has been variously described as the 'up-tick' exception: see Ford and Austin, above n 4, 916; and the 'last sale' rule: see Kedzior, above n 16, 341. Whichever meaning is ascribed to the provision, the 'condition about the sale price is an attempt to reduce the risk that the seller is a speculator selling on a falling market and is thus engaging in one of the less desirable ways of shortselling': Baxt, Ford and Black, above n 25, 298.
61. The Campbell Committee: *Australian Financial System — Final Report of the Committee of Enquiry* (AGPS 1981).
62. Section 846(3)(e). The history of this provision is traced in Kedzior, above n 16, 334–5. The reporting requirements of the ASX require that such sales be reported to the ASX as short sales. However the whole market is not informed.
63. The relevant Business Rule was formerly Rule 2.18. For a detailed discussion of the Rule and in particular Rule 2.11.4, refer to Baxt, Ford and Black, above n 25, 299–300. A list of approved securities appears in Appendix 6.6 to the ASX Business Rules. As at July 1998, there were some 231 securities designated as approved by the ASX (compared with 113 as at April 1993). They are predominantly fully paid ordinary shares or units issued by leading industrial and mining companies, banks, television networks, airlines, newspaper and publishing companies.

    ASX Business Rule Guidance Note 10/97 (8 December 1997) deals with the interpretation and scope of BR 2.11. The Guidance Note expresses the view that, if a seller has entered into an enforceable arrangement which grants it an unconditional right to transfer a number of securities to the buyer, the seller has a presently exercisable and unconditional right to vest the security in the buyer and BR 2.11 does not apply. The Guidance Note suggests that a sale of securities will not constitute a short sale if the seller is entitled, under a trust, to call for those securities to be transferred to the seller or at its direction at any time.

    The Guidance Note also notes that whether a seller, which has a borrowing arrangement in place, has a presently exercisable and unconditional right to vest the security in the buyer will depend upon the terms of the borrowing arrangement. The Guidance Note expresses the view that the seller will not have such a right if the borrowing agreement requires the lender's consent to the transfer of the particular securities until that consent has been obtained. The Guidance Note also indicates the Exchange's view that prudence and best practice require that borrowing arrangements and any notices or requests for securities under those arrangements should be in writing, or be confirmed in writing.

    The Guidance Note indicates that 'option arbitrage', where a seller sells shares in a listed company which it plans to deliver by exercising options to be issued shares in the company, amounts to a short sale. Such a transaction will contravene BR 2.4.1(1) because, at the time of the sale, the relevant securities will not have been admitted to official quotation. The Guidance Note also summarises reporting obligations under BR 2.11 concerning short sales.

> . . . declarations can be made in respect of securities of companies that have at least 50 million shares or stock units on issue, that have a market capitalisation of more than $100 million and where there is, in the opinion of the exchange, enough liquidity in the market in respect of the securities. Business rules stipulate that short sales cannot represent more than 10 per cent of the total number of units of the approved security. Short sales are to be reported to the exchange. The seller is to provide margin of at least 20 per cent of the contract price and there is to be no short sale below the last ordinary sale price. Short sales are not permitted while a takeover bid is current.[64]

It should be noted that ASIC is empowered to prohibit short selling in respect of securities generally, or a class of securities.[65] This provision is designed to facilitate the workings of a fair, orderly and efficient market and enables the regulator to protect the interests of investors who might sustain financial loss as a result of short sales, or to protect the public interest.

7. Exchange traded options: under the Corporations Regulations, certain option transactions are also exempted. Corporations Regulation 7.4.07 provides that the prohibition does not apply to the sale of a security which consists of the giving or writing of an option registered with Options Clearing House Proprietary Limited. Corporations Regulation 7.4.08 provides that the prohibition does not apply to a short sale of shares if the short seller holds exchange traded options at the time of sale which, if exercised, would result in the short seller holding at least the number of shares sold short.

The philosophy of disclosure, which lies at the heart of much of our corporate and securities regulation, is manifested in the requirement that a prospective seller under an arbitrage transaction, a three-day delivery transaction or a seller under the business rules who instructs a dealer to make the sale, must advise the dealer that the sale is a short sale.[66] There is also provision for buyers being warned on the contract note that a sale is a short sale.[67] These provisions are designed to alert the broker or other dealer as to the nature of the risk.

The current state of the law in Australia relating to the regulation of short selling has led Professor Howard to conclude that:

> The position taken by the law on the issue at the moment is basically to prohibit short selling but then create a number of exceptions, most of which are not really short selling at all. The effective result is that short selling is *possible under very restrictive conditions.*[68]

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64. Ford and Austin, above n 4, 917. Short sales permitted under BR 2.11 apply not only to sales of 'approved securities' (those in companies and trusts which have a substantial market capitalisation, a substantial number of shares of a particular class on issue, and an active market). They also apply to 'public securities', defined to include securities issued by certain government and semi-government authorities, other than securities issued in respect of a loan raised outside Australia and the Territories unless a declaration by the Treasury is in force that those securities are public securities for the purposes of the Income Tax Assessment Act, or loan securities issued after 12 April 1976 by a bank.
65. Section 847.
66. Section 846(4). Inquiries have revealed that, in practice, this requirement is routinely circumvented. Clients do not, as a matter of course, advise brokers of the short selling nature of the transaction and are therefore able to avoid having to make margin payments.
67. Section 846(5).
68. Howard, above n 9, 85. Emphasis added.

Drawbacks and deficiencies

There are a number of problems arising out of both the legislative provisions and the business rules. It has been argued that 'insufficient attention has been given by the legislature to the drafting of [s 846] and in particular to the use of the word "securities" in that section.'[69] The argument is that the 'inclusion of "a prescribed interest" as part of the "securities" definition . . . may create real difficulties of limiting the impact of [s 846].'[70] Where, for example, a person contracts to buy a unit off-the-plan and before completion on-sells to a second purchaser, 'is it not arguable that he has purchased a prescribed interest (a security) and has on-sold it in breach of [s 846]? If so, many people who have taken part in this type of scheme . . . have been unintentionally breaching [s 846 of the Corporations Law].'[71] There are other situations as well 'where the short selling provisions may prove to be overly restrictive [including some franchising arrangements] bullion schemes and time-sharing arrangements, all of which are now clearly within the prescribed interest definition.'[72]

A further problem is that contravention of section 846 results in the imposition of criminal liability only[73] — in other words, there are no civil remedies in respect of the offence of selling short. No satisfactory explanation has been given for this state of affairs. Whatever the rationale behind the rule, it has produced a highly anomalous situation in which investors who sustain significant loss as a result of any unlawful conduct of the short seller are placed in an untenable position, as they may not directly claim compensatory damages. This is not to say, however, that civil consequences can never follow from a short sale. It has been argued that, in the event of persistent infringement of section 846, it is conceivable that the court may exercise its discretion under section 1324(10) — which empowers the court to award damages in lieu of, or in addition to, an injunction — 'to order the short seller to pay damages to any person whose interests have been affected by the conduct, even presumably another investor who can show that the short sale had a detrimental effect on his market position.'[74]

The matter has not, however, been conclusively resolved and the contrary view also has influential support: '. . . in the absence of any legislative intention to provide a remedy in damages for breach of s 846 the power to award damages given by s 1324 is unlikely to be exercised.'[75] Thus, until a court finally decides the point, the debate continues as to

69. Deutsch, above n 16, 149. See s 92(1) and (2) of the Corporations Law for the definition given to 'securities'.
70. Ibid 143. The concept of prescribed interests has been replaced with that of interests in a managed investment scheme: Managed Investments Act 1998.
71. Ibid.
72. Ibid 145. See further Ford and Austin, above n 4, 394. It should be noted that the definition of 'time-sharing schemes' is confined to schemes which are to operate for not less than three years; and, as noted above, the concept of prescribed interests has been replaced with that of interests in a managed investment scheme: Managed Investments Act 1998.
73. The penalty for a first offence is a fine of $2500 or imprisonment for six months, or both; for a second or subsequent offence, the fine is $10,000 or imprisonment for two years or both: these are the maximum penalties for an individual. For a body corporate, the maximum fine is five times that for an individual: Baxt, Ford and Black, above n 25, 301.
74. Deutsch, above n 16, 147.
75. Baxt, Ford and Black, above n 25, 301.

whether damages may be awarded under section 1324(10).[76] This state of affairs is clearly unsatisfactory, as is the uncertainty surrounding the issue of whether a transaction, entered into in breach of section 846, is absolutely void for illegality and unenforceable. Again, different positions have been taken in the literature on the subject[77] and the matter similarly awaits a judicial ruling.

The business rule relating to short selling[78] is equally unsatisfactory in a number of respects. The implementation of notions such as 'marketability' and 'capitalisation' when designating a security as an 'approved security' gives rise to a number of difficulties. One is 'the subjective nature of the concepts.'[79] Furthermore, 'the Business Rule does not stipulate as to whether there is to be strict compliance with [the] arbitrary figures'[80] relating to these concepts. There is also a total absence of guidelines that are to be used in the determination of whether a sufficient degree of liquidity exists in the market for the security.[81] Finally, although the business rule relating to short selling is reasonably clear as to which securities are to be targeted for approval, its ambit of operation is not sufficiently broad. There are too many restrictions and technicalities built into the system of approval. Thus 'non-approved' securities is an area of inadequacy and the rule is, quite simply, not generous enough.

The regulatory regime in the United States

Short selling in the United States is principally regulated by the SEC and by certain rules of the stock exchanges and the NASD.[82] The rationale underlying this regulation is essentially the acceptance and sanction of the practice except where exchange-traded securities are sold short in a falling market. In other words, short sales are not permitted in a falling market, although they are permitted in a rising one. The prohibition on selling short in a falling market is, in turn, governed by the Short Sale Rule. The prohibition applies to every transaction effected on a national securities exchange and to transactions in certain exchange-traded securities effected in the OTC market.[83] The SEC has promulgated three rules that operate together to regulate short selling: Rule 3b-3, which defines the term 'short sale'; Rule 10a-1, which is the prohibition on short selling in a falling market; and Rule 10a-2, which prohibits broker-dealers from engaging in certain activities that could facilitate an

76. See Baxt, Ford and Black, above n 25, 301; Kedzior, above n 16, 342, 343; Deutsch, above n 16, 147.
77. Deutsch has suggested that, 'although the answer is far from clear,' the short selling contract would be void: Deutsch, above n 16, 148. Baxt, Ford and Black, above n 25, 301, state that 'While the contract in an illegal short sale would probably be enforceable by an innocent buyer, the seller might be met with the defence that the contract was void for illegality. In any event, the Federal Court or a Supreme Court may declare the contract void or voidable on the application of the ASC . . . [or] the ASX: s1114'.
78. Rule 2.11. See above n 63.
79. Kedzior, above n 16, 339.
80. Ibid.
81. Ibid 340.
82. Janvey, above n 16, 277. NASD refers to the National Association of Securities Dealers.
83. Worley, above n 16, 1256. OTC refers to over-the-counter trading.

illegal short sale.[84] It should also be noted that the Federal Reserve's margin regulations 'require a short seller to post a certain amount of additional cash margin and to maintain afterward an appropriate amount of cash margin.'[85] This limits the amount of short selling an individual investor can undertake, based on his or her financial resources.

Rule 10a-1, which is frequently referred to as 'the uptick rule', is the key regulatory device with respect to short sales. Its origins, as previously stated, derive from the aftermath of the bear raids of the early decades of the century. The short seller must find a buyer who will pay at least one-eighth point more than the last sale price (a 'plus tick'), or who will pay the same as the last sale price if the last change in the sale price was an increase (a 'zero-plus tick'). In theory, the rule is designed to 'prevent short selling from continually driving down the price of a stock, but evasion of this rule is possible, especially through overseas trading in stocks that can be traded in London, Tokyo, or other overseas markets.'[86] The SEC has proposed to amend Rule 10a-1 to provide for an exception that would allow a short sale that equalises the opening price of a foreign security on a U.S. exchange with its price in the principal foreign market for the security.[87] Furthermore, the SEC has proposed to exclude from the application of Rule 10a-1, transactions in corporate bonds and debentures effected in an exchange.[88]

Rule 10a-1 contains a number of exceptions to the rule's tick test, which are designed to permit certain types of trading that are believed to be beneficial to the markets, or that carry little risk of the kind of manipulative or destabilising trading that the Short Sale Rule was supposed to address. These include transactions in arbitrage accounts, international arbitrage accounts, special offering plans and underwriting distributions; there are also exemptions for 'registered specialists, registered exchange market makers, and third market makers, which permits short sales on zero-minus ticks.'[89] Finally, the Rule includes an exemption for certain odd-lot sales.

From the mid-1970s, the SEC began to seriously question 'the continued validity and necessity of a Short Sale Rule, in general, and the restrictions imposed by the 'tick test' in particular. The SEC has continued to create exemptions to the Short Sale Rule both by adopting new exemptive provisions and granting no-action letters, in recognition of the fact that many situations exist in which the Short Sale Rule should not apply.'[90] The 1992

84. Ibid 1256, 1257. In addition, the SEC has adopted Rule 10b-21(T) (on a temporary basis), which restricts certain short selling activities in connection with a public offering of securities: Ibid 1257.
85. Janvey, above n 16, 277.
86. Ibid. Furthermore, the rule does not currently apply to stocks that are traded OTC, and it does not apply yet in the NASDAQ system of the NASD. (NASDAQ refers to the National Association of Securities Dealers Automated Quotation trading). The NASD has in fact proposed a similar uptick rule, but this has yet to be implemented. The 1992 House Report (n 91 and n 155 below) also supported this recommendation: Ibid 292.
87. Ibid.
88. Ibid. See Release No. 34–0772, Short Sales, June 3, 1992 [Current Trans. Binder] Fed. Sec. L. Rep.# 84, 951.
89. Ibid 278, 279.
90. Ibid 278.

House Report,[91] the culmination of the congressional investigation into the practice of short selling, nevertheless recommended the retention of the uptick rule — by reducing issuers' and investors' vulnerability to problems from transitory price movements, the uptick rule is thought to be 'effective in stabilizing the market for exchange-listed stocks for the benefit of issuers and investors.'[92] For this reason too, the House Report recommended that the uptick rule should be extended to trading in NASDAQ issues as well. However, the approach adopted by the SEC over several decades has been to recognise the neutrality of certain short selling activities, such as those associated with the Merrill Lynch no-action letter,[93] 'as well as the need to tailor the Short Sale Rule to meet changes in the structure of the securities market.'[94]

Uses and Abuses

The 1934 Report of the Banking and Currency Committee,[95] established by the Congress of the United States to assess various practices of the securities markets, explained the arguments traditionally advanced by both sides to the debate thus:

> The proponents of short selling contend that it is a necessary feature of an open market for securities; that in a crisis short sellers are useful in maintaining an orderly market; and that their activities serve as a cushion to break the force of a decline in the price of stocks. Its opponents assert that short selling unsettles the market, forces liquidation, depresses prices, accelerates declines, and has no economic value or justification.[96]

In view of its inability 'to discover where the truth lay between the extreme views that had been expressed,'[97] the response of the United States' Congress was to settle on a 'compromise regulatory mechanism'[98] by placing the practice of short selling in registered

91. The U.S. House Committee on Government Operations published a report in January 1992 entitled *Short Selling Activity in the Stock Market: Market Effect and the Need for Regulation (Part1)*. Herein referred to as 'the House Report': see Janvey, above n 16, 270 and n 155 below.
92. Ibid 293. Transitory price movements caused by short sales that drive down a company's stock price can, for example, disrupt a planned public offering of shares to raise new equity capital. The House Report's endorsement of the uptick rule has however attracted criticism: see Ramsay, above n 16. He argues that the justifications for the uptick rule, including its supposed stabilising effect, are questionable and that the rule itself impedes market efficiency.
93. The no-action letter originated in December 1986, when SEC staff granted to Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) a no-action letter permitting it to sell stock short without regard to the 'tick test' under Rules 10a-1(a) and 10a-1(b) where such stock was being sold in the course of unwinding arbitrage positions. This was so even though Merrill Lynch might, on a net basis, have been short the stock as a result of positions in bona fide arbitrage, risk arbitrage, or bona fide hedge accounts being maintained elsewhere in the firm. Because of the multiple trading desks, each following a unique strategy, and the broad range of securities positions in which short selling played an integral part, Merrill Lynch had been concerned that it might not be able to achieve strict compliance with the Short Sale Rule. The SEC acknowledged these difficulties in granting such relief to Merrill Lynch: Ibid 281, 282.
94. Ibid 282.
95. Stock Exchange Practices, Report of S.Com. on Banking & Currency, S.Rep. No. 1455, 73rd Cong., 2d Sess. (1934).
96. Ibid 50.
97. Loss, above n 2, 649.
98. Deutsch, above n 16, 150.

securities 'under the plenary rulemaking authority of the [Securities Exchange] Commission.'[99] And indeed, the controversy surrounding the merits or otherwise of the practice of short selling continues unabated to this day.

At the core of the argument advanced by the opponents of short selling is the notion that 'the very idea of a person's selling something he does not own, in the hope of buying it back later at a lower price, is essentially immoral.'[100] In other words, it is the speculative nature of the transaction that has given it its perjorative connotation.[101] The result of this attitude, according to Professor Loss, is that 'short selling has been a favorite whipping boy, both when it has deserved to be and when it has not.'[102] It is said that short selling adds 'force to declining trends in stock prices, and [causes] disorderly markets where stocks are speculatively oversold.'[103] With respect to the latter, the difficulty is that buyers, who have unwittingly bought from short sellers, may encounter problems in obtaining delivery of share scrip from their sellers.[104] In addition, where a company is small, 'the total sales may exceed the number of shares on issue.'[105]

In the aftermath of the stock market scandals of the 1980s, particularly in the United States, it became clear that the misuses of short selling were associated not merely with bear raids, but more especially with insider trading, dubious takeover strategies, and other illegal tactics such as stock parking.[106] Many of the biggest players were involved: for example, the Wall Street firm of Drexel Burnham Lambert, which employed Michael Milken,[107] was reported to have covered a short position and established a long one in the stock of Viacom, a large cable and entertainment company based in New York, using Milken's inside information.[108]

Rumour spreading is perhaps a more difficult-to-detect practice that is sometimes connected with short selling. Here, a person or group seeking a decline in a stock's value might

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99. Ibid.
100. Ibid 647.
101. The fact that unrestricted short selling 'would permit the 'outright' speculator to speculate without having to put up any money' is said to be the main reason why short selling is regarded as dishonest or immoral: Kedzior, above n 16, 328.
102. Loss, above n 2, 647.
103. Baxt, above n 34, 146, quoting Mr. Ryan, the Commissioner of Corporate Affairs, whose comments on short selling after the Antimony Nickel Affair are illuminating. Professor Ford cites the same case: Ford and Austin, above n 4, 915. Baxt, Ford and Black cite three cases to illustrate the abuses arising from short selling (these being the only cases litigated in Australia on the subject): Baxt, Ford and Black, above n 25, 295–6: see above n 33–36. The Rae Committee commented that the dangers of short selling to 'the stability of the market became clear in the case of Antimony Nickel in early 1971 . . .': Baxt, above n 34, 145. It must be said, however, that the opponents of short selling construct their argument largely by generalising from such isolated incidents. Such a practice is fraught with danger.
104. Ford and Austin, above n 4, 915.
105. Ibid.
106. Stock parking is the illegal practice of transferring ownership of large blocks of stock to a nominal owner to avoid the requirements to disclose such ownership.
107. Two men — Michael Milken and Ivan Boesky — were market manipulators of epic proportions during the 1980s.
108. James Stewart, *Den of Thieves* (1992) 432. It should, however, be noted that many of the events that occurred during the 1980s in the United States were never officially made public because the main players, such as Michael Milken, Ivan Boesky and Martin Siegel, by pleading guilty to reduced charges, avoided full public trials.

spread false information indicating problems within a corporation.[109] Just as '"hot tips", whether true or false, can lead to a sudden surge of buying in a stock, rumors that predict trouble can cause a wave of selling and result in a decline in value,'[110] which is precisely the aim of the short seller.

It should also be said, however, that short sellers may be the victims of rumour spreading. A rapid rise in the price of a stock may often attract short sales, because a trader analysing the corporation in question may conclude that the price has gone too high, and a short sale might be in order. If the increase was caused by insiders buying on the basis of nonpublic information, the short seller may have fallen into a trap. For by the time he learns the facts, it is too late: the price may have gone still higher, and he has sustained a significant loss.[111]

Any discussion of short selling is incomplete without due consideration being given to the merits of the technique. Short selling is, in a wide variety of circumstances, a legitimate and useful practice, and it is this element which distinguishes it from those market practices generally regarded as 'misleading' or 'deceptive'. Indeed, the Corporations Law maintains the difference in approach originally created by the Security Industry Act 1980, between 'such practices as market rigging, the creation of false markets, insider trading (generally treated in the Corporations Law as misleading practices)'[112] on the one hand, and short selling on the other. Whereas the former are dealt with under Part 7.11, short selling is dealt with under Part 7.4 'as part of the controls of conduct of the securities business.'[113] The main reason for this is apparently that, as has been stated, there are compelling arguments justifying short selling as a useful and legitimate market strategy (unlike the misleading practices referred to), and indeed it is regarded as such on many leading overseas stock exchanges, such as New York and London.

According to the proponents of short selling, sustained selling in a down market is a normal activity and may be perfectly appropriate in light of prevailing market conditions. The practice originates from ancient commodity markets and it is still permitted in leading commodity markets throughout the world.[114] The argument is that Australia's competitive edge is being compromised by undue restrictions on Australian brokers, who may be unable 'to compete on an equal basis with overseas dealers.'[115] Short selling is also said to level out fluctuations in market prices: for it may 'assist in establishing a ceiling on a rising market in a particular share, and likewise, the subsequent buying transaction which covers the short position can assist in forming a base to a falling market.'[116]

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109. This would constitute a breach of the market manipulation provisions discussed in Part B, below.
110. Walker, above n 2, 38.
111. Ibid 44, 45.
112. Baxt, Ford and Black, above n 25, 294.
113. Ibid.
114. Short selling is also permitted in the Australian wool futures market.
115. Kedzior, above n 16, 330.
116. Baxt, Ford and Black, above n 25, 295, outlining some of the comments of the Brisbane Stock Exchange during the mining boom of the late 1960s. Deutsch and Kedzior are, however, critical of the argument that short selling smooths out fluctuations in the market prices of securities: see Deutsch, above n 16, 151; Kedzior, above n 16, 329. Kedzior also makes the point that unrestricted short selling can affect the price of different securities in different ways: Ibid.

Another argument advanced in favour of short selling is that it 'adds volume to trading and is [therefore] generally beneficial to all.'[117] The point here is that the person short selling securities generally does so because he or she believes the market will decline. Later, whether the prediction was right or wrong, the short seller must repurchase the security to cover the short. This means that an increase in liquidity is produced, which is 'good for all investors and for the market in general.'[118]

No doubt, the theoretical debate about the merits of short selling will continue — and in the absence of empirical research into the subject,[119] it is a debate that is unlikely to be resolved. In the real world, however, it cannot be denied that the practical applications of short selling are many and varied, and that it is a useful investment technique. There are today a multitude of commercial transactions in which short selling is featured. The sale of goods from a sample is a common occurrence, and provides a good illustration of the short sale. A housing developer who contracts to sell homes built to the specifications of a display home and on the client's preferred building site is, at the time the contract is signed, selling the house short: he did not have it at that time, but agreed to deliver it at a future date. An aircraft manufacturer who concludes a contract to sell 100 planes to a foreign country is similarly engaged in selling short: the details were agreed, the price established and the contract signed (thereby incurring considerable transaction costs), but the manufacturer did not then have the planes in stock. The company thereafter has to begin to manufacture the aircraft and deliver according to the agreed terms. At the time the sale was made, however, the company sold something it did not have.[120] Sportsmen who sign lucrative promotional contracts for a fixed term of, say, five years are likewise engaged in selling their services short. Further applications abound:

> Annual subscriptions to magazines are in effect a form of short sale — the magazine producers, while fully intending to produce future issues of the magazine, do not at the time of the contract in fact hold issues of it for later in the year.[121]

It is undoubtedly true, as Professor Baxt has pointed out, that these 'are of course not in the same category or class of "activity" as the short selling of shares.'[122] Nevertheless these illustrations perform a useful function: they answer the critics of short selling of shares, who take the view that it is an inherently deceptive practice, by highlighting the fact that similar practices are used in virtually every industry. The selling of a product or a service short is a widely accepted feature of commercial life. There is no mystique about it: for it means no more than that the seller agrees to deliver something in the future that he or she does not currently own or possess. If the seller does not make delivery properly according

117. Walker, above n 2, 6.
118. Ibid. See further Anon., 'The Secret World of Short-Selling' *Business Week* (New York), 5 August 1996, which argues that despite widespread misperceptions and some cases of excess, short sellers have an overwhelmingly positive impact on the stock market, especially 'when the bulls are running.'
119. The need for 'substantial statistical information' in Australia was recognised by Deutsch, above n 16, 150.
120. Walker, above n 2, 4.
121. Baxt, Ford and Black, above n 25, 294.
122. Baxt, above n 34, 144.

to the contractual terms, the result should be no different from what it would be had he or she contracted to sell something that he owned: namely a common law action by the purchaser for breach of contract.[123]

In the context of stock market practices, short selling has traditionally been viewed by the public with some scepticism, as 'both dangerous and subversive, the province of gamblers and market manipulators.'[124] However, the point has been aptly made that:

> To assert that the practice is simply a form of gambling is hypocritical in the extreme when the very essence of the options and futures markets (which are now well established markets in Australia) is speculation on the direction of future security prices . . . To simply ban the practice because it can cause short-term difficulties for buyers is to overlook the very real advantages the practice can have in a depressed market and . . . the problem can to a large extent be overcome by simply providing that in the event of a vendor selling short he shall disclose to the purchaser, prior to the date of contracting, that the sale is a short one. Caveat emptor should then be the rule.[125]

There have been those who have 'argued for years that efficient markets require investors to short overvalued assets as well as to buy undervalued ones.'[126] Markets rise and markets fall, and investors should be free to profit not only when prices rise, but also when they fall. To deny the capacity to short sell would be to utilise only half of the market's potential and thus produce an inefficient outcome.

Not all short selling is done purely as a speculation on a market decline[127]: it is often used by professionals as a means of facilitating other transactions.[128] For example, an area of the market[129] that frequently employs short selling is arbitrage.[130] There are many ways in which arbitrage can be carried out, some of which are risk-free, and in most cases, a short sale is part of the device.[131] The simplest form of arbitrage deals in geographic differences in security prices — the arbitrageur purchases a security in one market and

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123. This assumes that the contract to short sell is enforceable, but as stated previously, the current state of the law is such that the matter remains unresolved: see above n 77. Implementation of the proposal advanced here would settle the matter conclusively.
124. Hansell, above n 16, 62.
125. Deutsch, above n 16, 152. As stated previously, the principle of disclosure is manifested in the requirement that an 'intending seller under an arbitrage transaction, a three-day delivery transaction or a sale under business rules who instructs a dealer to make the sale must advise the dealer that the sale is a short sale: s 846(4). There is also provision for buyers being warned on the contract note that a sale is a short sale': Ford and Austin, above n 4, 917.
126. Hansell, above n 16, 62.
127. Loss, above n 2, 646, n.21. In this connection, the article by Ramsay, above n 16 is particularly instructive. He contends that much of the economic literature on short selling demonstrates that the practice is undertaken for a number of reasons, and that short selling undertaken for the purposes of speculation constitutes only a portion of total short selling. Much of the explanation for the increase in short selling in recent years, he argues, appears to be related to arbitrage and hedging opportunities.
128. Walker, above n 2, 52.
129. This is a reference to the United States securities market in particular. There is no published statistical data for Australia.
130. 'Arbitrage' (from the French meaning 'to judge') is the near simultaneous purchase and sale of the same or exchangeable security in the hope of showing a profit through a difference in markets. 'Put simply, the arbitrageur tries to find a situation in which he can buy at one price and sell at a higher price at virtually the same time': Walker, above n 2, 58.
131. Ibid.

simultaneously sells it, often short, in another market — but because disparities between markets tend to be closed quickly, the 'opportunities to engage in a bona fide arbitrage are quite few.'[132] It is also common in the trading of bonds,[133] and is employed to hedge positions,[134] to accrue tax benefits,[135] and to assist in ensuring the success of a new issue of stock.[136] The short seller is also quite active in futures markets.[137] A further application is the combination of 'equity options and short sales of stock . . . to produce imaginative market strategies.'[138]

An innovative technique involving the short sale has been the introduction of 'market-neutral portfolios',[139] which is a broad term applying to a wide range of money management programs:

> It is not an investment strategy per se but a way to implement any approach to picking stocks. Most commonly, it applies to funds . . . that buy a portfolio of stocks and simultaneously sell short an equal amount of other stocks. If the portfolio is constructed properly, it should be hedged against overall movements in the stock market. The return comes from the appreciation of the longs relative to the decline in the shorts plus an interest rate, roughly equivalent to that of Treasury bills, from the invested proceeds of the short sales . . . [A] number of leading pension funds and endowments have started putting from 2 to 5 percent of their assets in them . . . [It is estimated] that about $3 billion to $4 billion is now invested with market-neutral managers, and the sum is growing rapidly.[140]

In the mid-1980s, 'when the market looked like it was going to the moon, few talked publicly about short-selling.'[141] In the aftermath of the 1987 stock market crash, however, the practice of short selling of stocks became somewhat of a growth industry in the United

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132. Ibid 60. Bona fide arbitrage is considered to be beneficial to the markets because it tends to reduce irrational pricing disparities: Janvey, above n 16, 280. As noted above — n 93 — in December 1986, the SEC granted to Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) a no-action letter, which permitted it to sell stock short without regard to the 'tick test', where such stock was being sold in the course of unwinding arbitrage positions. Merrill Lynch was able to demonstrate that relief from the Short Sale Rule in the context of legitimate arbitrage could not lead to selling activity which would contravene the purpose of the Short Sale Rule: ie. to prevent bear raiding. In granting the no-action letter in these circumstances, the SEC recognised the neutrality of this activity, as well as the need to adjust the Short Sale Rule to meet changes in the structure of the securities markets: Janvey, above n 16, 281, 282. However, short selling frequently plays a part in the practice of risk arbitrage, and in this context it is essentially speculative in nature, and 'can often lead to disastrous results': Walker, above n 2, 6.
133. Walker, above n 2, 57. An arbitrage can consist of the purchase of one security, such as a convertible bond, and the simultaneous short sale of the security into which the bond is convertible: Ibid 6.
134. Kedzior, above n 16, 328; Walker, above n 2, 64. Investors have been exhorted to remember that: 'The safest way to take advantage of these short sale ideas is to use them in a portfolio that is hedged: part long, part short': Hulbert, above n 16, 285.
135. Walker, above n 2, 64.
136. Ibid.
137. Ibid 140.
138. Ibid 96. 'One such position involves an option position called a straddle. Straddles are used to profit from the degree of volatility that the underlying stock will experience during the life of the options': Ibid 97.
139. Hansell, above n 16, 58.
140. Ibid.
141. James Cramer, 'How To Stand Tall When Shorting Stocks' (1989) 123 *New Jersey Law Journal* 13. The Feshbach Brothers were notable exceptions: see n 150–154 below.

States: the 'short funds and the short research boutiques were inundated with money. Institutions that never shorted insisted on keeping a percentage of their funds short.'[142] 'How To . . .' articles[143] and books[144] were published advising investors of the pitfalls and potential rewards of short selling. Thus whereas the 'Great Bull Market of 1982-87 trampled nearly every bear on the way to its phenomenal 2000 point gain [and the] stampede crushed those who practice short-selling . . .,'[145] in uncertain times, with a more volatile market, opportunities abound for the short seller. After 1987, investors were advised that 'a balanced portfolio these days should contain at least one or two shorts . . .;'[146] that, with a 'market capable of declining 5 percent in a day, its nice to have a McDonald's, or a Telecommunications Inc., working for you on the way down,'[147] and that above all, shorts should be considered 'as "investments" instead of just short-term trades.'[148] IBM was given as an example of a good investment for shorting: 'The company's suffering a long-term decline, stemming from market erosion in all its businesses. Until that tide changes, shorting IBM is still a good investment.'[149]

The strategy employed by arguably the most successful of the short specialists in the United States is enlightening.[150] It is predicated upon the basis that:

> there are always speculative excesses in the market, and we've been able to keep our attention narrowly focused on things that are so grossly overvalued that when investors come around to realizing that fact, we benefit. That process can work whether the market's up or down.[151]

The approach adopted is to assess all the fundamentals, with particular emphasis upon product analysis, an understanding of management and their backgrounds, and cash-flow analysis, these being 'much more important than the typical financial ratios.'[152] Therefore, the aim is to identify and target companies that are 'really bad'[153] and where the elements of poor management, deficient business fundamentals, no product or uneconomic product and poor finances may be found. This particular short selling strategy does not depend upon predictions as to which way the market is likely to go:

> We basically go into the office each day assuming the market will be up . . . We don't bet on bear markets and we don't bet on the dollar falling or anything like that. We just figure that we've got to

142. Ibid.
143. See for example Cramer, above n 141, Cramer, n 145 below; and Matt Siegel, 'How to Sell Short if You're Bearish, Contrarian, or Merely Conservative' (1998) 137 *Fortune* 194, who argues that short selling can fit neatly into any strategy.
144. See for example Walker, above n 2.
145. James Cramer, ' Profiting with Shorts: Not Such a Tall Order' (1988) 121 *New Jersey Law Journal* 6.
146. Ibid.
147. Ibid.
148. Ibid.
149. Ibid.
150. This is a reference to the Feshbach Brothers of Palo Alto, California and their limited partnership, Southgate Partners: see Rohrer, above n 16, who chronicles the remarkable success of these short specialists for the period 1982–1989.
151. Ibid.
152. Ibid 84.
153. Ibid.

> short truly crummy companies that are not going to make it or that have materially misrepresented their numbers or where there are gross misperceptions about their business functions, fundamentals and opportunities.[154]

This investment technique has been remarkably successful, the more so that these short specialists have placed hundreds of millions of dollars, gathered from institutional and individual investors, 100 percent in downside bets. The strategy departs significantly from the practice of other short sellers who run hedge funds as a protective mechanism, and who ensure that only a portion of their assets are kept on the short side.

Misconceptions about Short Selling

In January 1992, the congressional investigation into the practice of short selling conducted by the U.S. House Committee on Government Operations,[155] culminated in the publication of a Report entitled 'Short-Selling Activity in the Stock Market: Market Effect and the Need for Regulation (Part 1).'[156] The interim[157] findings of the Committee are most illuminating, as they challenge many of the assumptions and preconceptions commonly held about the practice of selling short, and highlight the fact that its effects on the securities markets are not widely understood. As a result of its evaluation of short selling issues — carried out in the broad context of the 'psychological environment' within which the practice operates — the Committee concluded that 'many of the complaints about short seller abuse are not soundly based and may reflect a misunderstanding of the short selling process.'[158]

The House Report is the latest development in a process of review of short selling regulation in the United States which, as noted earlier, originated in the mid-1970s. At that time the SEC began to seriously question the rationale of the Short Sale Rule, and to create an ever increasing number of exceptions to it, including the Merrill Lynch no-action letter.[159] Arguably the most distinguishing feature of the recent congressional investigation was the extensive ambit of its enquiry, which included a review of the allegations of short seller abuse made by investors and company executives or reported in the press. Many of the complaints had 'alleged that short sellers, after establishing a major short position in a particular stock, [had] aggressively circulated false rumors about the company's financial condition, problems with its products, or the health or integrity of its officers, in an effort to drive down the stock price.'[160] Some short sellers were alleged to have directly contacted a company's major suppliers, customers, lenders, even institutional shareholders, often anonymously, to 'aggressively suggest false or misleading "facts" about the company.'[161]

154. Ibid.
155. Herein referred to as 'the House Committee'; see above n 86.
156. Janvey, above n 16, 270.
157. The Committee has not yet published its final conclusions and/or recommendations: Ibid 271.
158. Ibid 286, 287.
159. Janvey, above n 16, 278. See above n 93.
160. Ibid 284, 285.
161. Ibid 285.

Other complaints alleged that 'naked' short selling had been employed to manipulate and drive down the price of a stock improperly.[162]

It has been said that it is unfortunate that the Committee did not 'attempt independent verification of [the] accuracy [of the allegations] through field investigation.'[163] It was, therefore, unable to make any findings that certain of the allegations were 'conclusively demonstrated to be true . . . [or to] report documentation of specific incidents of abuse by short sellers.'[164] Having said that, the Committee found that many of the reports of rumour-spreading were entirely credible, and strongly suggestive of abuse.[165] As far as naked short selling was concerned, the Committee found that there was no direct evidence to support the allegations and that the circumstantial evidence offered was inconclusive.[166] Nevertheless, the Committee tentatively concluded that the reports of naked short selling might be true in some instances.[167] However, apart from these two categories, the Committee concluded that many of the complaints about short seller abuse were simply unfounded.

Of particular significance is the Committee's analysis of the psychological environment within which the practice of short selling operates. The Committee found that the subjective elements of psychology and perception among investors generally were essentially misplaced. Many investors had 'a perception that short sellers have great manipulative power over stocks,'[168] and that the SEC was indifferent to the manipulative activities of short sellers. Moreover, there was evidence of disillusionment with the fairness and efficiency of the equity markets, and a prevailing sense of 'being victimized by powerful but unknown abusers.'[169] In this connection, it is interesting to note the Committee's findings, namely:

> . . . that the fairness and efficiency of the equity market for stocks that are actively targeted by short sellers suffer from serious disturbances that cannot be attributed solely to specific instances of short seller abuse.[170]

In many instances, the critics of short selling are thought to have drawn conclusions about the manipulative power of short sellers without a solid factual basis. In part, this may have been due to the fact that, in the U.S., 'major short selling investors function entirely anonymously [for under] present reporting rules, it cannot be known, except through a

162. Ibid. Short selling in which the shares are not borrowed and are not delivered to the buyer is called naked short selling. Even the SEC was not immune from criticism, with allegations that it is 'soft' on short seller abuse, that it fails to pursue cases of false rumors even when the purpose is price manipulation, and that it actively assists short sellers by investigating companies whose stock is subject to large volumes of short investment. With respect to the latter, the publicity surrounding such investigations supposedly assists short sellers by causing other investors to sell their stock, thereby driving down the price: Ibid.
163. Ibid 285, 286.
164. Ibid 286.
165. Ibid.
166. Ibid.
167. Ibid.
168. Ibid 287.
169. Ibid 288.
170. Ibid 287.

special investigation by the SEC, the exchanges, or the NASD, who is holding the major short positions in a particular stock.'[171] More specifically, however, is the inherent bias that inevitably results from a situation in which a practice is conducted by a group with very substantial financial resources, and 'a capacity, financially speaking, to influence heavily or even dominate the trading activity'[172] in particular stocks. Given such an environment, the Committee found it 'readily understandable that these executives and shareholders of the affected issuer may reach exaggerated and ill-founded conclusions about the short selling "threat".'[173] Furthermore, when such exaggerated reactions become frequent and persistent, creating an 'unhealthy market psychology',[174] the potential damage to the market, in terms of a deterioration in pricing efficiency and market fairness, is substantial.

Targeting the complaint of abusive information distortion by short sellers, the Committee made a number of specific recommendations designed to improve 'the integrity of information flows about public companies, especially smaller companies.'[175] At a more fundamental level, however, the Committee pointed to the need for a commitment 'to dissipate the unhealthy psychological atmosphere that adversely affects the markets for many stock issues in which there is substantial short selling activity.'[176]

There has been no comparable investigation in this country, and although the ASX conducts a survey of brokers' firms on the subject from time to time, the findings are treated as internal documentation and have not been published to date. However, given the current thrust of Australian regulation of short selling — which is inherently biased against the practice — it may be suggested that there are important lessons to be learnt, and useful insights to be gained, from the 1992 House Report referred to above.

The Need for a New Direction

The existing regulation of short selling is overly cumbersome and complex, and is underpinned by an inherent bias against the practice of short selling that is no longer appropriate. Furthermore, it is unconscionable that investors who sustain financial loss as the result of any unlawful conduct of the short seller are not accorded the right of seeking compensatory damages, on the ground that the legislature intended that there should be no civil remedy. The logic of denying such investors the right to damages, whilst allowing those who suffer loss as a result of market rigging or insider trading activities to recover, can no longer be supported — if it ever could. This unsatisfactory state of affairs is amenable to significant improvement through implementation of the proposal advanced here.

The reforms that are needed to foster these goals are essentially straightforward. The prohibition against short selling and the exceptions thereto should be removed — they are

171. Ibid.
172. Ibid 288.
173. Ibid.
174. Ibid 294.
175. Ibid 289. Smaller companies are thought to be especially vulnerable to information distortion.
176. Ibid.

excessive restrictions on the operation of the market, and represent a posture which is, in significant respects, out of sync with overseas jurisdictions. In their place, provisions are required that broadly mandate the practice, except with respect to deceptive, fraudulent and manipulative conduct[177] in connection with short sales. Broadly speaking, persons would be prohibited from engaging in deceptive, fraudulent or manipulative activity, or from communicating material misrepresentations or half-truths in connection with the purchase or sale of a security.[178] A bear raider who can be proved to have knowingly or recklessly engaged in such activity is clearly within the ambit of the prohibition.[179]

Whilst it is still necessary to combat abusive short selling practices, and there is no doubt that these should be prohibited, the bulk of short selling transactions — which are not repugnant — should be left unregulated. On the premise that the regulations are designed to protect the capital market as a whole,[180] it is difficult to see how those interests are served by a regime that is highly idiosyncratic and inflexible and which, on recent experience, failed to achieve one of its primary goals: namely to limit the ability of traders to sell stocks short in a falling market.

There is no good reason why the regulation of short selling in Australia could not be more effectively dealt with along the lines suggested above. Combined with full disclosure of the short selling nature of the transaction — compatible with the whole philosophy of disclosure as a mechanism of investor protection which lies at the heart of the corporate and securities laws of Australia[181] — and civil remedies in the case of deceptive, fraudulent or manipulative activity where this accompanies the practice, or for breach of contract, such a regime would satisfy the requirements of all of the following: consistency, simplicity, flexibility, equity and efficiency.[182] Finally, research into the incidence and nature of short selling activity on Australian stock markets is imperative in order to remedy the glaring

177. This would clearly catch the abusive short selling practices of bear raiders. It is interesting to note that in the U.S. in 1975, the SEC proposed Rule 10b-21 that would have classified as manipulative or deceptive, certain practices in connection with short sales. The rule 'has not been adopted presumably on the assumption that sufficient regulation already exists': Thomas Hazen, The Law of Securities Regulation (1985) 291. It may nevertheless provide the blueprint for reform of the law in Australia.

178. Rule 10b-5, the main Rule adopted by the SEC pursuant to s 10 (b) of the Securities Exchange Act 1934. Section 15(c) of the same statute catches similar conduct by broker-dealers in the case of over-the-counter (OTC) transactions.

179. Worley, above n 16, 1290.

180. Deutsch, above n 16, 148.

181. 'Anyone investing in shares should be presumed capable of looking after his own interests to some degree, provided he is kept well informed. Investor protection in this area should not [however] be paternalistic': Trevor Sykes, *Two Centuries Of Panic — A History of Corporate Collapses in Australia* (1988) 555. It should be noted that the thrust of the recommendations made by the 1992 House Report was the legislative enactment of a variety of disclosure requirements, as a mechanism for improving information flows.

182. 'A certain amount of regulation is needed to enable the securities market to perform its price-determining functions, free from manipulative [and fraudulent] influences by those who seek to corrupt it for their own profit': Norman Poser, *International Securities Regulation* (1991) 6. 'Disclosure requirements . . . can be justified as necessary in order to make the securities market work properly': Ibid, 7.

information void that exists on the subject. It should be an essential preliminary to any reform of the law.[183]

In contrast with Australia, official interest in the subject of short selling in the U.S. has been on-going — beginning in the mid-1970s, it continued during the 1980s with the Short Sale Rule coming under increasing scrutiny.[184] Again in the early 1990s, the establishment of the House Committee represented congressional recognition of this significant market activity, and the need for accurate information relating thereto. It is pertinent that the House Report stressed the need for integrity of information relating to the practice of short selling. It placed particular emphasis on the need for accurate and timely information for investors as an essential pre-requisite for a fair and efficient securities market.[185] Accordingly, it recommended 'that the exchanges and the NASD develop a method for collecting daily short selling activity and weekly short interest data from brokers and dealers and make this information available electronically to the market *in aggregate form*.'[186] The implementation of such a proposal in this country would be equally useful in promoting a well-informed and efficient market.

Conclusion

It is important to recognise the distinction between over-regulation, which characterises our current securities laws, and successful regulation. The importance and wisdom of appropriately crafted, and vigorously enforced, securities laws cannot be underestimated. However, in the past, Australia has placed too much reliance upon the use of criminal sanctions in its securities laws. It is now apparent, however, that the wholesale criminalisation of the securities laws is not the answer, with most securities crimes being beyond the reach of law enforcement in any event. On the other hand, the issue of how much substantive regulation is appropriate is far more difficult.

In the context of short selling, the time has come in this country for the stigma attached to the practice to be removed, and for this change to be reflected in our laws. It is not merely that our current legislative provisions are out of sync with those in the major overseas stock markets, and with the options and futures markets, it is also that they are — like so many of our corporate and securities laws — overly complex and technical, and do not

183. As part of such a survey, it might be possible to adapt to the Australian scene, the interesting suggestion made by the SEC in 1976 — that 'the Short Sale Rule be suspended so that the operation of the exchange markets could be studied in the absence of the Rule': Worley, above n 16, 1255.

184. Ibid 1255, 1256.

185. Janvey, above n 16, 288.

186. Ibid 292. Emphasis added. It has been noted (above n 15) that in April 1995, the ASX amended its business rules to extend its reporting requirements to cover the reporting of short positions held in securities listed on the ASX. As at 7pm each night, brokers are required to send the ASX details of their short sale positions. However enquiries have revealed that, in order to avoid having to make margin payments, clients frequently do not advise brokers of the short selling nature of their transactions. Brokers also have the option of saying that they do not know if sales are short. These factors clearly undermine the value of this amendment to the business rules of the ASX.

meet the needs of our financial community. Ultimately they fail to recognise the fundamental truth: that the practice is usually associated with no wrongdoing, being a normal part of market operation in which people are constantly speculating on price rises or falls.

The proposal advanced here is that the basic prohibition against short selling should be removed, and the practice freed from excessive and inappropriate legal restrictions. Indeed, the ideological underpinning of the regulation of short selling should be acknowledgement of the practice as a useful, legitimate and respectable market strategy. This should not, however, be construed as support of totally unrestricted short selling activity. Due to the potential for abuse associated with short sales, some legal parameters are required and the need for a few simple and broadly formulated restrictions is not disputed: firstly to attempt to protect the market from bear raids (through the discretion vested in the ASX to prohibit short selling transactions where this is deemed necessary to maintain an orderly market and, arguably, retention of the up-tick rule); secondly, to uphold the principle of investor protection through disclosure of the short selling nature of the transaction; and finally, to protect the market from those deceptive, fraudulent and manipulative practices that on occasion accompany short selling. Beyond these parameters, there is no need for any legal impediments to the short sale of stocks.

Part B

Stock Market Manipulation

Chapter 2

History of the Regulation of Market Manipulation and Rationales for Regulation

Introduction

Professor Berle noted nearly sixty years ago that a 'summary of the history is necessary to a clear understanding of the present law regarding manipulation in the security markets.'[1] That statement is as true today as it was then for market manipulation, and the law's attempts to discover, prevent and regulate it, are old phenomena. Manipulation of stock prices has long been a concern of the common law, which imposed the well-recognised rules relating to fraud upon the securities markets. It was detected in United States' capital markets in the 1930s and featured in the 1974 Report of the Senate Select Committee on Securities and Exchange[2] which investigated the excesses of the early 1970s mining boom in Australia.

The purpose of this chapter is to outline these historical developments, together with the common law's response and subsequent legislative attempts, both in the United States and Australia, to place the regulation of price manipulation under statutory control.[3] The various traditional rationales for regulating manipulation are examined. Finally the chapter explores the issue whether the law *ought* to prohibit manipulation in financial markets.

The Common Law Applicable to Stock Market Manipulation[4]

The origins of the prohibitions against price manipulation may be found in the common law, which took a firm stand against interference with the free public market for financial securities.[5] Indeed the old common law recognised centuries ago that manipulation of stock prices was fundamentally a fraud upon the public.[6] The early English statutory crimes, borrowed from the Roman law, of engrossing, regrating and forestalling were recognised and

1. Adolphe Berle, 'Stock Market Manipulation' (1938) 38 *Columbia Law Review* 393.
2. Senate Select Committee on Securities and Exchange, *Australian Securities Markets and their Regulation*, (AGPS, 1974). (Commonly and herein referred to as 'the Rae Committee').
3. What follows is not intended to be an exhaustive exploration of these events, but merely an overview.
4. 'The story, as always, must start with the common law . . .': Louis Loss, 'The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States' (1970) 33 *Modern Law Review* 34, 40.
5. Paul Redmond, 'A Short History of Securities Regulation in Australia' in Gordon Walker & Brent Fisse (eds), *Securities Regulation in Australia & New Zealand* (1994) 99.
6. John Flynn, *Security Speculation — Its Economic Effects* (1934) 212.

punished.[7] Engrossing resembled our modern practice of cornering the supply. Forestalling consisted in intercepting sellers on their way to the market and buying their wares to keep them off the market. Regrating was the process of producing artificial scarcity by buying up supplies sufficient to control their flow into the market and thus affect the price.[8]

During the Napoleonic wars, a group of persons was tried in England for conspiracy to affect the price of the public funds and securities. The defendants were charged with spreading false rumours about the peace between England and France and the alleged death of Napoleon. In *Rex* v *De Berenger,*[9] it was held to be an offence to conspire to raise the price of Government securities by false rumours with intent to injure purchasers. The Court of King's Bench held that a combination to use wrongful means (false rumours) for a wrongful purpose (to give false value to a commodity in the public market) was a crime. This was so even though it was not alleged that any loss had actually been caused to particular purchasers of government securities. Indeed it was not necessary to show either that the government as such had been injured or that the defendants had benefited. Both the means used and the object sought were wrong. As a matter of the criminal law then, where two or more persons together engaged in market rigging, this was illegal at common law as a conspiracy to defraud. Thus the concept of a free, natural and open public market was created.[10]

Towards the end of the 19th century, 'the concept of market interference was extended to manipulation by trading alone, without accompanying rumours and misinformation.'[11] Thus in *Scott* v *Brown Doering McNab & Co,*[12] the unlawful transaction took the form of purchases of shares on the stock market at a premium the sole purpose of which, as the court found, was to mislead the public as to the market and to induce public buying. 'I can see no substantial distinction,' Lord Justice Lopes said, 'between false rumours and false and fictitious acts.'[13]

7. Ibid 213.
8. Ibid.
9. (1814) 3 Maule & Selwyn's Reports 67; Robert Baxt, H A J Ford and Ashley Black, *Securities Industry Law* (5th ed, 1996) 301–2.
10. See generally Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (3rd ed, 1995) 932.
11. Redmond, above n 5, 100.
12. (1892) 2 QB 724. It was held in this case that the purchaser could not sue the brokers he had employed to assist him in the fraud. However the case contains a dictum to the effect that a third person induced to buy from the manipulators at an unfair price may sue any or all of them for damages: (1982) 2 QB 724, 734. In reality the British courts have been reluctant to adopt the free market concept and plaintiffs purchasing in the open market have generally been unable to surmount the obstacles of reliance and privity, as is frequently the case in common law deceit actions: see generally Louis Loss, *Fundamentals of Securities Regulation* (2nd ed, 1988) 847–8 n 8.
13. Ibid 730.

United States' Developments[14]

The derivation of Australian legislative controls on stock market manipulation may largely be traced to the United States' federal securities regulation enacted by the Roosevelt administration in 1933–1934, and the influence of Professor Louis Loss, the leading U.S. authority on securities market regulation. Some of the provisions, including the anti-manipulation provisions, of the earliest State Securities Industry Acts of 1970 and 1971 reflected United States' law. The U.S. orientation was further re-inforced when Professor Loss was consulted by the Attorney-General's Department in the early 1970s prior to the enactment of the Federal Labor Government's legislative reform package in company and securities law and trade practices. Writing in 1973, his views influenced many of the provisions of the Corporations and Securities Industry Bill. This was introduced into the Senate in December 1974 by the Attorney-General, Senator Murphy. Although the Bill eventually lapsed, subsequent Australian law, when drafted, drew extensively upon U.S. federal securities law.

The substance of the provisions remains intact to this day. Thus section 997 of the Corporations Law broadly corresponds to section 123 of the Co-operative Scheme's Securities Industry Code 1980, which was the original Australian stock market manipulation prohibition based upon section 9(a)(2) of the Securities Exchange Act 1934; and section 998, the prohibition on false trading and market rigging transactions, broadly corresponds to section 124 of the Code, which was based upon section 9(a)(1) of the 1934 Act.[15] It is therefore appropriate to consider United States' developments before Australian history.

Federal securities regulation in the United States began in 1933.[16] The origins of the U.S. system of extensive regulation of the securities markets can be traced to the massive losses suffered by the public during the Depression. In the three-year period between

14. The legislative history of the U.S. securities laws, including the concerns about pools (defined in Appendix A), is exhaustively traversed in Steve Thel, 'The Original Conception of Section 10(b) of the Securities Exchange Act' (1990) 42 *Stanford Law Review* 385 (herein referred to as 'The Original Conception'), and Steve Thel, 'Regulation of Manipulation under Section 10(b): Security Prices and the Text of the Securities Exchange Act of 1934' (1988) *Columbia Business Law Review* 359 (herein referred to as 'Regulation of Manipulation').

15. Peter Meyer, 'Fraud and Manipulation in Securities Markets: A Critical Analysis of Sections 123 to 127 of the Securities Industry Codes' (1986) *Company and Securities Law Journal* 92, 94–5.

16. Professor Berle makes the point, often overlooked, that the fundamental doctrines relating to fraud were established by the courts, independent of statutory rule. Thus whilst the 1934 Act contributed significantly to the application of remedies (for example by providing for the expulsion of a member of a national exchange who had illegally manipulated securities), and also added a potential plaintiff, the SEC, staffed to bring actions, s 17(a) of the 1933 Act and ss 9 and 10(b) of the 1934 Act added very little to the substantive law and 'do not vary the standards already established by the courts': Berle, above n 1, 400. Professor Berle states: 'It is worthwhile emphasising the fundamental, or common law, doctrine since the specific provisions of the Act of 1934 and the detailed rules adopted under that Act have somewhat overshadowed the fact that manipulation by the very devices prohibited was probably quite as unlawful before the enactment of the legislation as it now is': Ibid 401. The position at common law by 1934 was that wash sales, matched orders, artificial activity, pegging operations, and mere false representations to the market, all constituted fraud and deceit which would have given rise to civil action by the plaintiff, to injunction under an appropriate statute or to criminal action under appropriate state or federal laws: Ibid 397.

September 1929 and July 1932, stocks listed on the New York Stock Exchange lost 83% of their total value, and fully half of the $50 billion worth of new securities floated in the United States during the 1920s proved to be worthless.[17] The losses were extensive, affecting some 20 million Americans who had tried to take advantage of postwar prosperity by investing in the stock market.[18] The Depression:

> created electoral pressures causing political leaders to investigate the stock market before any knowledge of previous market failures was disclosed. Disclosure of market failures — specifically of moral deception and fraud by leading financiers — was important when it occurred. It generated the critical symbolic resources needed politically to define a regulatory program that expanded the state's control over the market.[19]

Ultimately the U.S. Congress determined that regulations designed to ensure the honesty and integrity of the securities markets were necessary and in the public interest. Accordingly Congress passed the Securities Act of 1933, regulating the initial distribution of securities through registration requirements, and then the Securities Exchange Act of 1934 to deal with secondary market trading. It also created the Securities and Exchange Commission (SEC).

As finally passed, the legislation established the principle of federal control over the stock market.[20] Whereas the traditional response to financial panics had been to prosecute

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States began legislating against securities frauds in the early 20th century: Louis Loss, *Fundamentals of Securities Regulation* (1983) 8. Kansas passed the first state securities legislation in 1911. The legislation allowed the state securities commissioner to pass on the merits of the particular securities before it could be registered for trading. State merit legislation of this kind is known as 'blue sky law', supposedly because its initial impetus was a concern about eastern industrialists selling 'building lots in the blue sky in fee simple': Ibid. Blue sky laws established state regulation of securities transactions within state borders. The 50 states have each adopted legislation that duplicates federal regulation of securities. The states regulate the distribution of securities, trading in securities by brokers and dealers, and fraudulent activities in connection with securities transactions. The resulting dual state and federal regulatory system 'has provided a strong capital market, but it contains many inefficiencies, duplications, and hindrances . . .': David Ruder, 'Regulation of Corporations and Securities in Australia: Lessons from the United States' (paper presented at meetings held at the Law Offices of Baker & McKenzie, Sydney and Melbourne, 14–16 May 1990) 3.

See further Jonathan Macey and Geoffrey Miller, 'Origin of the Blue Sky Laws' (1991) *70 Texas Law Review* 347.

17. Amar Bhide, 'Efficient Markets, Deficient Governance' (1994) *Harvard Business Review* 128, 129.
18. Ibid.
19. James Burk, *Values in the Marketplace — The American Stock Market under Federal Securities Law* (1988) 43. The author traces the complex series of events leading to the adoption of the New Deal proposals for federal securities regulation, and in particular the role played by Ferdinand Pecora, counsel to the Senate Banking and Currency Committee investigating stock exchange practices. Pecora's particular achievement was securing disclosures of wrongdoing by highly placed and well-known stock promoters and investment bankers. 'It is difficult to exaggerate the importance of these disclosures. They created the perception that there was a market failure significant enough in proportion to warrant legislative action': Ibid 39. The author also warns against oversimplifying the origins of federal securities regulation, which are more complex than the simple hypothesis of market failure. For example compromises were required to ensure the passage of the law, and these compromises established limits on the range within which the government could exercise its control: Ibid 43–4.
20. The Securities Exchange Act 1934 requires that every corporation having equity securities listed on a stock exchange or having more than $5 million in total assets and 500 or more shareholders be registered with and report to the SEC: Ruder, above n 16, 3.

frauds[21] and allow the victims to shoulder their own losses, the new legislation of the 1930s was based on the premise of protecting investors before they incurred losses.[22] To this end the securities laws established an extensive disclosure regime to assist investors in making informed trading decisions.[23] Issuers of securities are required to provide information about directors, officers, underwriters and large shareholders, including remuneration, the organisation and financial condition of the corporation and certain material contracts of the corporation. Issuers are also required to file a number of reports. The information required is voluminous and includes descriptions of the corporation's business and activities and certified financial statements. An initial statement must be filed, followed by annual reports, quarterly reports, and reports of certain material changes in the corporation.[24] To discourage insider trading, the securities laws require every officer, director and 10% equity owner to report the securities they own.[25]

Broad anti-fraud laws were enacted making it illegal to engage in insider trading or market manipulation. With respect to the latter, the legislation sought to eliminate manipulation and sudden and unreasonable fluctuations of security prices. It forbade traders on the exchanges from employing trading strategies supposedly useful for those trying to manipulate stock prices. It specifically prohibited a number of the types of transactions previously carried out, such as pools, wash sales and matched orders, identified in 1933 by the Senate Banking and Currency Committee investigating stock exchange practices.[26] In addition to prohibiting transactions designed to manipulate prices or to create an illusion of active trading, the laws also prohibited the making of material false and misleading statements and spreading rumours about market rigging.[27]

Congress also empowered the SEC to adopt rules leading to the maintenance of just and equitable principles of trade.[28] Within the ambit of this authority the Commission has

21. In the pre-SEC era, the criminal attack on manipulation came under the mail fraud statute and special state legislation, primarily in New York: Loss and Seligman, above n 10, 932.
22. Bhide, above n 17, 129.
23. The cornerstone of the statutes was disclosure. See Loss, above n 16, 7 noting that 'there is the recurrent theme throughout these statutes of disclosure, again disclosure, and still more disclosure.' The rationale behind the federal regulatory scheme was that investors are adequately protected if all aspects of the securities being marketed are fully and fairly disclosed, thereby obviating the need for time-consuming merit analysis of the securities being offered: see Thomas Hazen, *Treatise on the Law of Securities Regulation* (2nd ed, 1990) 6–7.
24. Ruder, above n 16, 3.
25. Such insiders had to turn over any short-term trading profits (those that resulted from purchases and sales within any six-month period) to the company. Criminal sanctions were imposed for failure to report such transactions: Bhide, above n 17, 130.
26. The operation of 'pools' was one of the more serious abuses in the securities markets on which Senate investigators focused their attention in their 1933 hearings (see further n 19 above). Operators of pools ran up the prices of securities on an exchange by a series of well-timed transactions, then unloaded their holdings on the public just before the price dropped. See further Appendix A below for definitions.
27. Stock exchanges were required to register with the SEC, agree to comply with the Securities Acts and help enforce compliance by members. Subsequent attempts by Congress to protect investors has been by way of regulating the financial institutions that manage funds.
28. Sidney Robbins, *The Securities Markets — Operations and Issues* (1966) 106.

promulgated a myriad of regulations defining practices which are manipulative, deceptive or fraudulent; regulations on short selling, stabilising transactions and similar matters and has adopted safeguards with respect to the financial responsibility of brokers and dealers.[29] Extensive regulation also occurs through the stock exchanges and the National Association of Securities Dealers, Inc. These self-regulatory organisations[30] provide the first line of regulation in the securities industry. They promulgate rules, engage in market surveillance, inspect the financial records of the broker-dealers, bring actions for censure, fines, suspension or expulsion from the securities industry and generally engage in cooperative regulation with the SEC. The Commission has oversight powers over the SROs.[31]

Prior to the early 1930s, 'the securities markets were a jungle of deception and manipulation.'[32] Standards of honesty and fairness were widely abandoned by underwriters and dealers. The SEC reported that the 'orgy of speculation which had existed in the stock market, coupled with the fraud, manipulation and other malpractices then prevalent, could lead only to disaster.'[33] Whilst it is probably true to say that the anti-manipulation provisions of the Securities Exchange Act 1934, section 9 and in particular section 10(b), 'have been effective in preventing a recurrence of the widespread manipulation on exchanges which flourished in the 1920s',[34] securities price manipulation has by no means been eradicated. Professor Loss has aptly described the chequered history of manipulation as follows:

> Although a few large scale manipulations were detected in the early years of the Commission's history, the Commission was able by 1950 to express the belief that manipulation was no longer "an appreciable factor in our markets." This sanguine belief was not retained for long. Eleven years later the Chairman referred to "evidences of a substantial amount of manipulation." In April 1967, the American Stock Exchange announced that, in cooperation with the SEC . . . it was conducting an investigation of trading in certain listed stocks "which may have been influenced by alleged manipulative activities." There were rumours of underworld involvement . . .
>
> More significantly, in October 1988, Chairman Ruder announced the formation of a task force on penny stock manipulation, one consequence of which was the Penny Stock Reform Act of 1990 . . . At approximately the same time, the Commission initiated a series of significant *non*penny stock manipulation cases against Boyd L. Jefferies, Drexel Burnham Lambert, Inc., and Michael Milken, among others. To judge from this type of historical experience, manipulation seems no more capable of total eradication than its first cousin, "fraud."[35]

29. Ibid.
30. Referred to as SROs.
31. Ruder, above n 16, 4.
32. Robbins, above n 28, 106.
33. The Securities and Exchange Commission, 'A 25 Year Summary of the Activities of the Securities and Exchange Commission, 1934–1959' 1961 quoted by Robbins, above n 28, 106.
34. David Ratner and Thomas Hazen, *Securities Regulation — Cases and Materials* (1991) 859; Irwin Friend, 'The SEC and the Economic Performance of Securities Markets' in Henry Manne (ed), *Economic Policy and the Regulation of Corporate Securities* (1969) 185, 195.
35. Loss and Seligman, above n 10, 945. References cited omitted.

In recent years, as attempts to manipulate have become increasingly subtle and complex, the operation of traditional manipulative strategies is no longer the predominant concern of regulators in the United States. A major focus of concern today, at least with respect to stocks listed on the New York Stock Exchange, is the extent to which large transactions by institutional investors, such as pension funds, mutual funds and insurance companies, produce undesirable fluctuations and distortions in the market price of particular securities. Such program trading results from changes in investment patterns and other economic factors, rather than from the type of premeditated fraud with which the original securities legislation was concerned.[36] Computerised program trading thus raises for regulators, courts and others a raft of new and difficult issues in the regulation of stock market manipulation.[37]

The Australian Historical Context

In Australia the need for regulation in this area was recognised some forty years after the United States' Senate Committee on Banking and Currency appointed in 1932 uncovered major abuses in the securities markets of that country. The 1974 Report of the Senate Select Committee on Securities and Exchange[38] is the major detailed public study in Australia on the conduct of stock market manipulation. The Report had its genesis in the boom in shares of exploration and mining companies, most notably Poseidon NL, during the period 1969 to 1972 which disclosed shortcomings in the regulation of securities markets:

> The speculative activity spread rapidly to other mining and mineral exploration companies. Newspapers carried stories of fortunes gained or lost overnight. There was undoubtedly a great deal of abuse of the investing public through the flotation of nearly worthless new issues and manipulative activities in post-issue trading on stock exchanges.[39]

The Rae Report noted that:

> the deliberate manipulation of the market for listed shares on the organised exchanges has at times been widely practised in Australia. Although this manipulation has been known to prominent market traders, the practices have seldom been exposed publicly. They have not been effectively regulated.[40]

Stock market manipulation has traditionally been understood to involve certain distinct market practices originally identified in the United States and subsequently in Australia. These practices were documented by the Rae Committee, which described three particular market practices as manipulative. These were pooling, churning in shares, and organised runs on shares.[41] The Committee noted that the practices exhibited common features and all were:

36. Ratner and Hazen, above n 34, 859.
37. Program trading is discussed at length in Ch 4 below.
38. The Rae Committee Report, above n 2.
39. Redmond, above n 5, 93.
40. Rae Committee Report, above n 2, vol. 1, 207.
41. Refer to Appendix A for definitions of these manipulative practices.

> designed to artificially stimulate market turnover and share prices for the purpose of profiting, at the general public's expense, from the distortions inflicted on the market.[42]

Other forms of market manipulation were matched orders and wash sales.[43] It should be said at the outset that it is unfortunate that the Rae Committee's definitions do 'not coincide with the terminology used by the American commentators and legislature.'[44] This has caused considerable confusion in relation to the meanings attributed to the various manipulative practices. For example, 'churning' in shares was said to occur by the Rae Committee whenever a trader acquired shares and then proceeded to place both buying and selling orders for the same shares at about the same price, or at slightly rising prices in order to build up turnover.[45] The conduct thus described as churning in the Rae Committee Report is in fact the conduct described as a 'wash sale' for the purposes of the United States literature and legislation.[46] In the United States:

> 'churning' is said to occur whenever a broker or dealer is in a position to determine the volume and frequency of transactions on a customer's account by reason of the customer's willingness to follow the suggestions of the broker or dealer and he abuses the customer's confidence by over-trading. The essential element of the prohibited conduct is excessive trading so as to indicate a purpose of the broker to derive profit for himself while disregarding the interests of the customer.[47]

More recently the ASX has identified some principal modern techniques of market manipulation, such as warehousing and ramping, which developed during the 1980s.[48] In the 1990s, concerted program trading is regarded by some commentators as being manipulative.[49] With the rise in importance and power of institutional investors, a modern manifestation of the pools could also reappear. The danger is that:

> Unlike their averse corporate managers, who tend to favour steady earnings and stock price growth, institutional investors who possess *de facto* control can benefit from volatile swings in stock price and could manipulate corporate affairs to create profitable trading opportunities. The enactment of the Securities Exchange Act of 1934 was motivated to a considerable degree by Congressional dissatisfaction with the behaviour of 'notorious market pools', which were essentially trading syndicates formed by large investors to manipulate stock prices. Absent restrictions

42. Rae Committee Report, above n 2, vol. 1, 207.
43. Refer to Appendix A below.
44. Meyer, above n 15, 94.
45. Ibid 93; Ch 8 of the Rae Committee Report.
46. Meyer, above n 15, 94. Similarly the conduct described by the Rae Committee as 'pools' is included within the definition of 'matched orders' in the United States: Ibid.
47. Ibid 93. 'The insider trading cases generate the big headlines, but the burning of customers and the churning of their accounts hurts Wall Street more': Paul Gibson, *Bear Trap — Why Wall Street Doesn't Work* (1993) 159.
48. Refer to Appendix A below; the Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, 'Corporate Practices and the Rights of Shareholders' (AGPS, 1991) 2.1.5 (the 'Lavarch Committee'); and Redmond, above n 5, 98–9.
49. Refer to Ch 4 below.

on liquidity, the growth of institutional ownership creates the preconditions under which such pools could reappear.[50]

It is necessary to an understanding of the development of securities regulation in this country to appreciate that Australian company law and by extension its securities regulation, being historically a State matter, has been characterised by a lack of uniformity from State to State.[51] Shortly after the Senate resolved on 19 March 1970 to appoint the Rae Committee to inquire into and report on the desirability and feasibility of establishing a national securities and exchange commission to act against *inter alia* market manipulation and other injurious practices, the four Liberal Party states enacted legislation with respect to the securities industry.[52] The Securities Industry Acts of 1970 and 1971 provided for the licensing of persons carrying on the business of dealing in securities or the business of investment advice. They also prohibited a number of undesirable practices such as false trading, market rigging, fictitious dealing and the spreading of false information about securities.[53]

In July 1974 the Rae Report was published and in December 1974 the Attorney-General, Senator Murphy, introduced the Corporations and Securities Industry Bill into the Senate. In the explanatory memorandum to the Bill published by the Attorney-General, it was made clear that the Bill sought to implement the two broad objectives of national policy recommended by the Rae Report for legislation. These were to provide for the regulation

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50. John C Coffee, Jr 'Institutional Investors as Corporate Monitors: Are Takeovers Obsolete?' in John Farrar (ed), *Takeovers, Institutional Investors, and the Modernization of Corporate Laws* (1993) 78.

    A serious problem revealed by the Salomon scandal in government securities was the ability of trading houses with considerable market power to create the anomalies by which they profited. 'Proliferating marketplaces — options exchanges, unpublicized markets in London, Reuters computers — opened wide the opportunities to move prices in one market by manipulating another. As the 1980s wore on, proprietary trading by the big houses came to look more and more like the "pools" activity that dishonoured the stock exchange in the 1920s': Martin Mayer, *Nightmare on Wall Street — Salomon Brothers and the Corruption of the Marketplace* (1993) 70. (Herein referred to as 'Nightmare on Wall Street').

51. The Commonwealth has been regarded as having limited jurisdiction under the Constitution to make laws with respect to the incorporation and regulation of companies: *Huddard Parker & Co. Pty Ltd* v *Moorehead* (1909) 8 CLR 330; *New South Wales* v *Commonwealth* (1990) 8 ACLC 120.

    See generally Redmond, above n 5, 90–110.

52. Geoffrey Hart, 'The Regulation of Stock Market Manipulation' (1979) 7 *Australian Business Law Review* 139, 140. The state legislation was the Securities Industry Acts of 1970 and 1971 (Qld), (NSW), (Vic), (WA). The Acts specifically prohibited some practices and were similar in scope, but they were not uniform and contained some important differences. With the passage of the Securities Industry Acts of 1970, the general law prohibitions relating to fraud were strengthened by statutory prohibitions on manipulative activity. Broadly the practices that were banned were as follows: false trading and false markets; market rigging transactions; market fictions; and bogus transactions in Queensland: see further Baxt, Ford and Black, above n 9, 302.

53. H A J Ford, *Principles of Company Law* (4th ed, 1986) 691. Some of the provisions of the earliest State Securities Industry Acts reflected U.S. law. For example, s 71(1) of the Securities Industry Act 1970 Victoria and NSW captured the essence of s 9(a)(2) of the Securities Exchange Act 1934. Section 71(1) provided as follows: 'A person shall not effect, take part in, be concerned in or carry out, either directly or indirectly, any transactions in any class of securities which have the effect of raising or lowering the price of securities of that class for the purpose of inducing the purchase or sale of securities of that class by others.' See further Hart, above n 52, 146–7.

of public companies and the securities industry in Australia on a *national* basis, and secondly to maintain, facilitate and improve the performance of the capital market in the interests of economic development, efficiency and stability.[54]

Many of the provisions of the Corporations and Securities Industry Bill were influenced by United States federal securities regulation enacted by the Roosevelt administration in 1933–1934.[55] In particular the Bill provided for a Corporations and Exchange Commission (CEC) constituted along similar lines to the SEC. However the Bill eventually lapsed when the Whitlam Labor Government lost office in November 1975.[56] The incoming Fraser Government subsequently announced substantially different proposals for the co-operative regulation of companies and securities. Meanwhile the four Liberal Party states, facing harsh criticism of their administration of companies and securities in the Rae Report and the imminent prospect of federal securities legislation, enacted new and uniform Securities Industry Acts in 1975.[57]

As a result of the need to improve administrative efficiency and to create a body capable of regulating the securities industry on a nationwide basis, the Co-operative Scheme legislation was developed, coming into effect in 1980. The approach taken involved an agreement in 1978 between the Commonwealth and the States (the Northern Territory joined in 1986), called the Commonwealth-State Scheme for Co-operative Companies and Securities Regulation, or Formal Agreement. It sought to overcome the reluctance of some of the States to voluntarily handing over their powers in this area by recognising that both the Commonwealth and the States respectively had legitimate roles and interests in the regulation of companies and the securities industry.

Although for many practical purposes the effect was the same as if there had been one body of securities industry law, a number of structural problems remained. Ministerial accountability was diffused through the Ministerial Council comprising ministers from the various states: there was no single national legislature involved, and no single minister responsible for the legislation. Furthermore administration of the scheme rested to a large extent with the local registering authority of each State or Territory under delegation from the National Companies and Securities Commission,[58] the body charged with controlling the operation of the Scheme. It became apparent with time that it was unnecessarily

54. Australian Industries Development Association, *The Corporations and Securities Industry Bill 1975*, 1.1, 1.2. The purpose of this publication was to suggest alternatives to the Bill and amendments should it be proceeded with. It should be noted that various areas covered by the Bill drew upon recommendations for change made, not only by the Rae Report, but also by the Eggleston Report, and the report by Professor Louis Loss entitled 'Proposals for Australian Companies and Securities Legislation — Lessons from the American Experience.' The Attorney-General explained that in drafting the Bill certain of the recommendations of these various reports had been implemented and that regard had been paid to relevant legislation of the States and Territories as well as to legislation of other countries, particularly the U.S. and the U.K.: Ibid 1.3, 1.4. Also see William Paterson, 'Aspects of the Corporations and Securities Industry Bill 1974' (January 1975) *Company Law Bulletin* 1.

55. Redmond, above n 5, 95.

56. Ford, above n 53, 691.

57. See further Redmond, above n 5, 96.

58. The NCSC.

duplicative, inefficient and expensive to have a division of functions between the NCSC and State corporate affairs commissions.

Although it represented a considerable improvement on previous legislative structures, the Co-operative Scheme came under increasing pressure during the 1980s. It was a cumbersome compromise arrangement which sought, somewhat unsatisfactorily, to balance national and state interests. Rapid changes in the corporate and financial environment, including the development of an increasingly global financial market, resulting in more sophisticated corporate and market dealings, also made it obvious that a truly integrated national scheme was necessary. This was finally achieved on 1 January 1991 with the commencement of operation of the Corporations Law, but only after intense political debate and hostility on the part of some of the States and a High Court challenge to the constitutional validity of the new scheme.[59]

Chapter 7 of the Corporations Law today regulates securities: the securities exchanges, participants in the securities industry, the conduct of securities business as well as the prospectus requirements for securities issues. It consists of provisions that closely correspond to the Co-operative Scheme's Securities Industry Code 1980 — thus section 997 of the Corporations Law broadly corresponds to section 123 of the Code, the stock market manipulation prohibition based upon section 9(a)(2) of the Securities Exchange Act 1934; and section 998 of the Corporations Law, the prohibition on false trading and market rigging transactions, broadly corresponds to section 124 of the Code, itself based upon section 9(a)(1) of the 1934 Act.[60]

The Australian Securities and Investments Commision[61] is a Commonwealth statutory corporation created by the Australian Securities and Investments Commission Act 1989 (Cth). It has prime responsibility for the administration and enforcement of the national scheme.[62] The legal regulation of stock markets is also supplemented at a more informal level through the activities of the Australian Stock Exchange Limited,[63] in particular through ensuring that its Business Rules and Listing Rules are observed.[64] Indeed the system of regulation in this area is one of co-regulation.[65]

Rationales for Regulation

Although there is a subsequent section which asks whether the law ought to prohibit manipulation, it is appropriate initially to examine the traditional rationales for regulating manipulation in securities markets.

59. *New South Wales* v *Commonwealth* (1990) 169 CLR 482, 8 ACLC 120.
60. Meyer, above n 15, 94–5.
61. ASIC.
62. See generally H A J Ford, Robert Austin and Ian Ramsay, *Ford's Principles of Corporations Law* (8th ed, 1997) Ch 3, 66–76.
63. The ASX.
64. Ford, Austin and Ramsay, above n 62, 61.
65. Ibid 778. The authors note that, to a large extent, regulatory strategies in relation to the securities industry depend more on self-regulation than official government regulation. And this notwithstanding the number of legislative provisions governing the securities industry and the extensive powers of ASIC and the court: Ibid.

The insidious and widespread effects of stock manipulation have for long been thought to strike at the heart of the integrity of security markets. 'Securities laws outlaw fraudulent and deceptive conduct as matters both of business ethics and of public morality, and for its undermining of confidence in the integrity of the market.'[66] The need for regulation to control abusive trading practices arises principally because transactions in securities exchanges (and in the over-the-counter markets of the United States) are affected with a national public interest. In explaining this interest, the U.S. Securities Exchange Act of 1934 cites several factors, all predominantly economic in nature, in its introductory sections which describe the necessity for regulation. For example:

> Control of the markets is necessary in order to protect interstate commerce, the national credit, the Federal taxing power, and the national banking system and the Federal Reserve System.
>
> Transactions, conducted in large volume by the public, in the securities markets involve the use of credit, affect the financing of trade, industry, and transportation in interstate commerce and influence the volume of interstate commerce and national credit.
>
> The prices established are disseminated throughout the United States and foreign countries and constitute a basis for determining the amount of certain taxes and the value of collateral for bank loans.
>
> Prices of securities are susceptible to *manipulation* which gives rise to excessive speculation resulting in sudden and unreasonable fluctuations. This condition, in turn, can cause alternatively unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation and industry; can hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes . . . and can prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system . . .
>
> *Manipulation* and sudden and unreasonable fluctuations of security prices and excessive speculation may precipitate and intensify national emergencies, which, in turn, produce wide-spread unemployment, and the dislocation of trade, transportation, and industry.[67]

The drafters of the United States' securities legislation of 1933 and 1934 were convinced that because there was a direct link between excessive speculation, the stock market crash of 1929 and the Great Depression of the 1930s, regulatory controls were required to ensure the honesty and integrity of the securities markets in the national interest to prevent national emergencies.[68] That premise for regulation remains unchanged to this day. Woven through the whole fabric of federal regulation are the two basic aims of Congress, namely that stock markets should be fair and honest and that they should be orderly. A fair and honest market, where the opportunities and risks are the same for all investors, large and

66. Paul Latimer, 'Securities Regulation Laws — What Are They Trying to Achieve?' in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia* (1994) 167. The Rae Committee noted that regulation must not be seen purely in economic terms. More effective company and securities laws were required on grounds of fairness and commercial morality: Rae Committee Report, above n 2, vol.1, 15.2.
67. Securities Exchange Act 1934, s 2. Emphasis added.
68. Daniel Fischel and David Ross, 'Should the Law Prohibit "Manipulation" in Financial Markets?' (1991) 105 *Harvard Law Review* 503; Michael Mann, 'What Constitutes a Successful Securities Regulatory Regime?' (1993) 3 *Australian Journal of Corporate Law* 178.

small, and all are protected from fraud, creates a level playing field to which investors in the U.S. markets have always been attracted.[69]

The economic thrust of an orderly market was, according to Congress, one which is free from sudden and excessive price oscillations, and consequently a market which contributes to the confidence and trust of the investing public.[70] The thrust of this regulatory scheme then was to facilitate a fair and orderly market where prices were 'truly responsive to the expected influence of past and future events.'[71] By focusing on market integrity and full disclosure, it was anticipated that the regulatory system could foster economic growth and development without running the risk of becoming out-dated and unresponsive.[72]

Thus the recurring themes of the *national public interest*, which is inextricably linked to various economic issues and in particular the *maintenance of an efficient market*, together with the *protection of investors* and the resulting *investor confidence* in the integrity of the securities markets, constitute the theoretical underpinnings of legislative intervention to control abusive trading strategies.[73] Indeed, so entrenched are these rationales for regulatory control in this area that it is now widely accepted that the social value in preventing fraud, manipulation and deception of all kinds in the sale of securities is too obvious to require detailed elaboration.[74]

69. Mann, above n 68, 178; Robbins, above n 28, 154. Indeed President Roosevelt, in recommending passage of the 1933 Securities Bill, emphasised that the proposed act should give impetus to honest dealing in securities and thereby bring back public confidence in the securities markets: Louis Loss and Joel Seligman, *Securities Regulation* (Vol.1, 3rd ed, 1989) 218. Roosevelt anticipated that the full disclosure of material investment information about new issues would reduce investors' concerns that they could be defrauded or treated unfairly and thus help to facilitate an increased level of corporate securities sales: Ibid. During the early 1960s, as part of the successful campaign to persuade Congress to extend the periodic disclosure provisions of the 1934 Act to over-the-counter firms above a minimum size, it was again suggested by SEC spokespersons that investor confidence in over-the-counter firms' securities had suffered because the overwhelming preponderance of securities fraud cases had occurred in such securities: Ibid 218–9.
70. Nicholas Wolfson, Richard Phillips and Thomas Russo, *Regulation of Brokers, Dealers and Securities Markets* (1977), 11.03; Robbins, above n 28, 154. This must be taken to represent the theoretical ideal of an orderly market. In practice, stock markets are not immune from sudden price oscillations.
71. Robbins, above n 28, 45. Stock prices may reflect the expected influence of future events where, for example, the government has flagged a significant change in mining, tariff or taxation policy.

    In describing the behaviour of stock prices Robbins notes that, in theory at least, the prices of stocks are the outcome of the buying and selling decisions of large numbers of investors based on their judgments concerning the effects of 'an endless parade of rapidly changing events, both real and imaginary': Ibid 44. This theory however has been only partially true. In a significant number of instances, prices have been affected by external monopolistic practices, such as pools, corners, insider trading and market manipulation: Ibid.
72. Mann, above n 68, 178.
73. Robbins, above n 28, 125; Friend, above n 34, 186.
74. Not even the most avid proponents of the free market and *caveat emptor* would object to legal sanctions against fraud and sharp practice of all sorts. For fraud is not only objectionable on moral grounds, but also from an economic point of view in that it derogates from the voluntariness of investment transactions and thereby leads to an inefficient allocation of resources: A C Page and R B Ferguson, *Investor Protection* (1992) 35.

In the Australian legislative context, the legal policy foundations of the system of securities regulation in Chapter 7 of the Corporations Law have not been as clearly articulated in the legislation.[75] However it has been suggested that:

> some of the implicit policies are those of creating confidence and fairness in the operation of securities markets, investor protection from fraud or misrepresentation, the provision of adequate standards and procedures for securities exchanges and dealers, the provision of information about securities through a system of disclosure and these policies are backed up by the establishment of various accountability and control mechanisms.[76]

According to the Australian Securities and Investments Commission Act 1989 (Cth), s 1(2) the function of the Australian Securities and Investments Commission in enforcing the securities laws is stated to be, *inter alia,* to maintain, facilitate and improve the performance of securities markets 'in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy' and also 'to maintain the confidence of investors in the securities markets . . . by ensuring adequate protection for such investors.' Following the expansion of the national regulator's role in July 1998 to cover all consumer protection matters in securities, futures, life and general insurance, superannuation and deposit-taking activities, an additional objective is to promote the confident and informed participation of consumers in the financial system.

Section 3 of the former Securities Industry Code 1980 provided that the Code should be read and construed together with the Formal Agreement entered into on 22 December 1978 between the Commonwealth and the States, and which was annexed to the National Companies and Securities Commission Act 1979 (Cth). Recital A to the Agreement states in effect that it is in the interests of the public to promote commercial certainty and to bring about a reduction in business costs and greater efficiency in the capital markets and enhance investor confidence through suitable provisions for investor protection.

The views of the Committee of Inquiry into the Australian Financial System are also worthy of note.[77] Its final report states that the 'system could not operate effectively, let alone efficiently, unless investors at large had confidence in the underlying solvency of financial institutions generally and in the overall stability of financial markets generally.'[78] The Rae Committee Report recommended that legislative action to ensure that securities markets are properly regulated:

> . . . should be in pursuance of two broad, sometimes conflicting, objectives of national policy.
>
> (i) The first is to maintain, facilitate and improve the performance of the capital market in the interests of economic development, efficiency and stability.

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75. 'The legal policy foundations of the system of securities regulation in Chapter 7 of the *Corp Law* are not as apparent as the policies underlying the takeover provisions in Chapter 6 . . .': Roman Tomasic and Stephen Bottomley, *Corporations Law in Australia* (1995) 603.
76. Ibid; also see Ashley Black, 'Regulating Market Manipulation: Sections 997–999 of the Corporations Law' (1996) 70 *Australian Law Journal* 987, 988–9.
77. Report of the Committee of Inquiry into the Australian Financial System, 'Australian Financial System — Final Report of the Committee of Inquiry' (AGPS, 1981). (The 'Campbell Committee Report').
78. Ibid. The report also stated that 'Market practices should be as free of regulation as is consistent with the objective of maintaining investor confidence': Ibid 21.26.

(ii) The second is to ensure adequate protection of those who invest in the securities of public companies and in the securities market.[79]

According to an ASIC spokesperson, the rationales for regulation of our financial markets are as follows:

> The Law aims, by protecting investors, to increase the level of investor confidence and promote the integrity and efficiency of the market by facilitating a free flow of investment funds into commercial and industrial ventures which promote economic growth . . .
>
> . . . the ASC has recognised that without confidence in market participants, people will not be prepared to invest, and without investment the economy will stagnate.[80]

It may be deduced therefore that the regulation of the securities markets in Australia has two primary objectives, which broadly co-incide with the policy rationales for regulation of the securities markets in the United States: the maintenance of an efficient market and the protection of investors in the national public economic interest.[81]

Should the Law Prohibit Manipulation in Financial Markets?

Maintaining a legislative prohibition against market manipulation is not universally accepted as being essential or desirable as a matter of policy.[82] Indeed several commentators have questioned the soundness of basic manipulation theory.[83] Professor Fischel and David Ross argue that stock manipulation, however defined, is too vague a concept to form the basis for valid criminal charges. In a sharp departure from mainstream legal thought, they advocate that stock manipulation as a legal concept should be abandoned altogether — actual trades should not be prohibited as manipulative irrespective of the intent of the trader. And fictitious trades, such as wash sales and matched orders, should be analysed as a species of fraud.[84]

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79. The Rae Committee Report, above n 2, vol.1, 16.15.
80. Address by Michael McShane, Manager, Corporate Regulation, ASIC, 10 May 1995 at the ASX Forum, *ASC Digest* 1995, Vol 4, SPCH 71.
81. Meyer, above n 15, 93; it has been argued that investor protection and the resulting confidence are in fact the overriding goals of the United States regulatory scheme: Mann, above n 68, 178.

    It is interesting to note in this connection that a new and highly specific national interest principle has been identified and articulated in New Zealand in the 1990s — the attraction of foreign capital to 'an island nation far from the historic centres of world capital' — to operate alongside its traditional policy rationale of small investor protection: Gordon Walker, 'The Policy Basis of Securities Regulation in New Zealand' in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia and New Zealand* (1994) 171.
82. Black, above n 76, 988–9.
83. Fischel and Ross, above n 68; at least one court of appeals has entered the debate: see *United States* v *Mulheren*, 938 F. 2d 364 (2d cir. 1991). The Second Circuit, in reversing Mulheren's conviction, displayed its uneasiness with the concept of a crime that supposedly exists inside the defendant's head: Steve Thel, '$850,000 in Six Minutes — The Mechanics of Securities Manipulation' (1994) 79 *Cornell Law Review* 219, 294. (Herein referred to as 'The Mechanics of Securities Manipulation'). Also see Junda Woo, 'Law Theorists Call Stock Manipulation A Vague Concept, Seek to Abolish Term' *Wall Street Journal* (New York), 6 March 1992, recording reaction to the Fischel and Ross article.
84. Fischel and Ross, above n 68, 507.

As the Securities Exchange Act prohibits, but does not define, manipulation, Fischel and Ross tackle various commentators' definitions of stock price manipulation.[85] They reject the 'inducing people to trade' definition as too broad because it could catch even a mutually beneficial trade.[86] Another popular definition, 'forcing a security's price to an artificial level' is also rejected despite its intuitive appeal, since it might punish a trader who genuinely — though mistakenly — believes a stock's value is higher or lower than its price.[87] The authors conclude that there is no objective definition of manipulation — only dishonest intent to move stock prices can be called manipulative.[88]

Relying on the writings of Myron Scholes, a Stanford University professor whose research shows that trading often has no effect on securities prices, they further argue that single individuals are almost powerless to move stock prices. Thus people would not engage in manipulative trading even if it were legal, because it is extremely difficult to profit by manipulating security prices with trades. Profitable manipulations require two conditions: trading must cause the price of the relevant security to rise; and the manipulator must be able to sell at a price higher than the price at which the securities were purchased.[89] However the relationship between trading and price movements is complex and purchases seldom move securities prices higher. If they do, it is difficult to effect sales at the inflated price. Accordingly manipulative schemes are unlikely to be successful.[90] Given that trading is costly, it is argued, people will not even attempt to manipulate security prices.[91] Moreover, on a cost/benefit analysis, prohibiting manipulative trades is not justified: it results in significant enforcement and other social costs which outweigh any minimal benefits that the prohibition might yield. Because manipulative intent is difficult to identify, a rule prohibiting manipulative trades is expensive to administer and deters some appropriate and beneficial trading.[92]

Fischel and Ross concede that manipulation is possible if a trader makes false statements that would influence a stock's price, but they point out that false statements are already specifically prohibited under fraud statutes. They also note that if several people

85. Definitions are discussed in Ch 4 below.
86. Fischel and Ross, above n 68, 507.
87. Ibid 508–9.
88. Ibid 506.
89. Ibid 512. The authors concede that, unlike such trade-based manipulations, contract-based manipulations — schemes in which the trader's profit results from the ability to trigger a contractual right or benefit by trading — are more properly the subject of legal concern.
90. Cf the findings of the Rae Committee, above n 2, Ch 8, which found a direct correlation between manipulative practices such as pools, churning and organised runs and boosted reported turnover and price. Such manipulative schemes were at times widely practised and highly profitable.
91. Fischel and Ross, above n 68, 512–9; Thel, above n 83, 221.
92. Fischel and Ross, above n 68, 522–3. Examples of appropriate trading that might be deterred include situations where the activity in question creates a false and misleading impression but the primary purpose is the defence of a legitimate interest, eg share support operations to fend off a hostile take-over or to prevent an unreasonable decline in share prices to stave off creditors: How Chih Lee, 'Market Manipulation in the US and UK: Part 2' (1993) 14 *Company Lawyer* 123, 124.

collude to move prices, that is also fraud. Manipulation alone, the authors say, is so unlikely to occur and so difficult to detect that it should be declared lawful.

Several securities law specialists have balked at that suggestion, although they agree that manipulation is ill-defined.[93] Critics of the Fischel/Ross proposal point out that manipulation convictions not only are plausible but do take place every few years.[94] Professor Thel in particular has delivered a strong rebuttal of the position advanced by Fischel and Ross. He argues that despite the difficulty of manipulating price with trades, trading and price are connected. Manipulators can sometimes control prices with trades, and by doing so reap profits either by taking advantage of pre-existing contracts in which rights are contingent upon reported security prices or by inducing other market participants to trade at manipulated prices.[95] Relying on the evidence in the economic literature, Professor Thel states that manipulation is easier to accomplish than Fischel and Ross admit.[96] Indeed he posits that manipulation is 'theoretically possible, and it probably occurs fairly often.'[97] At the same time he concedes that manipulative intent is hard to identify, and the possibility of erroneous prosecution may discourage some appropriate trading.[98] Above all, a rule prohibiting intentional manipulation is an incomplete solution to the underlying problem because some price-affecting trades may cause damage by undermining the integrity of trading on a market for securities, regardless of the reason for which those trades are undertaken.[99]

Responding to Fischel and Ross' argument that the legal prohibition of manipulation creates extraordinary and unacceptable costs because of the need to delve into the state of mind of the trader, and furthermore that because severe sanctions turn on such state of mind, fear of prosecution casts a shadow over innocent and useful trading, Professor Thel argues that it is important to put the argument in perspective. According to Thel, the U.S.

93. Woo, above n 83.
94. Ibid. Arthur Matthews, a partner at the Washington DC law firm of Wilmer, Cutler & Pickering, said: 'You're talking about maybe one out of every 40 securities convictions are manipulation cases . . . [manipulation is] very hard to prove': Ibid. Professor Thel is reported as having stated that: 'It's difficult for a person to [manipulate stock prices], but it's not if they have a lot of resources behind them, and that's what has been happening': Ibid. Professor Thel believes that the SEC should define specific manipulative acts. Professor Norman Poser said one example of pure manipulation occurs when a trader breaks up a 500-share purchase into 100-share blocks to make it seem as if several people are jumping into the market. When other people begin buying the stock and the market rises, the trader sells at a profit. 'It's basically deceptive', Professor Poser is reported as having said. 'There's no social value in it, and it should be prohibited': Ibid.
95. Thel, above n 83, 221, 296–7.
96. Ibid 221–2.
97. Ibid 223.
98. Ibid.
99. Ibid. The damage to the integrity of the market arises because the manipulative activity affects the price at which all trades take place in the market within the relevant time period.

government brings relatively few securities manipulation cases.[100] Thus the deterrence to legitimate trading is minimal. Former SEC Commissioner Edward Fleischman on the other hand has argued along lines similar to Fischel and Ross that the costs of the existing regime have been understated and the benefits of regulation have been exaggerated. He does not conclude, however, that market regulation should be abandoned altogether. Instead he argues that broad standards protect the public and promote liquidity better than detailed rules and advocates the use of generic rules to regulate manipulation.[101]

Professor Thel observes that these difficulties 'suggest that the law should respond carefully to manipulative trading.'[102] He argues that those who crafted the U.S. securities laws recognised the need both to carefully calibrate the law so as to eliminate destructive practices without interfering unduly with appropriate trading, and to allow the law to develop as market practices change.[103] Hence the balance struck by the Securities Exchange Act, which makes it illegal to engage in a few clearly defined practices for specific purposes but otherwise charges regulators with studying the problem and devising appropriate rules in response.[104] The SEC in turn 'has promulgated a series of rules against particular trading practices, *most of which do not turn on a trader's motives.* These rules are supplemented by rule 10b-5 when manipulators use novel or particularly outrageous practices.'[105]

Despite the controversy as to the soundness of regulating price manipulation, Australian regulators like their U.S. counterparts regard fraud and manipulation in relation to the securities industry as a major concern and one which warrants government intervention:

> Maintaining credibility in our securities markets is a crucial factor in the economic process. With this in mind governments spend millions of dollars every year to ensure the integrity of its capital markets. In order to maintain confidence in our markets, market participants should aim to minimise the risk of fraud and inappropriate market practices. Fraud control and minimising the risk of fraud must start with the individual and have the active support of the firm and government.[106]

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100. Ibid 292. Although 'the pervasive problem of market manipulation was a principal focus of the SEC Enforcement Division in the 1980s': Harvey Pitt and Karen Shapiro, 'Securities Regulation by Enforcement: A Look at the Next Decade' (1990) 7 *Yale Journal on Regulation* 149, 256, there are (to the author's knowledge) no available statistics as to what percentage of all SEC securities cases have been market manipulation cases. There is only anecdotal evidence suggesting that one out of every forty securities *convictions* are manipulation cases: Woo, above n 83. (Also refer to n 94 above). This, however, only highlights the difficulty in proving the offence. The Commission has indeed suffered a number of setbacks, notably in *United States* v *GAF Corporation*, 928 F. 2d 1253 (2nd Cir. 1991) and *United States* v *Mulheren*, 938 F. 2d 364 (2d cir. 1991) (these cases are discussed in Ch 4 below). Overall, towards the end of the 1980s, the Commission began pursuing market manipulation cases with greater frequency: Pitt and Shapiro, 300. And at least from the Australian perspective, there is 'a substantial body of United States case law dealing with prosecutions for market manipulation': Black, above n 76, 1005.
101. Thel, above n 83, 295–6, referring to a letter from Commissioner Edward Fleischman to President George Bush dated 25 March 1992 (on file with the Cornell Law Review).
102. Ibid 223.
103. Ibid.
104. Ibid 297.
105. Ibid. Emphasis added. Professor Thel contends that, for the most part, this response is precisely what Fischel and Ross have shown is necessary: Ibid.
106. McShane, above n 80.

The maintenance of honest and orderly markets is a matter of 'enlightened self-interest since a well regulated market run on an ethical basis attracts the investor.'[107] Without regulation to ensure investor protection and confidence:

> our markets would cease to exist. If investors believed that prices were driven by backroom agreements rather than supply and demand, or if they believed that only "insiders" trading on confidential information could profit, they would take their money elsewhere. Without confidence in the markets, investors would, understandably, simply decline to participate.[108]

The historical evidence suggests that, absent regulation, stock markets would be marginal institutions.[109] Financial markets in Europe and the United States developed around debt issues, not equity. Prior to the 1920s, equities were regarded as unduly speculative and 'there were no large-scale markets in common stock . . . shares were viewed as akin to interests in partnerships and were simply conveniences for trading among business associates rather than instruments for public issues.'[110] The impact and example of U.S. regulation fundamentally altered this state of affairs.[111] In 1992, over U.S. $850 billion of capital was raised in U.S. markets alone.[112] Securities markets have become the capital raising vehicle of choice for many public companies and utilities today. Indeed 'both as vehicles for government sponsored privatisation or simply as means for capital raising, the role of bank financing has been vastly overshadowed by the direct use of the securities markets.'[113]

It should never be forgotten however that markets, although necessary and important, are like any speculative activity easily corrupted.[114] In the absence of effective regulatory structures, 'markets will be susceptible to fraud, mismanagement and even collapse based on the misdeeds of a greedy few.'[115] Thus the law should not lightly abandon its quest to prevent manipulation of financial markets.[116]

Conclusion

Although regulation is bound to be imperfect, securities markets that are firmly established, carefully regulated and responsive to the public interest make an immeasurable contribution

107. John Farrar, Mark Russell and Lindsay Hampton, *Company Law and Securities Regulation in New Zealand* (1985) 345.
108. Mann, above n 68, 178; 'Casinos with reputations for rigged games eventually drive patrons away': Bhide, above n 17, 130. In a similar vein, Black has recently argued that if manipulative practices lead to a loss of confidence in the integrity of the securities market, then investors would either look to other investment options, or would demand higher risk premiums, in either case increasing the cost of capital to listed companies: Black, above n 76, 988.
109. Bhide, above n 17, 131.
110. Ibid.
111. Friend, above n 34, 186.
112. Mann, above n 68, 179.
113. Ibid.
114. See generally Mayer, Nightmare on Wall Street, above n 50; and Robert Teitelman, 'The last days of Pompeii?' (August 1993) *Institutional Investor* 19.
115. Mann, above n 68, 179.
116. Thel, above n 83, 296.

to a national economy. On the other hand if 'professional insiders are free to manipulate prices, the economic role of the markets is not even subject to the restraints of the probability table, but becomes a pawn of gambling motivations.'[117] Indeed those markets which have not succeeded in creating at least an illusion of effective regulation have seen their market's integrity impaired.[118] A certain amount of regulation is needed then to enable the securities market to perform its price-determining functions, free from manipulative influences by those who seek to corrupt it for their own benefit.[119] The issue of how much substantive regulation is appropriate is far more difficult, but it is the critical issue.

117. Robbins, above n 28, 48.

118. The illiquidity of some European markets, such as the Belgian market, is attributed to the fact that restraints on insider trading, disclosure requirements and manipulative practices have traditionally been weak: Bhide, above n 17, 131.

Although Japan has one of the biggest capital markets in the world, its reputation in financial circles was impaired by recent scandals. It has therefore been suggested that '[i]n order for Japan to maintain its legitimacy in the "transnational" world of financial services, it needs to restructure its methods of regulating securities laws': Nicole Ramsay, 'Japanese Securities Regulation: Problems of Enforcement' (1992) 60 *Fordham Law Review* S255, S277.

Also see Andrea Borch, 'Market reform is in the air — but is it real?' (August 1993) *Institutional Investor* 21, discussing recent attempts by various Asian markets to restore some measure of fairness, transparency, corporate accountability and integrity to their capital markets behaviour.

119. Norman Poser, *International Securities Regulation — London's "Big Bang" and the European Securities Markets* (1991) 6.

Chapter 3

Overview of the Market Manipulation Provisions

Introduction

This chapter challenges the assertion frequently made about the regulation of stock market practices that the major problem is one of effective enforcement rather than the substance of the law. A careful analysis of the legislative controls devised to deal with the various forms of market manipulation leads inevitably to the conclusion that, quite apart from enforcement issues, there are serious deficiencies in the formulation of the legislative provisions themselves.

The discussion begins with an analysis of the relevant anti-manipulation sections of the Corporations Law — ie section 997 (actual trades) and section 998 (fictitious trading). The elements of the respective offences are detailed, in particular the central but problematic issue of manipulative intent. Comparison is then made with the equivalent offences in the United States and also with the Australian market manipulation offences as they apply to the futures industry.

The dearth of Australian caselaw and expert commentary on sections 997 and 998 renders comparative dimensions especially significant, and explains the preponderance of U.S. material in this chapter.

Australia — The Legislative Response to Stock Market Manipulation and False Trading

Part 7.11 of the Corporations Law regulates various forms of 'wrongful' conduct by those who work in the securities industry. It has been framed to 'reflect the legislature's concern that investors be shielded from "unscrupulous activity in the securities market", and that market integrity be maintained.'[1] Structurally, Part 7.11 comprises a number of distinct divisions which together constitute the relevant regime of liability governing abusive conduct in the securities market.[2]

Division 2 (sections 995–1001) introduces a broad provision in section 995(2) which places a blanket prohibition on conduct that is misleading or deceptive, or is likely to

1. *Australian Corporations & Securities Law Reporter* (CCH looseleaf service, 1995) 231–000.
2. Div 1 (s 994) — interpretation; Div 2 (ss 995–1001D) — prohibited conduct; Div 2A (ss 1002–1002U) — insider trading; Div 3 (ss 1003–4) — powers of the court; Div 4 (ss 1005–1015) — civil liability; and Div 5 (s 1015A) — exemptions.

mislead or deceive, in relation to any dealing in securities.[3] This provision is based on section 52(1) of the Trade Practices Act 1974 (Cth) and is intended to be a comprehensive catch-all provision. Its scope is potentially very wide and although contravention of section 995(2) does not create a criminal offence, it has the effect of triggering the civil liability provisions of section 1005.[4] It should be noted that, if section 52(1) of the Trade Practices Act is to be used as a model for the interpretation of section 995(2),[5] it is not necessary to prove intention to engage in the misleading or deceptive conduct in relation to the securities. Furthermore this interpretation accords with the clear language of the provision.

Thereafter are a number of sections which make more specific prohibitions, all of which require some degree of criminal intent and all of which carry a maximum penalty in the case of a natural person of a fine not exceeding 200 penalty units and/or five years' imprisonment, or in the case of a body corporate of a fine not exceeding 1000 penalty units.[6] Illegal conduct within the ambit of these prohibitions encompasses the making of

3. It has been said that the use of misleading and deceptive statements in relation to a security, as well as the misuse of inside information, are examples of market manipulation: Roman Tomasic and Stephen Bottomley, *Corporations Law in Australia* (1995) 684.

4. See further Michael Adams and Mark Freeman, 'The Securities Market in Australia' in Gordon Walker and Brent Fisse (eds) *Securities Regulation in Australia and New Zealand* (1994) 142; and *Australian Corporations & Securities Law Reporter*, above n 1. Refer to ASIC Practice Note 12, issued 30 July 1991, for the views of the Australian Securities and Investments Commission on the interpretation of s 995(2).

5. Note the recommendation of the Corporations Law Simplification Task Force that the relationship between s 52 of the Trade Practices Act and those provisions of the Corporations Law regulating dealings in securities, including s 995, be clarified. The Task Force proposed that fundraising, takeovers and other dealings in securities be regulated under the Corporations Law to the exclusion of the Trade Practices Act: Attorney-General's Department, Corporate Law Newsletter, 2 January 1996.

6. Schedule 3, Corporations Law; see further Baxt, Ford and Black, below n 8, 308. These are maximum penalties: ss 1311(1), (2), (3), and 1312. The penalties are, in monetary terms, a maximum $20,000 fine and/or five years' imprisonment in the case of a natural person, or $100,000 in the case of a body corporate. They have been regarded as 'heavy' penalties: *Australian Corporations & Securities Law Reporter*, above n 1, a conclusion which must be viewed with some scepticism in light of the fact that under s 129 of the former Securities Industry Code 1980, the penalties applicable to individuals were the same as apply today ie. $20,000 or imprisonment for five years or both; and for a body corporate, the fine applicable was only half what it is today ie. $50,000. Note the recent formulation of the penalties in terms of units allows a great deal more flexibility.

   The Proceeds of Crime Act 1987 (Cth), in addition, allows for the disgorgement of illegally obtained funds. Section 14 provides for a forfeiture order against property that is tainted in respect of an indictable offence, where a conviction has been entered for that offence. It also allows for a pecuniary penalty order against the convicted person in respect of benefits derived from the offence.

   With respect to criminal prosecution, the ASX has stated that, in its view, the defendant is usually not liable unless he was actually aware of the relevant facts. Civil liability may arise where, although the defendant did not know the relevant facts, a reasonable person in his position would have known or would have established the truth by inquiry. However, 'the application of this latter proposition to the market manipulation provisions of the Securities Code has yet to be tested in litigation': Australian Stock Exchange Circular to Member Organisations, 'Sections 123 and 124 of the Securities Industry Code' 21 June 1990. (Herein referred to as 'ASX Circular to Member Organisations'). Sections 123 and 124 are the legislative predecessors to ss 997 and 998 respectively of the Corporations Law and are couched in substantially the same terms.

false or misleading statements or omissions from prospectuses (section 996); stock market manipulation (section 997); false trading and market rigging transactions (section 998); false or misleading statements in relation to securities (section 999); fraudulently inducing persons to deal in securities (section 1000) and dissemination of information about illegal transactions (section 1001).[7]

In addition to the criminal penalties described above and in common with the other prohibitions contained in Part 7.11, such as those relating to insider trading, the making of false and misleading statements and fraudulently inducing persons to deal in securities, the Corporations Law provides a civil remedy under section 1005 to any person who suffers loss as a result of breach of any of the market manipulation or false trading provisions.[8] In proceedings to establish civil liability, the standard of proof is of course the balance of probabilities and not the criminal standard of beyond reasonable doubt.[9] In addition, a person who contravenes sections 997 and 998 may be subject to an injunction and/or damages under section 1324 and any other order which the court may make under the broad discretionary powers conferred by section 1114.

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7. The practices of ramping and warehousing — other forms of market manipulation, see Appendix A — are also prohibited by the legislation. With respect to warehousing, ss 707–16 and s 741 of the Corporations Law provide that where aggregations of interest exceeding 5% of the company's capital are involved, and there is no disclosure, a party acting as a 'warehouse' is in breach of the substantial shareholding provisions. If aggregations exceeding 20% are involved, s 615 is also breached. Where warehousing is suspected there is also power to seek information as to the controllers of the shares under ss 717–27 of the Law.

8. Such liability primarily arises under the general liability provisions of s 1005 and is extended by the additional head of civil liability imposed by s 1014. The amount of the loss is the difference between the price at which the securities were dealt and the price at which they would be likely to have been dealt in if the contravention had not occurred: s 1015. The maximum amount recoverable is the total loss on the transaction less the amount, if any, that the defendant may be liable to pay to any other person under Part 7.11 of the legislation or under s 232(7): Robert Baxt, H A J Ford and Ashley Black, *Securities Industry Law* (5th ed, 1996) 308.

   It should be noted that the scope for an action under s 1005 extends to a person 'who suffers loss or damage by conduct of another person that was engaged in in contravention of a provision.' It has been said of s 1005 that it 'seems fairly broad in scope' because the other person need not be convicted of an offence: Mark Vodicka, *International Securities Trading* (1992) 92. Furthermore, as several people may well be acting in concert, 'the person against whom the action is brought need not be the chief figure': Ibid. Finally, the term 'engaged in' is potentially very broad and could in certain circumstances extend to any person 'who had actual knowledge, encouraged or positively acted in furtherance of the proscribed scheme': Ibid.

   The particular difficulties in assessing damages in relation to manipulation occurring on market are discussed in Ashley Black 'Regulating Market Manipulation: Sections 997–999 of the Corporations Law' (1996) 70 *Australian Law Journal* 987, 1004.

   There is no 'extensive mixture of public and private enforcement as exists in the United States': Vodicka, 93. Section 1313A does, however, allow the anti-fraud provisions an extraterritorial application although there are limits to this: see further Mark Vodicka, *International Securities Trading* (1992) Ch 9; Janet Albrechtsen, 'Extraterritorial Implications of Australian Securities Laws' in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia and New Zealand* (1994) 750.

9. Section 1332 Corporations Law. Proceedings may be instigated within six years after the cause of action arose: s 1005(2).

Finally, Division 2A of Part 7.11 establishes the legislative scheme prohibiting insider trading in securities together with the substantial monetary penalties and civil liability provisions for persons guilty of insider trading.[10]

Stock market manipulation: Section 997 Corporations Law

At common law, a market transaction involving an actual sale or purchase of securities might be void for illegality if motivated by an attempt to deceive other traders in the market. In *Scott* v *Brown Doering McNab & Co,*[11] the plaintiff instructed stock brokers to buy shares on market at a premium to the issue price in order to encourage other investors to take up the shares because they were trading at a premium. An action brought by the plaintiff under its contract with the stockbrokers failed on the ground that the contract was void for illegality. It was held that the purchases of shares on the stock market at a premium was unlawful because its sole purpose, as the court found, was to mislead the public as to the market and to induce public buying.

Transactions which are effected 'not for legitimate trading purposes but with the intention of creating a false impression in the minds of the public that there is a genuine demand are prohibited by section 997.'[12] The provision focuses on participation in transactions which have, or are likely to have, *a price effect* (by increasing, reducing or stabilising) with intent to induce other persons to sell, buy or subscribe for the securities.[13] Specifically, it prohibits a person from entering into or carrying out, either directly or indirectly, two or more transactions in securities of a body corporate, where the transactions:

- have or are likely to have the effect of increasing the stock market price of the securities and are intended to induce others to buy or subscribe for securities of the body corporate or of a related body corporate (section 997 (1));[14]
- have or are likely to have the effect of reducing the price of the securities and are intended to induce others to sell securities of the body corporate or of a related body corporate (section 997 (4)); or

10. In the case of a natural person, the penalty for contravention of s 1002G (the primary prohibition against insider trading) is $200,000 or imprisonment for five years or both; in the case of a body corporate the fine is $1,000,000 — by virtue of s 1312, an amount five times greater than the fine which can be imposed upon a natural person. Section 1002U allows the court to make a wide range of other orders where s 1002G has been contravened and s 1013 allows a range of civil remedies if a person has contravened s 1002G(2): see further Baxt, Ford and Black, above n 8, 336–40.
11. (1892) 2 QB 724. Discussed further in Ch 2 above. It was held in this case that the purchaser could not sue the brokers he had employed to assist him in the fraud.
12. Baxt, Ford and Black, above n 8, 304.
13. Peter Meyer, 'Fraud and Manipulation in Securities Markets: A Critical Analysis of Sections 123 to 127 of the Securities Industry Codes' (1986) *Company and Securities Law Journal* 92, 95. Whereas s 997 prohibits price effect transactions, s 998 (which deals with fictional transactions for market manipulation purposes) prohibits conduct which affects market volume as well as the price of the securities: Ibid 96.
14. 'Transactions aimed at increasing prices may be entered into, for example, by management seeking to prop up the price of securities because of the fact that such securities may have been used as collateral for a loan': Tomasic and Bottomley, above n 3, 684.

- have or are likely to have the effect of maintaining or stabilising the price and are intended to induce others to sell, buy or subscribe for securities of the body corporate or of a related body corporate (section 997 (7)).[15]

According to section 997(10), the term 'transaction' in relation to securities extends to the making of offers to buy or sell securities, and to the making of invitations which expressly or impliedly invite a person to offer to buy or sell securities. The section 997 prohibition is based on section 9(a)(2) of the U.S. Securities Exchange Act 1934,[16] and the courts in the United States have similarly held that the concept of transaction in the context of section 9(a)(2) includes the placing of bids in an auction market, which will force competing bidders to increase their bids.[17]

It is an essential ingredient of the section 997 prohibition that transactions have, or are likely to have, the effect of raising, lowering or stabilising the price of securities. The ordinary meaning of the word 'likely' connotes a real and not remote chance that the transactions will have such an effect, whether or not that chance is greater or less than fifty per cent.[18] Expert evidence will normally be required in order to demonstrate that transactions were likely to have the effect in question.

The term 'securities' is defined in section 92 both generally and in relation to a body corporate to include what are commonly known as debentures, stocks, bonds and interests in managed investment schemes, units of debentures, shares or managed investments; as well as any instrument that may be categorised as an option contract, but not a futures contract.[19] Finally the provision goes somewhat further than its U.S. equivalent, section 9(a)(2)

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15. The Australian formulation of the prohibition against stabilising stands at odds with the approach adopted in the United States (and for that matter the United Kingdom). This matter is more fully addressed in Ch 4. However broadly speaking, whereas s 997(7) is a blanket prohibition on market stabilisation, s 9(a)(6) of the U.S. Securities and Exchange Act 1934 only prohibits 'pegging, fixing or stabilising the price of securities where it is in contravention of rules and regulations prescribed by the Commission. Generally speaking, stabilisation is prohibited in the United States except where it relates to stabilisation for the purposes of a distribution of securities by a corporation. It is not settled in the United States that such stabilisation should be completely eliminated and it is argued by some that it is essential for the purpose of "preserving the ready flow of capital into industry"': Meyer, above n 13, 95; see further Black, above n 8, 993–4.
16. Section 9(a)(2) of the Securities Exchange Act 1934 is discussed in detail later in this chapter. Broadly speaking, the provision prohibits any person, alone or with others, from effecting a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in the security, or raising or lowering its price, for the purpose of inducing others to purchase or sell the security.
17. *Kidder, Peabody & Co.*, 18 SEC 559, 568–70 (1945); Black, above n 8, 989.
18. Black, above n 8, 990.
19. A futures contract is defined in s 72 and is regulated by the Australian Securities and Investments Commission and Ch 8 of the Corporations Law.

    The courts have recognised the difficulty with the word 'security' in a number of cases and how it can have a variety of different meanings. In *Brick and Pipe Industries Ltd* v *Occidental Life Nominees Pty Ltd* [1992] 2 VR 279, the Court indicated that the word 'security' could refer to property over which a creditor, or other obligee, is given rights by a debtor, or other obligor, in order to secure performance of a promise to repay money or some other undertaking. Alternatively, another legal meaning of security can be a type of legal claim called a 'chose in action.' Shares in a company are certainly within the common-law and statutory definitions of a security. This was identified by Farwell J in *Borland's Trustee* v *Steel Bros & Co Ltd* [1901] 1 Ch 279: Adams and Freeman, above n 4, 132.

of the Securities Exchange Act, in that subscription is covered in addition to sale and purchase, and related corporations are also embraced.

In each of the three limbs, the offence comprises two ingredients — the prohibited activity and the intent to induce. The prohibited activity in each case is the entering into or carrying out, either directly or indirectly, of two or more transactions in securities.[20] According to the Australian Stock Exchange[21] however, 'great emphasis must be placed on the ingredient of intent to induce in proving the offence.'[22] The word 'induce' has been defined as to 'prevail on, persuade, bring about, give rise to.'[23]

The rationale for the 'intent to induce' requirement in section 997 is to distinguish between manipulative and non-manipulative trading.[24] However the same trade may be carried out with different motives, and since it is usually impossible to ascertain with certainty what motivates a particular trade, significant conceptual difficulties exist in distinguishing proper non-manipulative market participation — which leads to an increase in market activity or an alteration in the market price for securities — from improper manipulative trading — which has a corresponding market or price effect but is undertaken for an impermissible purpose. It has even been suggested that the object of *every* bid or offer on the stock market might be interpreted as being to raise the price to induce another to sell, or to reduce the price to induce another to buy.[25] Consequently there should be nothing wrong *per se* in such actions and the section should be eliminated altogether. This would effectively leave section 998, the false trading provision, to deal with the problems which arise when transactions are entered into for the purpose of creating a false or misleading appearance with respect to the price or volume of securities.[26]

Section 997 has not, however, been abandoned by the legislature and the obvious difficulty with its manipulative intent component has given rise to the requirement of 'clear evidence of a strong motive to induce purchase, sale or subscription of securities, combined

20. Section 123 of the Securities Industry Code — on which s 997 is modelled — referred to the prohibited activity in terms of 'effecting, taking part in, being concerned in or carrying out' either directly or indirectly, two or more transactions in securities. The view of the ASX is that these words are broad enough to include the activity of a broker acting on behalf of a client: ASX Circular to Member Organisations, above n 6, 1.4.
21. As s 997 is cast in near-identical terms to its predecessor, s 123 of the Securities Industry Code, (as s 998 is cast in the mould of the former s 124), it is pertinent to consider the interpretation given to these provisions by the Australian Stock Exchange (ASX): Australian Stock Exchange Circular to Member Organisations, above n 6.
22. Ibid 1.6.
23. *The Concise Oxford Dictionary* (6th ed, 1976); *Ryan* v *Triguboff* [1976] 1 NSWLR 588, where Lee J held that the word 'inducing', in the definition of 'dealing in securities' in s 4 of the Securities Industry Act 1970 (NSW), also meant to prevail on, persuade or bring about. A similar construction has been given to the word 'induce' in the context of s 75B of the Trade Practices Act 1974 (Cth): *Trade Practices Commission* v *Service Station Association Ltd* (1992) 109 ALR 465, 477–8.
24. Black, above n 8, 990. The purpose of a legislative prohibition on market manipulation is 'not to prohibit market transactions which may raise or lower the price of securities, but to keep an open and free market where the natural forces of supply and demand determine a security's price': *Trane Co* v *O'Connor Securities*, 561 F. Supp. 301, 304 (S.D.N.Y. 1983).
25. Meyer, above n 13, 96. Emphasis added.
26. Ibid.

with two or more transactions carried out in accordance with that motive'[27] in order to provide sufficient evidence of intent for conviction under the section. In the context of the United States equivalent provision, section 9(a)(2) of the Securities Exchange Act 1934, the word 'purpose' is used. There being no effective distinction between purpose and intent in the criminal sense, proof of the requisite mental element in the United States is usually based on inferences drawn from circumstantial evidence.[28]

In Australia, as indicated above, the ASX has also declared that where there is 'evidence of a motive to manipulate the market, together with trading activity in accordance with that motive, manipulative intent may be inferred.'[29] Furthermore, a finding of manipulative intent 'may of necessity be based upon inferences drawn from circumstantial evidence, apart from evidence of motive.'[30] Findings may be based upon:

> a mass of factual detail, relating to such matters as patterns of behaviour, apparent irregularities in trading patterns and other trading data. These may reveal indicators of a manipulative scheme designed to tamper with free market forces. Such indicators might include:
>
> - 'consistently appearing as the highest bidder', a device which could be used to support or raise the price of securities;
> - 'price leadership by use of the uptick', consistently upticking from the previous sale price. Progressively higher bids may bear no relation to the merits of the investment. As a consequence, the higher activity is the inducement to others to deal, for the more frequently the stock moves, the more apparent the activity and the more active the appearance of the market for the security;

27. ASX Circular to Member Organisations, above n 6, 1.6.
28. Reliance upon circumstantial evidence is illustrated by the U.S. case *S.E.C.* v *Zico* No.87 Civ. 8487 (T.P.G.) (S.D.N.Y. Dec. 1987). In that case, a number of sale transactions through a nominee account caused the price in shares, for which there was a small market, to fall. This had the effect of benefitting those engaged in a tender offer. Notwithstanding the lack of direct evidence, it was inferred that the market had been manipulated based on the benefit gained and the motive to manipulate. Direct evidence through telephone records was only used to identify the parties involved.

    An Australian commentator has observed that the United States courts have readily inferred the requisite element of intention to induce others to trade from the facts of a transaction: Black, above n 8, 990.

    With respect to the precise theoretical definition of 'purpose' and whether there is any theoretical distinction between 'purpose' and 'intent' in the criminal sense, Professor Loss has commented that such matters are better left to the metaphysicians and that it is far more fruitful to consider what evidence has sufficed to prove purpose in specific cases under s 9(a)(2): Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (3rd ed, 1995) 940.
29. ASX Circular to Member Organisations, above n 6, 1. 'Some examples [of manipulative intent being inferred from a motive to manipulate accompanied by trading activity in accordance with that motive] are:
    - conduct to increase the price of securities for the purpose of maintaining an artificial price level at which new shares are to be issued;
    - price manipulation necessary to fulfill promises made to induce earlier purchasers to buy the security;
    - conduct to interfere with the market for securities so as to affect the outcome of a takeover;
    - trades in securities which increase or maintain the price, in circumstances where there exists a direct financial interest in a price rise or price maintenance, due to a substantial existing long position in either equities or options;
    - transactions for taxation purposes which are not executed at the prevailing market price;
    - trades in securities which stabilise or raise the price, in circumstances where loans exist to a substantial shareholder which would be margined if the stock fell below a specific price': Ibid 1–2. According to the ASX, these are 'only a few circumstances which are suggestive of market manipulation. There are obviously many other examples': Ibid 2.
30. Ibid 2.

- 'transactions at successively higher prices', the use of actual purchases and sales at successively higher prices may have the effect of giving the appearance of real activity by investors despite the absence of bona fide investor demand for the stock;
- 'domination and control of trading', purchasing a significant volume such that one client or dealer artificially can set market prices. This might be followed by upticking the bid prices to desired but artificial levels despite the absence of bona fide investor demand for the stock. Similarly, attempts to reduce a stock's liquidity may lead to manipulation;
- 'ramping at the close', placing actual bids, often for small parcels or bids at or near the close of the trading day that are unable or unlikely to be executed due to the short trading time available, so as to cause the stock to close at a higher price than the prior sale price;
- 'guarantees' or 'payments', guaranteeing purchasers against loss or making payments to induce others to purchase the security; and
- 'use of nominee/fictitious accounts', the use of accounts to stage widespread buying and selling activity at designated price levels, thereby concealing the actual control exercised by the manipulators and the purpose of such activity.[31]

It should be noted that section 997 is not limited to transactions which take place on a stock market although they must have, or be likely to have, an effect on the price of securities on a stock market.[32] Indeed it has been suggested that 'such transactions would need to involve a large number of shares in order to have any impact on the price of securities.'[33] The section further provides that two or more transactions are required to constitute a breach.[34] This requirement contrasts with section 9(a)(2) of the Securities Exchange Act 1934 which specifies a series of transactions.[35] In the United States, a series is satisfied by three purchases, although it has been suggested that 'perhaps even two would suffice.'[36]

The inherent defect with the requirement of at least two transactions is that it would be 'as undesirable for a person to enter into one transaction to affect the price of the security with intent to induce sale or purchase, as it is for that person to enter into two or more transactions with that intent.'[37] Nevertheless a single transaction accompanied by fraudulent intent, however objectionable, is simply not caught by the provision — a position which is logically indefensible.

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31. Ibid 2, 3. Clearly, some of these examples may more appropriately fall within the statutory definitions of false trading and market rigging contained in s 998 Corporations Law. This is not surprising given the considerable overlap between the ss 997 and 998. It should be noted that this part of the ASX Circular is couched in broad terms applicable to stock manipulation generally.
32. Meyer, above n 13, 95; and Baxt, Ford and Black, above n 8, 305: the 'section is not confined to transactions on a stock market.' Cf Tomasic and Bottomley, above n 3, 684 who state that the manipulation proscribed by s 997, whether undertaken directly or indirectly, must take place on a stock market.
33. Vodicka, above n 8, 91.
34. Single transactions are not caught by the provision presumably because they are less likely to involve an intenion to induce others to come onto the market: Black, above n 8, 989.
35. Loss and Seligman, above n 28, 938. Another distinction between s 997 and s 9(a)(2) is that the latter refers to transactions 'creating actual or apparent active trading . . .' as an alternative to those transactions having a price effect, which is the sole concern of s 997. These words, although omitted from s 997, are 'partly enacted in s [998]': Meyer, above n 13, 96.
36. Loss and Seligman, above n 28, 938.
37. Meyer, above n 13, 95.

By way of comparison, it is instructive to note at this point the elements of the market manipulation offence applicable to the futures industry under Part 8.7 of the Corporations Law. According to section 1259, a person must not take part in, be concerned in, or carry out, whether directly or indirectly, a transaction or two or more transactions that *have*, are *intended to* have, or are *likely to* have the effect of creating or maintaining an artificial price for dealings in futures contracts on a futures market in this jurisdiction.[38] The manipulative act clearly comprises the taking part in, being concerned in or carrying out either a single or multiple transactions which have, are intended to have or are likely to have the effect proscribed.[39] The fact that a single manipulative transaction is contemplated is a distinct improvement over the section 997 formulation in relation to stock manipulations. Furthermore, intent is not a necessary element of the section 1259 offence:

> Paragraphs (a) and (b) of the section make it quite clear that the results described in paragraphs (c) and (d) [relating to the creation and maintenance of an artificial price] must either have been intended or, on a completely objective test, have been the likely effects of the transactions . . . There is nothing in the section nor in any interpretation provision to support a subjective gloss on the phrase 'likely to have the effect'.[40]

Fraudulent, artificial and fictitious trading in securities: Section 998 Corporations Law

There are broadly speaking two categories of manipulation — those governed by section 997 that affect the price of a security by actual trading, discussed above, and those governed by section 998 that affect the price or volume of the trading of a security by *fictions*.[41] Although section 998 broadly governs fictional transactions for market manipulation purposes, it specifically creates two offences: false trading and market rigging.[42]

False Trading: Section 998(1) provides that a person shall not '*create,* or do anything that is *intended* or *likely to* create, a false or misleading appearance of active trading in any securities on a stock market or a false or misleading appearance with respect to the market for, or the price of, any securities.'[43] It can be seen that the section 'prohibits conduct

38. Emphasis added.
39. John Currie, *Australian Futures Regulation* (1994) 224.
40. Ibid 225. The difficulty then becomes one of establishing that 'the conduct or market practice complained of or, in some cases, that the price result, was artificial or fictitious': Ibid 222.
41. Geoffrey Hart, 'The Regulation of Stock Market Manipulation' (1979) 7 *Australian Business Law Review* 139, 141, where the criticism is made that no provision in the Securities Industry Acts 1970 recognised the distinction between manipulation by actual trading and manipulation by the creation of a false or misleading appearance of active trading: Ibid 146–7. The statute 'only provides that the rigging of a market by a fiction is illegal. Rigging a market by a real transaction is not currently illegal in Australia': Ibid 141–2. This, of course, is no longer the situation in view of the terms of s 997 Corporations Law but whether the current position is an improvement over what we had before is debatable.
42. Briefly, s 998(1) deals with the creation of a false or misleading appearance of active trading or with respect to the market or the price of the securities; and s 998(3) prohibits trading by purchases or sales of securities which do not involve changes in their beneficial ownership, or by fictitious transactions or devices, which have the effect of maintaining, increasing, reducing or causing fluctuations in the market price of those securities. These are discussed below.
43. Emphasis added.

which affects market volume as well as the price of securities.'[44] The analogous provision in the United States is section 9(a)(1) of the Securities and Exchange Act 1934 and in both cases the prohibited activity is to 'create a false or misleading appearance.'[45]

It will not always be easy to distinguish, in any given fact situation, between a genuine transaction and one which created, or was intended or likely to create, a false or misleading appearance of active trading or with respect to the market for or the price of securities. For example, the sale of a large parcel of shares in a short time-span may lead to a reduction in the reported market price of those securities, by satisfying demand for the shares at the lower price. However the mere fact that the sale gives rise to an appearance as to the price of the securities which differs from that which might exist in the absence of that sale, does not constitute a contravention of section 998(1).[46] Similarly the fact that the price of securities may increase where an on-market bidder is standing in the market to acquire shares does not give rise to a contravention of section 998(1), even if the price of the shares would have been lower had that bid not been made.[47] The purchase or sale of shares in circumstances where a trader can profit by an arbitrage[48] between the securities and futures markets is also likely to be a legitimate transaction, even if the transaction affects the market price of those shares.[49]

On the other hand, in *Fame Decorator Agencies Pty Ltd* v *Jeffries Industries Ltd*[50] it was held that the sale of a reasonably large parcel of shares had breached the misleading or deceptive conduct provisions of the Corporations Law and had created a misleading appearance as to the price of the shares in contravention of section 998. The sale (by the former chairman of Jeffries Industries) had taken place in a thinly-traded market in the last hour of trading at a price well below the previous sales price in order, as the trial judge found, to create an artificially low price for determining the number of shares to be allotted on conversion of certain redeemable preference shares in the company to ordinary shares. A lower price had the effect that a substantially larger number of ordinary shares would be issued under the conversion formula.

The seller sought to explain the circumstances of the sale of the shares on the basis of the need for funds to repay debts and advance a loan to a third party. However the judge found that finance was available from alternative sources and that there was no need to deliberately sell the shares at the lowest bid prices of 13–14 cents, a price well below the previous market price of 25–50 cents.

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44. Meyer, above n 13, 96. Cf s 997 which prohibits conduct having a price effect.
45. The prohibition in the former s 124(1) of the Securities Industry Code was cast in terms of creating, causing to be created or doing anything calculated to create, a false or misleading appearance.
46. Black, above n 8, 996.
47. Ibid.
48. 'Arbitrage' (from the French, meaning 'to judge') is the near simultaneous purchase and sale of the same or exchangeable security in the hope of showing a profit through a difference in markets. 'Put simply, the arbitrageur tries to find a situation in which he can buy at one price and sell at a higher price at virtually the same time': Joseph Walker, *Selling Short — Risks, Rewards, and Strategies for Short Selling Stocks, Options, and Futures* (1991) 58.
49. Black, above n 8, 996.
50. (1998) 16 ACLC 1,235 (New South Wales Court of Appeal upholding the decision of Cohen J in *Fenwick* v *Jeffries Industries Limited* (1995) 13 ACLC 1334).

The New South Wales Court of Appeal, per Gleeson CJ, Powell JA concurring, upheld the decision that the sale was not an indication of genuine supply and demand. The conduct of a seller of thinly traded shares which was calculated to effect sales at the lowest, rather than the highest, obtainable price and which was timed to deflect the possibility of some purchasers bidding up the price, had both the purpose and effect of temporarily creating an artificial market and price. Such conduct upon the market for shares in Jeffries, and the market price, was not merely incidental. The central objective and intention of such conduct was to give a misleading appearance as to the real price of the shares for the purpose of calculating the conversion of the preference shares.

However according to Priestley JA (dissenting), the seller took the market as he found it. His purpose was not to create a false or misleading appearance with respect to the market for, or the price of, Jeffries shares; nor did he do so. The purpose was to bring about a close of market price based on his own view of what would be to his advantage, in light of publicly available information, by selling shares in accordance with known market procedures. What happened in the market happened because of the market's own mechanism. Jeffries had made the rules about its converting shares. The seller took advantage of them. In doing nothing more than selling shares in accordance with market procedures, without collusion, connivance, prearrangement or even communication with anyone other than his agent, there was no breach of either section 995 or section 998 of the Law.

Assistance with regard to what may constitute a false or misleading appearance of active trading under section 998(1) may be found in the deeming provisions of section 998(5).[51] These provisions, which are designed to facilitate proof, broadly refer to conduct which may be described as wash sales and matched orders.[52] These are deemed to create a false or misleading appearance of active trading in securities on a stock market. In other

51. Therefore, *apart from the operation and general effect of s 998(1)*, a person will be deemed to have created a false or misleading appearance of active trading in securities if any one of the three tests set out in s 998(5) is satisfied. Guidance as to what constitutes a false or misleading appearance of active trading may be found in the decision of the NSW Court of Criminal Appeal in *R* v *M & Ors* (1978–79)4 ACLR 610.

52. According to s 998(5)(a), 'wash sales' are those transactions that do not involve any change in the beneficial ownership of the securities in the extended sense referred to in s 998(7). Section 998(5)(b) and (c) govern 'matched orders' or 'prearranged trades'. According to these provisions, these occur where a person makes or causes to be made an offer to sell or purchase securities where he has made or proposes to make, or knows that an associate has made or proposes to make, a corresponding offer to purchase or sell on substantially the same terms.

With respect to associates, conceptually there are two categories: the objective category which includes *inter alia* a company and its director or secretary; a company and its related company; and persons who are partners in a business of dealing in securities, or in any business where both partners are aware of the relevant transaction. The subjective category of associates includes *inter alia* persons acting in concert in relation to a transaction or proposing to become associated in any of the ways referred to above: see further ASX Circular to Member Organisations, above n 6, 6.2–3. It should be noted that a broker is not an associate of the client by virtue merely of being the client's securities adviser. However, additional facts may give rise to an associate relationship. The ASX has expressed the view that for the purposes of s 998, the subjective category of associates places brokers at risk wherever they know there is any connection between two clients involved in one transaction or connected transactions: Ibid 6.4. According to the ASX, the best protection for a broker is to satisfy him/herself that a manipulative intent is not present and to include in the report of the trade a condition code identifying the trade as such. Sections 10–17 of the Corporations Law govern associates.

words, where either of these types of transactions occurs, an offence is deemed to have been committed without the need to prove any intent to manipulate on the part of the person involved.[53] However, a defence is available under section 998(6) in respect of any of the acts referred to in section 998(5), if the purpose or purposes of the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading in securities on a stock market. The effect of these provisions is thus to reverse the onus of proof as to intent. Once the wash sale or matched order is proved, it is for the accused to prove that the intention was not to create a false or misleading appearance: *Endresz* v *Whitehouse*.[54]

The deeming approach thus utilised elevates the significance of the element of intent in the operation of the provision and lends credence to the view expressed by Mason J in the High Court decision of *North* v *Marra Developments Ltd*,[55] that the provision presupposes an intentional element. However, a literal interpretation of the subsection makes it clear that the false or misleading appearance must either have been intended *or*, on a purely objective test, have been the outcome *or* likely outcome of the actions undertaken.[56] In other words,

53. ASX Circular to Member Organisations, above n 6, 5.2. It has been stated, *obiter*, that in respect of a person who is prosecuted for entering into a transaction that is deemed to be false trading by virtue of s 998(5)(a), the prosecution is not required to prove an intention to commit a contravention of the provision: *Endresz* v *Whitehouse* (1994) 12 ACLC 803, (1997) 15 ACLC 936.

54. (1994) 12 ACLC 803, (1997) 15 ACLC 936. Also see ASX Circular to Member Organisations, above n 6, 5.2. In *Endresz* v *Whitehouse*, a director of a listed company (Emu) gave instructions to a broker to sell four million shares in Emu owned by a proprietary company which he controlled. He also gave instructions to another broker to buy four million shares in Emu at above the market price. The director was charged with contravening ss 124(1) and 124(3)(a) of the Securities Industry Code, the ss 998(1) and 998(5)(a) Corporations Law equivalents. At first instance, Hansen J noted *obiter* that s 124(3)(a) of the Securities Industry Code removed the requirement for the prosecution to prove an intention to commit the s 124(1) offence; that the defendant's intention is only relevant in establishing that the purpose was not, or did not include, the purpose of creating a false or misleading appearance of active trading within the defence under s 124(4), the s 998(6) Corporations Law equivalent; and that the onus of establishing that defence rests on the defendant.

Endresz relied on the defence that the purpose of the transaction was not, or did not include, the purpose of creating a false or misleading appearance of active trading in securities on the stock market. He claimed that the purpose of the transaction in question was merely to obtain a short-term loan. Hansen J however found that this purpose could not be supported by the surrounding circumstances.

On appeal, the Supreme Court of Victoria, Court of Appeal, dismissing the appeal, also rejected Endresz's alleged purpose and found that the only inference available to it was that the price of the four million shares was raised so as to create a false and misleading appearance of active trading at a substantially higher price in the Emu shares. Market manipulation was inferred from the activities of Endresz and it was found to be a significant purpose. Endresz's defence was unsuccessful as he failed to prove that market manipulation could be excluded as one of the purposes of the transaction.

55. (1981) 148 CLR 42.

56. This interpretation has been confirmed by the Federal Court in *Australian Securities Commission* v *Nomura International PLC* 29 ACSR 473, discussed at n 75 et seq below.

The similarities with the s 1259 offence in the context of futures manipulation should be noted here. See above n 38–40. The s 1260 false trading offence in the futures context is couched in broadly similar terms. It prohibits a person from creating, causing to be created or doing anything that is calculated [ie intended] to create a false or misleading appearance of active trading or with respect to the market or the price for futures contracts on a futures market within the

the section may operate 'wherever a false or misleading appearance was in fact created [or likely to be created], irrespective of the relevant person's intentions.'[57] This interpretation is reinforced by the ASX guidelines in relation to the legislative predecessor of section 998(1):

> The prohibition in Section 124(1) relates to creating, causing to be created or doing anything calculated to create a false or misleading appearance. A broker who executes trading instructions on behalf of a client could (in appropriate circumstances) be said to have created a false or misleading appearance of active trading. His client, however, has caused the appearance to be created, by giving the instruction. It is to be noted that in both of these cases, there is no specific requirement for an intent to create a false or misleading appearance — the question is whether one was actually created. Conversely, in relation to a trade which is 'calculated to create' [intended to create] a false or misleading appearance, it does not matter whether a false or misleading appearance was in fact created, so long as there was an intention to create that appearance.[58]

In *North* v *Marra Developments Ltd*,[59] the High Court had occasion to interpret section 70 of the Securities Industry Act 1970 (NSW) — a provision similar in material respects to the current section 998(1). The case arose, not out of a prosecution under section 70 of the New South Wales statute, but out of a claim for compensation by members of a stockbroking firm who had attempted to create a false and misleading appearance of active trading in securities for their client, and who were claiming the balance of remuneration for their professional services.[60] The appellants had acted as advisers to Marra Developments Limited in connection with its capital reorganisation and proposed takeover of Scottish Australian Holdings Limited. The takeover involved an exchange of shares in the two companies. Scottish had been advised that their shares should be valued at $1.50. Marra believed that the market price of its shares did not reflect the true value of the company. The appellants, with Marra's approval, thereupon devised a scheme in which they and the directors of Marra would, by stock market transactions, 'establish a market' in Marra shares at $16.50 per share or thereabouts. Pursuant to the scheme, the appellants bought Marra shares at that price.

The High Court held that the agreement to effect the scheme for the purchase of Marra's shares, and the implementation of that scheme, involved illegality and were contrary to the section 998(1) equivalent. The purchases had been calculated to create a false market or false price. Mason J, in the course of delivering the majority judgment of the High Court, stated that:

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jurisdiction. It has been said that, by virtue of the component of 'doing anything calculated to create' a false or misleading appearance, this is an intentional offence: Currie, above n 39, 229. This is to overlook the other elements of 'creating or causing to be created' which, it is submitted, are objectively determined.

57. Meyer, above n 13, 97.
58. ASX Circular to Member Organisations, above n 6, 3.2. In *North* v *Marra Developments Ltd* (1981) 148 CLR 42, in interpreting s 70 of the Securities Industry Act 1970 (NSW) — a provision similar in material respects to s 124(1) of the Securities Industry Code — Mason J stated that the word 'calculated' meant designed or intended rather than adapted or suited: Ibid. 112.
59. (1981) 148 CLR 42.
60. The observation has been made that what is remarkable about the case is that such well-established brokers should have pursued a claim of this nature to the High Court, thus 'suggesting that such deceptive market practices were widely perceived to be normal at that time': Tomasic and Bottomley, above n 3, 688.

> In terms the statutory provision is directed against activity which is designed to give the market for securities or the price of securities a false or misleading appearance . . . It is not altogether easy to translate the generality of this language into a specific prohibition against injurious activity, whilst at the same time leaving people free to engage in legitimate commercial activity which will have an effect on the market and on the price of securities. Purchases or sales are often made for indirect or collateral motives, in circumstances where the transactions will, to the knowledge of the participants, have an effect on the market for, or the price of, shares. Plainly enough it is not the object of the section to outlaw all such transactions.[61]

To the extent that the judgment of Mason J thus appears to presuppose the existence of an intentional element in the offence, its validity must be doubted.[62] For there is 'nothing in the section nor in any interpretation provision to support a subjective gloss'[63] on the objectively determined phrase 'shall not create or do anything that is likely to create' a false or misleading appearance. The utilisation of such a phrase by the drafters of the provision is a clear indication that there is no need for the prosecution to prove a fraudulent intent.[64]

Interestingly, Mason J was also prepared to find that the legislative equivalent to section 998(1) could operate against both real and fictional transactions:

> Transactions which are real and genuine but only in the sense that they are intended to operate according to their terms, like fictitious or colourable transactions, are capable of creating quite a false or misleading impression as to the market or the price. This is because they would not have been entered into but for the object on the part of the buyer or of the seller of setting and maintaining the price, yet in the absence of revelation of their true character they are seen as transactions reflecting genuine supply and demand and having as such an impact on the market.[65]

The High Court's conclusion that the provision is not only concerned with 'fictitious or colourable' transactions, but also with real and genuine transactions as well, highlights further fundamental conceptual inconsistencies in the legislative regime governing manipulative stock market practices. If the analysis of Mason J is accurate, the parameters of section 998(1) are very broad, duplicating and overlapping extensively with section 997, and lending support to the view that 'it is not necessary to draw a legislative distinction between real and fictional transactions.'[66] With section 998(1) operating as 'a provision of general application to catch all types of manipulative practices in relation to stock markets',[67] it may well be that section 997 should be regarded as redundant.

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61. (1981) 148 CLR 42, 58.
62. *Australian Securities Commission* v *Nomura International PLC* 29 ACSR 473, discussed at n 75 *et seq* below.
63. This is to borrow the phrase so effectively used by John Currie in relation to the similarly worded s 1259 offence in the context of futures manipulation: John Currie, *Australian Futures Regulation* (1994) 225, referred to above n 39–40.
64. With respect to s 999, the provision regulating false or misleading statements in relation to securities which are *likely* to induce certain specified consequences, it has been categorically stated that it is not necessary for the prosecution to prove a fraudulent intent: *Australian Corporations & Securities Law Reporter*, above n 1, 232–400; also see Black, above n 8, 997.
65. (1981) 148 CLR 42, 58. This approach has been endorsed by the Supreme Court of Victoria, Court of Appeal, in *Endresz* v *Whitehouse* (1997) 15 ACLC 936 (see above n 54.) Justice Ormiston concluded that the transaction in question was 'real and genuine'. It did operate according to its terms, but its terms were established so as to create a false or misleading impression of the market.
66. Meyer, above n 13, 97.
67. Ibid.

Market Rigging: Section 998(3) provides that a person shall not 'maintain, increase, reduce, or cause fluctuations in, the market price of any securities' by means of:

(a) transactions in securities that do not involve a change in the beneficial ownership of those securities; or
(b) any fictitious transactions or devices.

The essence of the provision is 'the occurrence of a transaction of the kind described in (a) or (b) which has an effect on market price.'[68] According to section 998(7), no change occurs in the beneficial ownership of securities, within the meaning of the first limb, if a person who has an interest before a purchase or sale, or an associate of that person, has an interest after the transaction. It is significant that the nature of the interest held before and after the transaction need not be identical.[69] A purchase or sale of a security may satisfy the description of fictitious transaction or device within the meaning of the second limb where it is a 'sham'. That is to say, where the common intention of the buyer and seller is that the transaction should not give rise to the legal rights and obligations which it appears to create between them.[70]

In an alleged offence based on a transaction under the first limb where there is no change in beneficial ownership, there is a defence under section 998(8) if the trader did not have a purpose of creating a false or misleading appearance with respect to the market for, or the price of, the securities. The defence only operates where no such purpose existed at all — if 'the dominant purpose was legitimate, but there was a subsidiary purpose of creating a false or misleading appearance, then the defence does not apply.'[71]

With respect to the second limb of section 998(3), it is interesting to note section 1260(2) — the equivalent market rigging offence in the context of the futures industry, which prohibits fictitious or artificial transactions and devices which maintain, inflate, depress or cause fluctuations in futures prices. Section 1260(3) makes it clear that in determining fictitiousness or artificiality for the purposes of sub-section (2), it is not conclusive that the parties to the transaction intended it to be genuine, ie. to have effect according to its terms. Unlike the U.S. position, 'intent, in the form of knowledge of the fictitious nature and character of the transaction'[72] is not required in Australia before a violation of the provision can occur. The only obligation incumbent on the prosecution is to establish the

68. ASX Circular to Member Organisations, above n 6, 4.1.
69. Ibid 4.2. See above n 52 for a discussion of the concept of 'associate' for the purpose of these provisions. Thus it is sufficient for no change in the beneficial ownership to occur if the person who had an interest in the securities before the purchase or sale, continues to have an interest after the purchase or sale, either directly or indirectly, such as where the interest is held by an associate.
70. Black, above n 8, 1000.
71. ASX Circular to Member Organisations, above n 6, 4.3; see further Black who argues that the shift of the onus to establish this defence to the defendant may have some practical significance in relation to transactions which do not involve a change of beneficial ownership. Presumably the defendant could satisfy the onus if, for example, there was a legitimate commercial or tax purpose for the sale of securities by a company to another company which holds those shares on trust for the seller: Black, above n 8, 1000.
72. Currie, above n 39, 229; whether conduct has in fact created a false or misleading appearance as to the market for or the price of securities may be established by expert evidence: *R* v *Wright* [1980] VR 593; Black, above n 8, 997.

fictitious or artificial nature of the transaction — in itself no easy task.[73] By way of comparison, it should be noted that there is no reference in section 998(3), or indeed anywhere else in the section, to any requirement of intent in the context of the market rigging of stocks by means of fictitious transactions or devices. No defence is provided equivalent to the defence under section 998(8) which applies only to the first limb of section 998(3) ie. to an alleged offence based on a transaction where there is no change in beneficial ownership. The wording of this second limb of section 998(3) is clearly couched in terms designed to exclude consideration of any subjective element of intent and is thus, like its futures counterpart, to be assessed objectively.

It should also be noted that if two or more persons together engage in market rigging, that conduct is criminal conspiracy at common law. Thus in *Rex* v *De Berenger,*[74] it was held to be an offence to conspire to raise the price of Government securities by false rumours with intent to injure purchasers.

Australian Securities Commission v *Nomura International PLC*[75]

Background

The interpretation and application of section 998(1) (3) (6) and (8) were the subject of the recent market manipulation case involving the house of Nomura, heard before His Honour Mr Justice Sackville. The Australian Securities and Investments Commission[76] sought declarations and injunctions[77] against Nomura, a company incorporated in the United Kingdom,[78] alleging that Nomura, in transactions carried out on its behalf on 29 March 1996 on the Australian Stock Exchange[79] and the Sydney Futures Exchange,[80] contravened provisions of both the Corporations Law and the Trade Practices Act 1974 (Cth). In effect, ASIC alleged that Nomura manipulated the market for securities on the ASX, taking advantage of the opportunities provided by lower liquidity and trading volumes on the ASX compared with some overseas exchanges.[81]

Nomura was a stock index arbitrageur. Towards the end of March 1996, it had established an arbitrage position in index futures traded on the SFE, known as SPI Contracts, and in securities traded on the ASX. Its holdings were very large. Nomura held 10,912 sold March 1996 SPI Contracts due to expire on 29 March 1996. It held a 'matching' basket of securities, as part of its arbitrage position, worth about A$600,000,000.

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73. Generally speaking, the U.S. experience 'casts a warning for Australian regulators that the artificiality element is not easily established': Ibid.
74. (1814) 3 Maule & Selwyn's Reports 67. Discussed further in Ch 2 above.
75. *Australian Securities Commission* v *Nomura International PLC* (1998) 29 ACSR 473.
76. ASIC.
77. The proceedings were brought pursuant to ss 1114,1268 and 1324 of the Corporations Law.
78. Nomura did not have any permanent presence in Australia at the relevant times.
79. The ASX.
80. The SFE.
81. The facts of the case are essentially taken from Sackville J's summary which accompanied the reasons for judgment.

Nomura allowed the SPI Contracts to go to expiry on 29 March 1996. The expiry price of the SPI Contracts was determined by the level of the All Ordinaries Index[82] on that day. The understanding of Nomura's traders (which was not entirely accurate) was that the level of the All Ords was calculated exclusively by reference to the *last traded price* of each of the 353 securities comprised within the index.[83] The Court found that the strategies devised on Nomura's behalf, which in part involved self-trades at depressed prices, were intended to lower the price of securities included in the All Ords at the close of trading on 29 March 1996. Nomura's motivation was to obtain 'speculative' profits from the expected fall in the price of securities and the consequential fall in the closing level of the All Ords and the expiry price of the SPI Contracts.

Nomura adopted strategies which, according to it, were designed to capture the profit from the arbitrage position it had built up by 29 March 1996. The strategies adopted by it were complex, the two key ones being the 'March Sale Orders' and the 'Bid Basket'.[84]

The March Sale Orders comprised instructions given by Nomura to ten separate brokers. These required the brokers to sell Nomura's basket of securities very aggressively near to the close of trading on 29 March 1996. The brokers were, in effect, instructed to

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82. Herein referred to as the All Ords or the index.

83. In certain circumstances, however, the calculations are based on bids or offers for stock current at the close of trading. According to the trader responsible for Nomura's strategy on 29 March 1996, had he ascertained the correct information, Nomura's strategy for unwinding its arbitrage position would have been quite different.

84. The other strategies were the placement of the 'Ask Basket'; the placement of the 'London Bid Side Sell Orders'; and the placement of the 'London Offer Side Sell Orders'.

The Ask Basket was the mirror image of the Bid Basket. Nomura instructed the same broker who placed the Bid Basket to place sell orders for the same securities as were covered by the Bid Basket. The quantities were in substance the same, but the sell orders were to be placed between five and twenty per cent above the previous day's closing price, depending on the liquidity of the particular security. The reason for this remarkable strategy was that Nomura was concerned about 'front running', whereby other participants in the market, realising that heavy selling is about to occur, sell ahead of the market. If this had occurred on 29 March 1996, there was a risk that the price of the securities would rebound before the close. The purpose of the Ask Basket was to confuse and to create the impression that there was a genuine seller in the market pursuant to the Ask Basket. However it was accepted by counsel for ASIC that the Bid Basket was at the core of ASIC's case and that the Ask Basket could fairly be described as an ancillary part.

The fourth and fifth of Nomura's strategies were designed to deal with the risk that Nomura would be 'high ticked' at the close of trading on 29 March 1996. In general terms, high ticking refers to a last minute rebound in price after a seller has disposed of securities at a lower price. At about 3.20pm on 29 March 1996, Nomura officers in London instructed a broker to sell 10,000 of each of the top ten securities in the All Ords as assessed by market capitalisation. These instructions were referred to as the London Bid Side Sell Orders. The broker was required to effect the sale as the last trade of the day and to do so by hitting the bids (ie. offers to sell) recorded on the bids schedule of SEATS. In fact the broker placed only nine orders and did so only after the close of trading at 4.00pm. Six orders resulted in trades. According to ASIC, Nomura's intention was to ensure that the closing prices for the ten securities was lower than might otherwise be the case. In other words, Nomura was attempting to fix the closing market price of these ten securities. In effect, this strategy was an insurance policy against the failure of the other strategies.

The final strategy adopted by Nomura through its London office was to instruct a broker to place further sale orders for the same top ten securities in the All Ords. The instructions were given at about 3.30pm on 29 March 1996. The trades, referred to as the London Offer Side Sell Orders, were for much greater volumes than the London Bid Side Sell Orders. The broker was required to place the orders on SEATS at the level of the best ask (ie. the lowest offer to sell). None of these orders resulted in trades.

sell without being concerned about the extent of any drop in price that aggressive selling would produce. An important feature of the case is that many of the securities covered by the March Sale Orders were 'illiquids' — that is, they were thinly traded on the ASX. Accordingly there was very limited opportunity for 'latent demand' for these illiquids to emerge during the brief period of aggressive selling contemplated by Nomura.

The second key aspect of Nomura's strategy on 29 March 1996 was the placement of the Bid Basket. This consisted of buy orders for the same securities and in the same quantities as the March Sale Orders. However the broker responsible for placing the Bid Basket was instructed to record bids at prices substantially *below* the last traded price of each security. In the case of the most illiquid securities, the bid price was 20 per cent less than the last recorded sales.

For a variety of reasons, most of the brokers entrusted with the March Sale Orders did not fully comply with their instructions. Despite this, in the case of two securities, Metal Manufacturers Ltd and National Mutual Property Trust units, Nomura's aggressive selling at the close of trading on the ASX produced the result that it 'hit' its own Bid Basket. That is, in these two cases, brokers implementing the March Sale Orders 'hit' bids placed on Nomura's behalf in the Bid Basket. Since the Bid Basket recorded bids well below the previous sales, the effect was that Nomura 'bought' its own securities at depressed prices. Sackville J found that, had the brokers responsible for the March Sale Orders carried out their instructions fully, the Bid Basket would have been hit on many more occasions and Nomura would have completed many more self-trades.

Nomura argued that, in implementing these and other strategies, it was merely acting as an index arbitrageur, legitimately endeavouring to realise profits from the unwinding of the arbitrage position it had established. Nomura contended that it was a price-insensitive seller of securities; and that the sale of these securities in this manner was an inevitable consequence of unwinding its arbitrage position. Witnesses called by Nomura confirmed that its strategy on 29 March 1996 involved the sale of a basket of securities having a value of nearly $600 million in a manner that was largely price-insensitive. For reasons connected with the calculation of the All Ords, Nomura was assured of realising a profit from its arbitrage position if it could sell its basket of securities on 29 March 1996, on average, at prices equivalent or higher than the closing price of the securities in the basket. According to these witnesses, Nomura's intention was not to obtain the maximum price for each of its securities; nor was it to drive down their price. Rather it wished to sell the securities (which matched its holdings of futures contracts expiring on 29 March 1996) at a price equal to or better than the closing price (whatever that might be) for each of the securities on that day. Thus the actual closing price for each of the securities on 29 March 1996 was a matter of indifference to it.

However His Honour Justice Sackville found that Nomura was not in fact a price-insensitive seller of securities on the ASX.[85] No doubt Nomura wished to realise a profit

85. Sackville J noted that this was one of the more important factual issues in the case, namely whether Nomura's dealings were in fact as price insensitive as its witnesses maintained. He observed that, while sophisticated participants in and observers of the ASX might appreciate that some large players in the market are price insensitive, this is by no means generally understood by less sophisticated or knowledgeable investors. Indeed the evidence suggested that one of the

from its arbitrage position. But the fact that a trader had an objective that could be described as economically legitimate did not necessarily mean that all strategies consistent with that objective were lawful. Here the strategies devised on Nomura's behalf were intended to lower the price of securities included in the All Ords at the close of trading on 29 March 1996. In particular, Nomura intended that the combined effect of the Bid Basket and the March Sale Orders would be to lower the price of the illiquids at the close of trading. It intended to bring this about, in part, by self-trades at depressed prices. The prices would not have reflected the forces of genuine supply and demand, but would have been unilaterally determined by Nomura. The Court found that Nomura's motivation was to obtain 'speculative' profits from the expected fall in the price of securities and the consequential fall in the closing level of the All Ords and the expiry price of the SPI Contracts.

Specifically the Court found that Nomura had placed orders to:

(a) buy an identical number of shares at a discount of 5–20% below the previous day's closing prices for the purpose of trading with itself in the event that there was insufficient liquidity in the market for the shares that it had to sell;
(b) in relation to two stocks, Nomura traded with itself as a result of these buy orders;
(c) sell an identical number of shares at a similar premium to the previous day's closing prices for the purpose of confusing one of its brokers; and
(d) sell parcels of stock unrelated to its arbitrage unwind in order to prevent the market from moving back up after Nomura had finished selling.

In short, the judgment found that Nomura endeavoured to 'move the close' in its trading on the ASX. Nomura was motivated by a number of factors. These included its intention to establish a closing price for illiquids well below previous levels; its desire to obtain profits on the expiry of the March SPI Contracts; and its plan to 'resell' illiquids at higher prices than the sales into the Bid Basket. That it enjoyed limited success in its endeavours was due to a combination of failures of communication, the inability or unwillingness of brokers to implement instructions and a degree of ineptitude on Nomura's part.

Findings in relation to the alleged contraventions of section 998 Corporations Law

In relation to the principal legal questions in the case as they relate to stock market manipulation, the Court concluded that:

(a) in two instances, by the combined operation of the March Sale Orders and the Bid Basket, Nomura both sold and purchased securities in a manner that involved no change of beneficial ownership in contravention of section 998(1) of the Corporations Law. It also thereby contravened section 998(3).

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reasons why Nomura's instructions were not consistently implemented was that some brokers had difficulty in grasping or accepting instructions that required them to sell stock at heavily discounted prices at or shortly before the close of the market at 4.00pm on 29 March 1996.

(b) Nomura, in placing the Bid Basket and giving instructions for the March Sale orders, engaged in conduct *intended* to create a false and misleading appearance of active trading on the ASX in illiquid securities held by it on 29 March 1996. It also engaged in conduct *intended* to create a false or misleading appearance with respect to the price of the illiquid securities held by it on the same day. Nomura's conduct in this respect contravened section 998(1) of the Corporations Law.
(c) in the alternative to (ii), Nomura engaged in conduct *likely* to create a false and misleading appearance of active trading on the ASX in illiquid securities held by it on 29 March 1996. For this reason as well, it contravened section 998(1).

His Honour also found the other alleged contraventions substantiated, namely that Nomura contravened section 1260(1)(b) of the Corporations Law (by intending to create a false and misleading appearance with respect to the price for dealings in contracts in the futures market); that Nomura's conduct in placing the Bid Basket and the March Sale Orders involved contraventions of section 995(2) of the Corporations Law and section 52(1) of the Trade Practices Act; and that the other strategies adopted by Nomura on 29 March 1996 also contravened section 995(2) and section 998(1) of the Corporations Law and section 52(1) of the Trade Practices Act.

Commentary

The *Nomura* judgment reflects the complexity of section 998. It clarifies some, but not all, questions of construction previously in doubt. For example, with respect to the three limbs in section 998(1), which prohibit a person from (a) *creating*; or (b) doing anything that is *intended* to create; or (c) doing anything that is *likely* to create a false or misleading appearance, it was common ground between the parties in *Nomura* that these are alternative elements. Therefore any suggestion that the provision presupposes an overriding intentional element must now be regarded as incorrect.[86]

On the other hand, Sackville J was not prepared to express a final view as to the meaning of 'intended' in the sub-section. His Honour quoted the judgment of Mason J in *North* v *Marra,* which refers at one point to a state of affairs being intended if it was the actor's 'sole and primary purpose'; and at another point to a less stringent test than that of sole and primary purpose, namely whether the transaction 'would not have been entered into but for the object of setting . . . the price.'[87] Sackville J also referred to *Fame* v *Jeffries,* the other principal authority on the construction of section 998(1) discussed earlier, where Gleeson CJ on the one hand quotes the 'sole or primary purpose' phrase used by Mason J in *North* v *Marra,* but then states that the 'central object' of Fame's conduct was to influence the market price, making it unclear whether he preferred one approach over the other. Ultimately Sackville J in *Nomura* was content to proceed on the basis that, having regard to the

86. See, for example, the view expressed by Mason J in the High Court decision of *North* v *Marra Developments Ltd,* discussed earlier.
87. (1981) 148 CLR 42, 59.

fact that section 998(1) creates a criminal offence, the word 'intended' in section 998(1), should be construed as referring to the alleged manipulator's 'sole or dominant purpose' *or* 'central object'.

Still on the issue of intentional conduct, counsel for Nomura argued that section 998(1) could not be read as covering mere attempts. There could be nothing misleading about Nomura's conduct until its strategy was put in place. Save for the two self-trades which actually occurred, the strategy was never implemented. His Honour rejected this argument, stating that one of the ways in which a contravention could occur was when the trader did anything intended to create the proscribed appearance. Therefore it could not be said that section 998(1) was not concerned with attempts.

On the question of the meaning of the third alternative in section 998(1) — conduct 'likely to create' the misleading appearance — which introduces an objective test of criminal liability (compare 'intended to create' in the second alternative), His Honour preferred the adoption of a narrow construction of 'likely' in favour of an alleged manipulator, in order to mitigate the harshness of criminal liability. Thus the view was taken that 'likely' means 'more probable than not'; more likely than not, or more than a fifty per cent chance. Attributing a broader meaning to the phrase, such as a 'real chance', regardless of whether it is more or less than fifty per cent, would unjustifiably attract criminal liability to a trader who neither creates, nor intends to create, a misleading appearance, but merely creates a real chance of a misleading appearance:

> By the words "likely to create", the drafter sought to prohibit conduct which, objectively assessed, was likely to create a false or misleading appearance and thus be likely to detract from the operation of the ordinary forces of supply and demand. The severity of the consequences attaching to a breach of s 998(1) are sufficiently recognised by construing 'likely' to mean more probable than not.

Still on the question of the third limb of section 998(1), counsel for Nomura argued that it did not create a strict liability offence, but required proof of *mens rea:* namely knowledge that, at the time of the allegedly contravening conduct, the specific false and misleading appearance was likely to be created. After reviewing the authorities, His Honour thought (without expressing a final view on the issue) that no such knowledge was required. However this did not mean that no mental element was involved, and it was necessary to show that the alleged manipulator intended to carry out the conduct relied on as creating the likelihood of a misleading or deceptive appearance.

On the question of the meaning of 'any securities', as used in section 998(1), Sackville J was not prepared to accept Nomura's contention that the phrase should be construed as confined to securities in a particular, identifiable corporation. Nomura's argument was that ASIC could not establish a contravention of the third limb of section 998(1) (doing anything *likely* to create a misleading appearance in any of the specified respects) unless it showed that Nomura's conduct, at the time it was engaged in, was likely to create the misleading appearance in relation to securities in a particular, identifiable corporation. His Honour held that section 998(1), on its ordinary construction, applied to a case where the relevant conduct was likely to create a false appearance of active trading in a number of securities within an identifiable class of securities. The class could comprise, for example, all securities

within a portfolio held by the alleged manipulator. It was irrelevant that, at the time of the conduct, it was not possible to identify precisely which of the securities within the class would be the subject of a false or misleading appearance of active trading:

> This construction of s 998(1) seems to me to accord with the object of the section. As Mason J said in *North* v *Marra* . . . the object "is to protect the market for securities against activities which will result in artificial or managed manipulation". His Honour did not refer to the market for a *particular* security. Mason CJ also emphasised that s 998 seeks to ensure that "the market" reflects the forces of genuine supply and demand.
>
> As the present case illustrates, a trader may engage in conduct intended or likely to bring about an artificial or managed manipulation of the market (in the form of misleading appearances of the kind identified in s 998(1)), yet it may not be possible to identify precisely which securities within a broader class will be the subject of the manipulation . . . Unless this construction is adopted, the sub-section may be unavailable in the case of large-scale market manipulation spreading across many securities, not all of which can be identified in advance.

The self-trades, in which Nomura on two occasions acquired shares from itself by hitting its own Bid Basket, raised issues relating to the availability of the defence embodied in section 998(6). Counsel for Nomura conceded that, unless the defence in section 998(6) was available to it, Nomura's self-trades in the two securities contravened section 998(1). Sackville J held that, as section 998(6) applies only in 'a prosecution of a person for a contravention of' section 998(1), these restrictive words limited the specified defence to prosecutions for an offence. Accordingly as these were civil proceedings, Nomura was unable to invoke the defence.

That the parameters of section 998(1) overlap with section 998(3) is amply demonstrated by *Nomura's* case. Sackville J conceded that, as the self-trades constituted a breach of section 998(1), it added little to consider the application of section 998(3). Nevertheless, as submissions had been made, the record should show that Nomura's self-trades also contravened section 998(3). Nomura's 'purchase' of its own shares constituted the purchase of securities that involved no change in the beneficial ownership of those securities, and thus by virtue of section 998(5), Nomura should be deemed to have created a false or misleading appearance of active trading in those securities contrary to section 998(1). By means of the 'purchase' of these shares, Nomura also reduced, or caused fluctuations in, the market price of those securities contrary to section 998(3). The transactions were not genuine sales between a buyer and a seller. The effect of the 'purchase' in each case was to reduce the recorded price of each security at the close of trading on 29 March 1996 by twenty per cent from the previous level. This in turn reduced the level of the All Ords at the close of trading on that day and the expiry price of the SPI March Contracts. Furthermore, Nomura could not avail itself of the defence in section 998(8). The same reasoning applied as in the case of its counterpart, section 998(6), discussed earlier. As a matter of construction, the defence was not available in civil proceedings.

Nomura illustrates the highly complex nature of section 998 of the Corporations Law. Sackville J noted that ASIC's case had been put in a variety of ways, because of the large number of permutations and alternatives within the provision. Although a number of matters of construction remain unresolved, the meticulous detail of the judgment in explaining

the requirements of various elements of the section 998 offences, as well as the defences, is to be welcomed. However it ultimately serves to reinforce the argument in favour of a complete revision of the area.

Section 998(3) has been criticised for overlapping considerably with section 998(1).[88] Conduct within the parameters of the first limb of section 998(3) — which prohibits, by means of any purchase or sale of securities which do not involve a change in their beneficial ownership, a person from maintaining, increasing, reducing or causing fluctuations in the market price of any securities — is said to also breach section 998(1) — the prohibition on creating a false or misleading appearance either of active trading or with respect to the market or price of any securities — unless the transaction in question was 'so insignificant as to be incapable of having any price effect.'[89] Precisely why section 998(3) should prohibit conduct already caught by section 998(1) is not entirely clear. It should also be noted that the second limb of section 998(3), which is limited to the use of fictitious transactions and devices, appears to be more narrowly drawn than section 998(1), the provision of general application designed to catch all types of stock market manipulative practices.

It has therefore been suggested that section 998(3) should be amended by deleting the first limb altogether to avoid unnecessary duplication, and by expanding the second limb to become a catch-all provision against deceptive, fraudulent or fictitious transactions and devices.[90] Implicit in the argument is the premise that such a provision would operate in tandem with the fundamental anti-manipulation provision of section 998(1).

The merit in adhering to such a piecemeal approach to regulatory reform is questionable, unless what is really being suggested is a complete overhaul of the law relating to stock market manipulation. This has been partially achieved with the introduction of section 995 which, as stated earlier, places a broad prohibition on misleading or deceptive conduct in relation to dealings in securities. It is true that the scheme outlined above, combined with the abolition of section 997 with all its attendant difficulties previously discussed, may have the benefit of eliminating the confusion caused by unnecessary duplication. However it does not overcome the complexities inherent in section 998(1).

This is not to suggest that a broad prohibition against manipulation is not needed. Indeed it is appropriate to enact a broad residual prohibition against manipulation that will combat unusual or novel manipulative techniques in addition to the well known strategies. However this should be formulated *de novo* and from part of a more comprehensive package of regulatory reforms of the area.

Concluding remarks

The prohibitions governing stock market manipulation in Australia, whether via actual or fictitious trades, are no doubt laudable provisions. However, they are an unfortunate web of complexity, containing numerous internal deficiencies and creating difficult problems of

88. Meyer, above n 13, 97.
89. Ibid.
90. Ibid.

classification and proof. The classic illustration of stock market manipulation seen in *Rex* v *De Berenger* is now covered by both sections 997 and 998 which overlap in many respects.[91] The difficulties surrounding commission of the section 997 offences are especially worrisome. The parameters of the section are not wide enough to cover individual manipulative transactions and enforcement hinges upon the prosecution proving the mental element of the offence ie. the requisite intention as to manipulation: 'Was there an intention to induce other persons to come on to the market?'[92] Since direct evidence of such intention is seldom available, conviction depends upon circumstantial evidence which itself may not be conclusive. In light of these difficulties, and the myriad other problems associated with the criminal process including the burden of proof beyond all reasonable doubt, it must seriously be questioned whether the provision has any meaningful scope for operation.[93]

The formulation of section 998 is riddled with internal inconsistencies and is also hamstrung by the need to delve into difficult questions of intent and artificial pricing. In particular there is confusion as to whether the provision encompasses real as well as fictitious transactions. Elements of the section 998(3) offence overlap with section 998(1). There is a defence provided to the first limb of section 998(3) but not to the second, with the result that intent is rendered only partially relevant in the context of the subsection. There is also, incidentally, no consistency in the overall legislative scheme regulating the various manipulation offences as they apply to the stock market and to the futures markets respectively.[94] The lack of a coherent scheme of regulation makes it imperative that a comprehensive overhaul of the anti-manipulation provisions is undertaken in the context of Australian stock market regulation.

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91. Indeed s 998 has been described as 'analogous to the market manipulation provision' ie. s 997: Vodicka, above n 8, 92.
92. Baxt, Ford and Black, above n 8, 305.
93. Referring to s 997, it has been stated by one commentator that 'a far-reaching anti-fraud provision is that of market manipulation': Vodicka, above n 8, 91. However s 997 does not appear to fit that description. Moreover there have only been two recorded convictions under the provision. Bruce Emerton Miles was charged and convicted on six counts of having breached the Securities Industry Code: *Mark Richard Howard* v *Bruce Emerton Miles* (ACT Magistrates Court, Dainer SM, 30 July 1990, unreported). Five of those charges related to breach of ss 124 and 145, and only one (CC 89/15906) to breach of s 123, the s 997 equivalent, and s 145: confirmed by Jill Paulga of the ACT Magistrates Court, 28.11.96. Michael Robert Shearer was sentenced to eighteen months jail after pleading guilty in the Adelaide District Court to an ASC charge of market manipulation under s 997(1) of the Corporations Law. The charge related to an attempt by the defendant in October 1996 to cause increases in the price of shares in Reef Mining NL over a two week period by buying and selling 1.275 million shares in the company, with the intention of inducing other persons to buy or subscribe for shares. Shearer had hoped that this trading would cause the share price to increase, enabling him to resell his original holding of 100,000 shares back into the market at a clear profit: *R* v *Michael Robert Shearer* (District Court Adelaide No 36/98, David J, 18 June 1998, unreported).
94. The sixth paper released under the Government's Corporate Law Economic Reform Program, entitled: 'Financial Markets and Investment Products: Promoting Competition, Financial Innovation and investment' (AGPS, Canberra) 1997, proposes to replace existing Corporations Law categories, securities, futures and other derivatives, with a new integrated regulatory framework based on functionally similar markets and products, with categories based on 'market operation' and 'financial intermediation'. This model provides the blue-print for regulation of all financial markets and investment products. Thus the existing market misconduct provisions for securities and futures markets respectively will be replaced by harmonised provisions for all markets where financial instruments are regularly traded by multiple buyers and sellers.

The United States' Regulatory Framework

Over twenty years ago, Professor Baxt wrote that the United States legislation relating to the manipulation of securities prices:

> contains a wide-ranging series of prohibitions covering many more specific situations than the existing Australian State legislation. For example the various offences of pegging, fixing or stabilising prices is defined in great detail in the legislation (see for example section 9(a)(6) and the statements issued by the Commission in relation to this type of activity). Regulations have also been promulgated in relation to the use of manipulative or deceptive devices or contrivances. Apart from Rule 10B-5 . . . there are a significant number of other rules under the 10B heading, which deal specifically with the regulation of manipulative devices . . . It is hoped that over a period of time, the equivalent commission in Australia, if it is established, will be able to promulgate rules along the same lines as those issued in the United States. This will ensure that particular activities will be restrained in certain situations.[95]

This development in the context of Australian regulation of stock market manipulation has not come to pass and our own poor track record of successful prosecution in this area stands in marked contrast to that of the United States.[96] It is not only that manipulation is an important and high-profile component of the enforcement program at the Securities and Exchange Commission. It is also that the distinctive characteristics of the U.S. federal securities laws have proved to be remarkably effective tools (comparatively speaking) in attacking the problem of price manipulation. The federal scheme comprises specific prohibitions, the grant of rule-making authority to the Securities and Exchange Commission in certain areas and a general prohibition against any trading for a manipulative purpose.[97]

In the case of the insider trading provisions, CLERP Policy Paper No 6 proposed that the new regime would be based on the *securities* provisions. At that stage, there was some doubt as to whether the securities provisions would also prevail under the harmonised regime with respect to *other* forms of market misconduct, such as market manipulation, false trading and market rigging transactions, and the dissemination of information about illegal transactions. CLERP 6 did not specifically address this matter. The Consultation Paper entitled 'Financial Products, Service Providers and Markets — An Integrated Framework', issued on 3 March 1999, however, makes it clear that no revision of the current provisions is being contemplated and that the existing offences contained in Part 7.11 Division 2 of the *Corporations Law* (the securities provisions) will largely be retained in their present form but will be extended to apply to all financial products.

95. Robert Baxt, *The Rae Report — Quo Vadis?* (1974) 123. It is interesting to note, however, that there may be no need to adopt the U.S. approach of specific provisions for specific offences. As matters stand, the vast majority of U.S. cases are brought under the generic anti-fraud provisions of s 10(b) of the Securities and Exchange Act 1934 and its implementing rule, SEC rule 10b-5, and the specific prohibitions have been under-utilised: How Chih Lee, 'Market Manipulation in the US and UK: Part 2' (1993) 14 *The Company Lawyer* 123, 124; Professors Loss and Seligman note that 'in the more recent cases the Commission has been deemphasising the s 9(a)(2) approach, although it has never been abandoned': Loss and Seligman, above n 28, 944.
96. In contrast to the substantial body of United States' case law dealing with prosecutions for stock market manipulation, there are few reported Australian cases in the area. Although more U.S. prosecutions might be expected, there is unlikely to be proportionally less manipulative activity taking place on the Australian stock market compared with the United States, since a smaller and less liquid market is likely to be more susceptible to manipulation: Black, above n 8, 1005.
97. Loss and Seligman, above n 28, 935.

This statutory scheme, which is designed to define the concept of manipulation with a degree of precision and particularity and to supply an enforcement and preventive mechanism, has been described as 'a blend of fraud theories and the open market concept developed in the English and American cases.'[98]

It should also be mentioned that securities transactions in the U.S. are subject to regulation under state law as well as federal law. The federal securities laws apply to all securities transactions involving the use of the mails or facilities of interstate commerce (except for securities which are specifically exempted). At the same time, however, they preserve the right of the states to supplement or duplicate federal requirements to whatever extent may be deemed appropriate.[99] Indeed the state securities acts constitute an independent regulatory framework which the federal securities laws have not preempted or otherwise replaced. These state laws are known as 'blue sky' laws, 'after an early judicial opinion describing their purpose as the prevention of "speculative schemes which have no more basis than so many feet of blue sky."'[100]

Despite discrepancies from state to state, blue sky laws generally contain the following categories of provisions: '(a) prohibitions against fraud in the sale of securities; (b) requirements for registration of brokers and dealers; and (c) requirements for registration of securities to be sold in the state.'[101] There have been some attempts to synchronise state securities laws, in particular by the promulgation in 1956 of the Uniform Securities Act by the Commissioners on Uniform State Laws.[102] The Uniform Act is divided into four parts[103] with states being free to select whichever part or parts they wish to adopt. Whilst many states have adopted most or all of the provisions of the Act, the trend towards uniformity has been hampered by such factors as the failure of some of the most important commercial states to adopt any part of the Act at all, and the enactment of subsequent substantial changes by those states that have adopted it.[104]

It is the federal securities laws, however, which have traditionally constituted the most significant body of law governing securities. A prime objective of federal securities regulation is 'the prevention and, insofar as feasible, the elimination of manipulative, deceptive, and fraudulent practices in the securities markets.'[105] The federal laws basically consist of

98. Ibid.
99. David Ratner and Thomas Hazen, *Securities Regulation — Cases and Materials* (1991) 5; also refer to Mark Sargent, 'State Disclosure Regulation and the Allocation of Responsibilities' in Marc Steinberg (ed), *Contemporary Issues in Securities Regulation* (1988) 103; and Marc Steinberg, 'State Securities Laws: A Panacea for Investors?' (1994) 22 *Securities Regulation Law Journal* 53 which discusses the reasons why the state securities laws are likely to be invoked with greater frequency by investors.
100. Ratner and Hazen, above n 99, 5.
101. Ibid.
102. Ibid.
103. The four parts consist of the anti-fraud provisions; the broker-dealer registration provisions; the security registration provisions; and definitions, exemptions, administrative and liability provisions.
104. Ratner and Hazen, above n 99, 5.
105. Nicholas Wolfson, Richard Phillips and Thomas Russo, *Regulation of Brokers, Dealers and Securities Markets* (1977) 2.01.

six statutes enacted between 1933 and 1940 and periodically amended since, one enacted in 1970 and several more enacted in the period 1984–1990.[106]

The most important of these statutes are unquestionably the Securities Act of 1933 and the Securities Exchange Act of 1934, which established the fundamental framework of securities regulation for the United States that has prevailed ever since. The Securities Act 1933 regulates initial public offerings of securities, essentially via the mechanism of public disclosure of financial and related information concerning such securities. A concurrent purpose is to prohibit misrepresentation and other fraudulent acts in the sale of securities, whether or not registration is required with the Securities and Exchange Commission.[107] The Securities Exchange Act of 1934 extends federal regulation to trading in securities already issued and outstanding. It contains a number of distinct groups of provisions, aimed at the regulation of different participants in the securities trading process.[108] It was the intention of Congress in the 1934 Act to provide additional means for controlling manipulative and deceptive practices as well as to confer upon the SEC the power to adopt rules and regulations outlawing such practices in the purchase, as well as sale, of securities.[109]

There are three basic 'antifraud' provisions found in the securities laws — generalised prohibitions against such evils as 'fraud or deceit' and 'manipulative or deceptive devices or contrivances.'[110] Section 17(a) of the 1933 Securities Act prohibits fraudulent or deceptive

106. They are the Securities Act 1933; Securities Exchange Act 1934; Public Utility Holding Company Act 1935; Trust Indenture Act 1939; Investment Company Act 1940; and the Investment Advisers Act 1940. These are more fully discussed in Ratner and Hazen, above n 69, 6–9. The Securities Investor Protection Act was enacted in 1970; the Insider Trading Sanctions Act in 1984; the Insider Trading and Securities Fraud Enforcement Act in 1988; and the Securities Enforcement Remedies and Penny Stock Reform Act in 1990.

107. Sidney Robbins, *The Securities Markets — Operations and Issues* (1966) 86.

108. For example, s 4 established the Securities and Exchange Commission and transferred the responsibility for administration of the 1933 Act to it (which responsibility had originally been assigned to the Federal Trade Commission); ss 12, 13, 14 and 16 impose disclosure and other obligations on publicly-traded companies; ss 5, 6 and 19 require national securities exchanges to register with the SEC; ss 7 and 8 authorise the Federal Reserve Board to prescribe rules regulating credit and borrowing limits in connection with the purchase of securities. See further Ratner and Hazen, above n 99, 6–8.

109. Wolfson, Phillips and Russo, above n 105, 2.01.

110. Manipulation, although not to be equated with fraud as a matter of strict legal analysis, is nevertheless related to the field of fraud: Loss and Seligman, above n 28, 929. 'The concept of manipulation is to be distinguished from the concept of fraud, which implies failure to disclose. *While nondisclosure is not necessarily an element of manipulation*, nondisclosure of the manipulation almost invariably accompanies the offense of manipulation. Thus, most, if not all, manipulation cases also involve antifraud violations': Wolfson, Phillips and Russo, above n 105, 3.02. Emphasis added. See further Ch 2 above.

Note that the U.S. Supreme Court in *Schreiber* v *Burlington Northern, Inc.* 105 S. Ct. 2458 (1985) held that the term 'manipulative' as used in section 14(e) of the 1934 Securities Exchange Act — and by extension s 10(b) — necessarily involves misrepresentation or nondisclosure. Furthermore according to the Court, deceptive acts and manipulative acts are not different kinds of behaviour. However there is some controversy as to whether the Supreme Court is correct in holding that deception is an essential element of manipulation under s 10(b) of the Exchange Act 1934. This matter is discussed in Ch 4 below.

It is important to note that the prohibitions against manipulative and deceptive acts and practices are commonly referred to in all the literature as the 'antifraud' provisions.

practices in the sale of securities.[111] Section 10(b) of the 1934 Securities Exchange Act prohibits various kinds of 'manipulative or deceptive devices or contrivances' in connection with the purchase or sale of securities. Section 15(c) of the 1934 Act, limited to over-the-counter transactions, is applicable only to transactions by brokers and dealers and prohibits them from effecting any transaction by means of manipulative, deceptive or other fraudulent devices. In the context of sections 10(b) and 15 (c) of the 1934 Act, where the word 'manipulative' is used, the United States Supreme Court has stated obiter that it is 'virtually a term of art' reflecting the intention of Congress to 'prohibit the full range of ingenious devices that might be used to manipulate securities prices.'[112] In addition to these basic antifraud provisions, section 9 of the 1934 Act outlaws a series of specific manipulative practices such as wash sales, matched orders and pool operations and regulates stabilising transactions.[113]

With respect to these provisions, section 10(b) of the 1934 Act undoubtedly has 'the broadest jurisdictional reach'[114] and is therefore the provision most frequently invoked. In addition rule 10b-5, promulgated by the SEC under the general authority delegated to it by section 10(b), has become a highly significant enforcement weapon against securities fraud both in SEC proceedings and in private litigation.[115]

Applying and extending the language of section 17(a) of the Securities Act to the purchase or sale of securities by any person, whether corporate insider or outsider, rule 10b-5 closed the gaps left by the earlier statutory provisions. These had failed to deal with fraud in

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111. Note that s 17(a) prohibits fraud and misstatements in the *sale* of securities. It contains no comparable provision prohibiting such practices in connection with the *purchase* of securities. It was left to the SEC to overcome the gap thus created. It made the necessary modifications to s 17(a), by adding the words 'in connection with the purchase or sale of any security' and presented the finished product as rule 10b-5: Ratner and Hazen, above n 99, 453. See further below n 121.

The other major provisions in the 1933 Act are s 11, which establishes civil liability for false or misleading statements in registration statements for public offerings of securities subject to the Act, and s 12(2) which extends civil remedies to investors who are induced to purchase securities, whether or nor registrable under the Act, by false or misleading statements: Wolfson, Phillips and Russo, above n 105, 2.01.

112. *Sante Fe Industries, Inc.* v *Green*, 430 U.S. 462, 477 (1977).

113. Robbins, above n 107, 92. Professor Poser has commented as follows with respect to the anti- manipulative provisions of the Securities Exchange Act: '. . . the meaning of manipulation in these separate provisions is closely interrelated. It should be observed . . . that the remedies provided by the federal securities laws are cumulative, and that a cause of action may be stated under one or more of the general antimanipulative provisions regardless whether the conduct involved is of the kind proscribed under another, more specific prohibition. For example, an independent cause of action for manipulation can exist under section 10(b) even though one or more of the elements of a section 9(a) violation may be missing': Norman Poser, 'Stock Market Manipulation and Corporate Control Transactions' (1986) 40 *University of Miami Law Review* 671, 701. (Herein referred to as 'Stock Market Manipulation'.)

114. Ratner and Hazen, above n 99, 452.

115. Norman Poser, *International Securities Regulation — London's "Big Bang" and the European Securities Markets* (1991) 299. (Herein referred to as 'International Securities Regulation'). Today a substantial amount of litigation in the federal courts consists of civil actions under rule 10b-5 for insider trading, manipulation, misrepresentation, churning of an account and other types of securities fraud: Ibid. It has not been possible, however, to ascertain how much of this litigation relates solely to manipulation.

the purchase of securities by persons other than brokers and dealers. Thus officers, directors or principal stockholders of a corporation could, prior to the introduction of rule 10b-5, purchase its securities by fraudulent and manipulative practices and only be subject to criminal prosecution under the mail fraud statute.[116]

What follows is a discussion of the major elements of the U.S. federal regulation of fraud and manipulation.

Section 17(a) Securities Act 1933

Prior to the Securities Act, the U.S. federal government could only deal with securities frauds via criminal prosecution for violating the mail fraud statute or for conspiring to violate it. Section 17(a) prohibits, by the use of any facilities of interstate commerce or the mails, fraud and misstatements in the *sale* of securities. It 'comprehensively prohibits schemes to defraud, untrue statements of a material fact, or omissions to state a material fact, and practices and courses of business that operate as a fraud in the offer or sale of securities.'[117]

This is the general pattern for defining fraud under the securities laws, but in the case of section 17(a) it is restricted to the sale or offer for sale of securities.[118] Thus whilst the provision prohibited fraud and misstatements in the sale of securities, there was no comparable prohibition in connection with the purchase of securities. It was left to the SEC to overcome the gap thus created by the legislative provision. As stated earlier the Commission, following the legislative mandate conferred by section 10(b) of the 1934 Act,[119] made the necessary modifications to section 17(a), by adding the words 'in connection with the *purchase or* sale of any security' and presented the finished product as rule 10b-5.[120]

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116. Robbins, above n 107, 92. The federal mail fraud statute, 18 U.S. Code s 1341, prohibits the 'use' of the mail to further a 'scheme to defraud': William Wang, 'Recent Developments in the Federal Law Regulating Stock Market Insider Trading' in Marc Steinberg (ed), *Contemporary Issues in Securities Regulation* (1988) 59, 77. This article discusses *inter alia* the subject of federal mail and wire fraud.

117. Wolfson, Phillips and Russo, above n 105, 2.01; Patricia O'Hara, 'Churning Claims under Federal Securities Law' in Marc Steinberg (ed), *Contemporary Issues in Securities Regulation* (1988) 331.

118. Despite similarities in the *general* pattern for defining fraud, there are important variations in the statutory language relating to other securities provisions: Harold Bloomenthal, *Securities Law in Perspective* (1977) 60.

The emphasis in the 1933 statute on deceptive selling arises because this is a statute primarily concerned with the process of distribution: Louis Loss, 'The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States' (1970) 33 *Modern Law Review* 34, 41. (Herein referred to 'Corporate Insiders').

119. See below n 171 *et seq.*

120. Ratner and Hazen, above n 99, 453. There was no realisation that eventually rule 10b-5 'would be the biggest thing that had ever happened': remarks attributed to Milton Freeman, the Attorney and Assistant Solicitor, SEC, 1934–46: Ibid. The rationale for the introduction of rule 10b-5 by the SEC in 1934 was simply to overcome the obvious shortcomings inherent in s 17(a): Ibid, 453–4. Professor Thel has noted that the SEC 'adopted the rule [10b-5] hastily and without much thought about its consequences': Steven Thel, 'The Original Conception of Section 10(b) of the Securities Exchange Act' (1990) 42 *Stanford Law Review* 385, 462. (Herein referred to as 'The Original Conception').

The history of the adoption of rule 10b-5 in the spring of 1942 is provided by Professor Loss, Corporate Insiders, above n 118, 41–2.

Nevertheless the unique contribution of section 17(a) is that it represented a 'material advance over the mail fraud statute, in that it referred specifically to the sale of securities, afforded the civil remedy of injunction, and was applicable to material misstatements and half-truths.'[121]

Section 9 Securities Exchange Act 1934

Section 9, which applies to the exchange markets, outlaws a series of specific manipulative practices such as wash sales, matched orders and pool operations. When not in contravention of SEC rules, however, the section permits stabilising transactions for the purpose of preventing or retarding a decline in the price of a security during a public offering.[122]

Section 9(a)(1), which is broadly equivalent to our section 998(1), prohibits wash sales and matched orders when the purpose is to create 'a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security.' The specific purpose requirement has been given a strict meaning.[123] Thus 'there is nothing illegal about the sale and immediate repurchase of a security in order to establish a capital gain and obtain the benefit of a higher cost base for tax purposes. Again, the mere "crossing" of orders is not itself illegal.'[124]

Section 9(a)(3)–(5) contains a series of prohibitions against manipulation of the market in registered securities by false statements, rumours or paid touts.[125] Section 9(b)–(d) gives the SEC rule-making authority with respect to 'the acquisition, endorsement and guarantee of any put, call or other option or privilege, as well as the effecting of transactions in connection with which such option or privilege is outstanding.'[126] These specific provisions in section 9 are supplemented by section 9(e) on civil liability, and a general provision in section 9(a)(2) — our section 997 equivalent — which was designed to deter pools and other perceived manipulative practices.[127] Section 9(a)(2) makes it:

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121. Robbins, above n 107, 90.
122. Ibid 92.
123. Louis Loss, *Fundamentals of Securities Regulation* (2nd ed, 1988) 851 n 22. *Contra* Poser, Stock Market Manipulation, above n 113, 702, who argues that since the only likely purpose of engaging in wash sales and matched orders is to falsify the market, the requirement of specific intent has not been an obstacle to imposing liability for this kind of activity.
124. Loss, above n 123, 851 n 22.
125. Ibid 851. The Corporations Law equivalents are the prohibitions on making false or misleading statements and fraudulently inducing people to deal in securities, to be found in ss 996, 999–1001.
126. Loss and Seligman, above n 28, 936, where the manipulation-prone history of these instruments is noted.
127. Daniel Fischel and David Ross, 'Should the Law Prohibit "Manipulation" in Financial Markets?' (1991) 105 *Harvard Law Review* 503, 534; Poser, Stock Market Manipulation, above n 113, 703–5. Professor Thel notes with respect to s 9(a)(2), 'Three years before the Act was adopted, Adolph Berle wrote that of all of the objectionable manifestations of stock market manipulation, the freedom to arrange trades so as to unduly influence prices "arouses public condemnation more than any other single legal element in the situation." Section 9(a)(2), which is at the heart of the Act, is the response to this abusive practice. It is true that section 9(a)(2) does not forbid trades that change prices

> unlawful for any person, directly or indirectly . . . [i] To effect, alone or with one or more persons, a series of transactions in any security registered on a national securities exchange [ii] creating actual or apparent active trading in such security or raising or depressing the price of such security, [iii] for the purpose of inducing the purchase or sale of such security by others.[128]

The objective of the provision is 'to outlaw not only pool operations, but "every other device used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage."'[129] There are three elements that require proof under the provision:

(i) A person must effect a series of transactions. One who initiates a transaction 'effects' it even though they act as agent for another; the word 'series' is satisfied by three purchases although it is possible that two might suffice. And the SEC has stated that the term 'transactions' has a broader meaning than purchases or sales and may, in an auction market, be satisfied by the mere placing of bids. These may influence price as effectively as a completed sale.[130]

(ii) As far as the prohibited activity is concerned, the creation of actual or apparent active trading and the creation of an artificial price (ie. an alteration in the price by raising or depressing it) are clearly alternative requirements.[131] This represents an important

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unless they are undertaken for the purpose of inducing others to trade, but the purpose clause was included in section 9(a)(2) only to protect traders who are not motivated by a desire to affect price, but who know that their trades will do so': Steve Thel, 'Regulation of Manipulation under Section 10(b): Security Prices and the Text of the Securities Exchange Act of 1934' (1988) *Columbia Business Law Review* 359, 429. (Herein referred to as the 'Regulation of Manipulation').

128. The bracketed numbers are inserted to assist in identifying the three elements that must be proved under the provision. This follows the formula adopted by Professor Loss.

It should also be noted that, although s 9 is limited to securities registered on a national securities exchange, 'it is not altogether correct to speak of s 9 as coextensive with manipulation of the exchange markets. On the one hand, it applies to over-the-counter manipulation of registered securities — that is, those that are either listed or admitted to unlisted trading privileges . . . On the other hand, s 9 does not apply to exempted securities even when they are traded on an exchange . . . There the attack on manipulation is made on the same basis as it is with respect to securities that are traded solely in the over-the-counter market': Loss, above n 123, 851 n 23.

Note that rule 10b-3 prohibits broker-dealers from engaging in manipulative or deceptive acts and practices with regard to securities *not* on a national exchange and thus closes a large part of the gap left by s 9, which applies only to transactions through a national exchange: see Hazen, below n 184.

It should further be noted that the only statutory bases for dealing with the manipulation of unregistered securities are the general antifraud provisions of the 1934 Act — ss 10(b) and 15(c) — together with s 17 of the 1933 Act. Nevertheless, 'consistently with the legislative intention that the Commission should use its administrative powers to place the regulation of the two markets on a par so far as practicable, it has managed to put over-the-counter manipulation beyond substantially the same pale as manipulation of the exchange markets': Loss, above n 123, 857.

129. Stock Exchange Practices, Report of Commission on Banking & Currency, S. Rep. No. 1455, 73d Cong., 2d Sess. (1934) 54. In the same vein, it has been said of s 9(a)(2) that its goal 'extends beyond merely outlawing pool operations. The section regulates all acts and devices that tend to create an illusion of supply or demand where no such supply or demand exists': Lawrence McCabe, 'Puppet Masters or Marionettes: Is Program Trading Manipulative as Defined by the Securities Exchange Act of 1934?' (1993) 61 *Fordham Law Review* 207, 221.

130. Loss and Seligman, above n 28, 938.

131. Ibid.

difference between section 9(a)(2) and section 997 Corporations Law since the latter focuses solely on transactions which have a price effect with intent to induce others to purchase or sell.[132] In the United States context of 'raising or depressing the price' it has been held that even a small price change suffices.[133]

(iii) The mental element required is a purpose to induce other investors into purchasing or selling securities — a manipulative purpose — and most of the litigation under section 9(a)(2) has 'involved [this] troublesome requirement.'[134] The SEC has held that, since 'it is impossible to probe into the depths of a man's mind, it is necessary in the usual case (that is, absent an admission) that the finding of manipulative purpose be based on inferences drawn from circumstantial evidence.'[135] Thus a motive to manipulate, such as a separate pecuniary motive, accompanied by the requisite series of transactions, *prima facie* establishes the manipulative purpose and has the effect of reversing the onus of proof onto the accused.[136] As to the motive, it might include:

> . . . an option to purchase a substantial amount of the security at a price above the current market, or a desire to obtain more than the current market price for a block of stock that the manipulator plans to distribute either as owner or as a best-efforts underwriter, or what is left in an underwriter's hands after a "sticky" offering, or to get rid of a "white elephant," or to make more attractive a security pledged as collateral for a bank loan that the borrower is being pressed to repay or reduce, or to further or defeat a tender offer.
>
> The *evidence* of purpose might be an option to buy successive blocks at stepped-up rates, or the pattern of trading. Again, to reduce or "dry up" the overhanging supply of the security, the series of purchases may be coupled with devices of one sort or another such as agreeing with large holders to withhold their securities from the market, or sending out misleadingly "bullish" literature . . . or arranging for the issuer to declare a dividend at a critical juncture in the manipulation.[137]

It has been held that the immediate resale of the shares purchased by the manipulator is not a necessary requirement of the offence, although 'it is of great evidentiary weight in determining the purpose with which the buying was undertaken.'[138] The SEC has however stated that, in the absence of a satisfactory explanation, an inference of manipulative purpose arises from the mere fact that a person who has purchased stock in a series of transactions, thereby raising its price, disposes of the stock 'before the true effect of his purchases has been dissipated by other market factors.'[139] Purchasers who acquire securities *bona fide* are consequently advised to ensure that a sufficient period of time

132. Meyer, above n 13, 96. Meyer also makes the point that the words '. . . creating actual or apparent active trading' which appear in s 9(a)(2) are not only absent from our equivalent s 997, but they are 'partly enacted in s. [998].'
133. Loss and Seligman, above n 28, 939 referring to *Kidder, Peabody & Co.*, 18 SEC 559, 571 (1945) (1/2 point on a $50 stock).
134. Loss and Seligman, above n 28, 939. This matter is further discussed in Ch 4 below.
135. Loss and Seligman, above n 28, 940.
136. Ibid; thus a violation of the provision does not hinge upon the existence of criminal intent or 'bad' purpose. Nor must there be proof of fraud: Ibid; McCabe, above n 129, 223.
137. Loss and Seligman, above n 28, 941.
138. Federal Corp., 25 SEC 227, 231 (1947); Op. Gen. Counsel, Sec. Ex. Act Rel. 3056 (1941); Loss, above n 123, 856.
139. *Thornton & Co.*, 28 SEC 208, 223 (1948); Loss and Seligman, above n 28, 942; Poser, Stock Market Manipulation, above n 113, 705.

elapses so that the market for the securities may find an appropriate level created by external forces of supply and demand, independently of their own activities. How much time will be required for the effect of the buyer's purchases to be dissipated in order to satisfy this requirement is impossible to predict. The answer, which is clearly unsatisfactory from a commercial standpoint, will depend upon such factors as:

> the character of the market, the length of time during which the buying activities continued, their pattern, the extent of the market rise, and the size of the floating supply. The period may be weeks or months. If the purchases dried up virtually the entire supply, it is difficult to say when a resale may be effected without creating an inference that the purchases had a manipulative purpose.[140]

Whereas the general prohibition in section 9(a)(2) may well have once 'led the attack on manipulation of the exchange markets',[141] the Commission has in more recent years been 'de-emphasizing the 9(a)(2) approach, although it has never been abandoned.'[142]

While section 9(a)(2) focuses on manipulation generally, other provisions deal with particular practices. The most important of these is section 9(a)(6) which regulates the practice of pegging or stabilisation.[143] In contrast to the typical manipulative scheme, 'in which the objective is to buy low, manipulate the price upward, and sell high, pegging is an attempt to maintain a security at a specific price. When undertaken by an underwriter or its affiliates in connection with an initial public offering, pegging is usually referred to as "stabilizing" the offering because it is an attempt to maintain the market price of a security at the offering price.'[144] Unlike section 997(7) of the Corporations Law, section 9(a)(6) does not prohibit pegging or stabilising *per se*; rather it prohibits:

> any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the [Securities Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Implicit in the provision is that pegging or stabilising activity not in contravention of the Commission's rules is permissible under section 9(a)(6).[145] However, as Professor Loss

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140. Loss and Seligman, above n 28, 942.
141. Ibid 938.
142. Ibid 944. Although Professor Loss does not explicitly state so, it is implicit from the context in which this observation is made that the technical difficulties facing the SEC in meeting the requirements of the provision account for its disinclination to rely upon s 9(a)(2).
143. See Ch 4 below, for a discussion of the Australian approach to stabilisation.
144. Fischel and Ross, above n 127, 535.

    Stabilisation, 'which is a generic term, has been described by the Commission as "that process whereby the market price of a security is pegged or fixed for the limited purpose of preventing or retarding a decline in contemplation of or during a public offering of securities"': Sec. Ex. Act Rel. 4163 (1948), Loss and Seligman, above n 28, 945.
145. Fischel and Ross, above n 127, 535. Professor Thel notes that stabilising the market 'in connection with the distribution of securities is thought to be a necessary and legitimate technique because of the possibility that a distribution puts pressure on price . . . it is considered legitimate for those involved in large distributions to support — that is, to stabilize — the market for the security. This stabilization entails being prepared to buy the distributed security on the market during the course of the distribution if the new supply appears to be depressing the security's price. The theory is that while it is wrong to push the price of a security up before a large sale, it is acceptable to offset the downward pressure of the sale with carefully orchestrated purchases': Thel, Regulation of Manipulation, above n 127, 430.

has noted, 'by placing the provision on stabilization in a section titled "Prohibition Against Manipulation of Security Prices", [the statute itself recognises] that stabilization is a form of manipulation.'[146] This ambivalence has characterised the regulation of stabilisation ever since and reflects the uncertainty of Congress as to the value of stabilising operations, which it found to be 'far from conclusive.'[147] The legislative response of Congress as seen in section 9(a)(6), which essentially adopts a more relaxed regulatory posture with respect to stabilising transactions, is to exclude certain types of manipulation (ie. pegging and stabilising activities) from the general prohibition contained in section 9(a)(2) and to subject them to the Commission's rule-making authority.[148]

In the mid-1950s the SEC adopted rules pursuant to section 9(a)(6) which still largely govern trading during distributions.[149] The most significant of these is rule 10b-6 which is the 'central antimanipulative rule'[150] regulating the securities transactions of participants in securities distributions. The rule provides that 'it is a manipulative or deceptive practice for any underwriter, issuer, broker or other participant in the distribution process, either alone or in concert with others, to bid for, purchase, or advise others to purchase any security being distributed until he has completed his part in the distribution.'[151]

The rationale for the rule was 'to remedy the vagueness of section 9(a)(2)'[152]essentially by obviating the need to inquire whether an individual was acting for the purpose of inducing others to trade, and substituting instead 'an objective definition of specific, prohibited behaviour.'[153] The underlying premise was that making or inducing purchases during a distribution of securities by persons interested in the distribution constituted manipulation *per se* without regard to any purpose requirement. Nevertheless rule 10b-6 contains many

146. Loss and Seligman, above n 28, 946. Wolfson, Phillips and Russo, above n 105, 3.02, note that in 1940 the SEC stated that it was 'unanimous in recognizing that stabilizing is a form of manipulation.' Professor Thel also acknowledges that the problem of stabilisation is treated under the rubric of manipulation: Thel, Regulation of Manipulation, above n 127, 432.

147. H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934); Loss and Seligman, above n 28, 947. Also refer to the discussion in Wolfson, Phillips and Russo, above n 105, 3.02. There they point out that trading by underwriters, where the purpose is to create artificial interest in a stock, is obviously manipulation which should be prevented. However certain so-called stabilising transactions have long been viewed as helpful and desirable. This dichotomy between permissible and unlawful market activities during a distribution is reflected in ss 9(a)(2) and 9(a)(6).

148. Thus s 9(a)(6) was designed to act 'as a limitation on section 9(a)(2)': Loss and Seligman, above n 28, 945.

149. Fischel and Ross, above n 127, 535.

150. Wolfson, Phillips and Russo, above n 105, 3.01. They state that rule 10b-6 was adopted in August 1954 in an effort to codify and clearly formulate the prior twenty years of SEC interpretations and decisions. 'It attempts to itemize a class of transactions that is per se violative of the antimanipulation provisions of the 1934 Act': Ibid 3.02. By virtue of the operation of s 10(b), which prohibits manipulative devices in connection with the purchase and sale of securities whether in the over-the-counter market or on an exchange, in contravention of rules and regulations of the Commission, the scope of rule 10b-6 thereby extends to both the exchange and over-the-counter markets: Ibid • 3.02 n 6.

151. Fischel and Ross, above n 127, 535.

152. Ibid; Wolfson, Phillips and Russo, above n 105, 3.02.

153. Fischel and Ross, above n 127, 535.

exceptions including one for stabilising bids in compliance with rule 10b-7, which defines the conditions under which a participant may stabilise an offering of a security.[154]

These rules have been described as 'a nightmare in operation.'[155] Far from fulfilling the original goal of providing simple and objective standards, the outcome has been the opposite and there is still 'widespread and continuing disagreement among practitioners and the SEC over the scope and application of . . . rule [10b-6].'[156] Professor Loss has commented that 'one's expectation of complexity in an area of this sort is not disappointed on an examination of the rule.'[157]

Recent events shed light on the flexibility with which the SEC is prepared (some might say compelled) to exercise its powers with respect to the application of rule 10b-6 and the other Trading Rules.[158] The 1993 listing on the New York Stock Exchange of Daimler Benz AG, Germany's largest industrial company and the first German company to list its shares on the NYSE, demonstrated the SEC's willingness to grant class exemptions from rules 10b-6, 10b-7 and 10b-8 in order to facilitate the offer and sale of the German securities in the U.S.[159] The German Exemptions replace the operation of rule 10b-6 with a

154. Ibid. See also rule 10b-8 which regulates rights offerings. Rules 10b-6 and 10b-7 are further discussed in Loss and Seligman, above n 28, 948–955 and in Fischel and Ross, above n 112, 536 et seq. Fischel and Ross point out that the main conceptual difficulty underlying rules 10b-6 and 10b-7 is that they assume that there is a distinction between manipulative trades during distributions, which are prohibited, and 'stabilising' trades which are permitted. Thus the rules appear to distinguish between 'bad' and 'good' manipulations. Trades that cause price increases are 'bad' manipulations, but trades that prevent price decreases are 'good' manipulations. They also comment that, in the final analysis, stabilisng trades are somewhat of a mystery and that further study of the practice is needed in order to gain some understanding of the purpose of such trades: Ibid 539.

Wolfson, Phillips and Ross, above n 105, 3.01 n 2, outline the eleven exemptions from rule 10b-6, for registered and unregistered distributions, that are set out in paragraph (a)(3) of the rule.

155. Fischel and Ross, above n 127, 535.

156. Wolfson, Phillips and Russo, above n 105, 3.02.

157. Loss, above n 123, 862.

158. Rules 10b-6, 10b-7 and 10b-8 are collectively referred to as the Trading Rules. As stated earlier, the Trading Rules, and rule 10b-6 in particular, are the principal anti-manipulation provisions which regulate market activities during distributions of securities in the United States. They are essentially investor-protection rules that are designed to promote public confidence in the fairness and efficiency of the U.S. securities markets and in their integrity as an independent pricing mechanism.

159. Diane Roberts, 'A Kinder, Gentler Approach to the Regulation of Market Manipulation under the Securities Exchange Act of 1934: Extension of the Approach Taken with Respect to Distributions of Certain German Securities to Distributions of Certain U.S. Securities' (1994) 20 *North Carolina Journal of International & Commercial Regulation* 1, 2.

Also see Michelle Celarier, 'A German Private Placement in the US May Be a Harbinger of More to Come' (June 1992) 6 Global Finance 18. The latter article describes how SAP, a German computer software house, has found a way around the technical details and differences with U.S. regulators, to become the first German equity issuer in the U.S. market. In May 1992, SAP raised $275 million through 70,000 privately placed nonvoting preference bearer shares. This was facilitated both by SEC Rule 144a, which allows foreign issuers to avoid cumbersome U.S. disclosure regulations by selling privately to institutional investors, and by a 'no action' letter sent in 1991 to the German securities industry that allowed an exemption from U.S. rules designed to prevent market manipulation. These rules force underwriters to stay out of the market after the offering, except for stabilisation purposes. In Germany, where there is no division between underwriting and market making, such rules do not exist.

'kinder, gentler' form of regulation,[160] involving disclosure to the investing public as well as notice, reporting, record keeping and record production obligations to the Commission. It has been argued that they 'may prove to be the cornerstone of the next generation of market manipulation regulation'[161] because:

> inter alia, with such regulation taxpayers save certain bureaucratic costs that accompany conventional regulatory oversight; the investing public receives more information to make well-informed investments decisions; and foreign issuers, underwriters, and their affiliates avoid the cost and coerciveness of the Trading Rules as they historically have been applied.[162]

The Commission has indicated that similar exemptions would be granted in the future in respect of securities of highly capitalised issuers from other countries.[163] Underlying these exemptions is the Commission's general recognition that:

> with respect to the regulation of market manipulation, it may be appropriate to impose strict conditions on transactions effected in "price discovery" markets (i.e., securities markets in which trading is likely to have a significant effect on the price of the security being distributed), and less stringent, or no conditions, on transactions effected in markets that are not likely to be "price discovery" markets (i.e., securities markets in which trading is not likely to have a significant effect on the price of the security being distributed).[164]

It has been suggested that, in the new legal environment thus created with respect to the regulation of market manipulation, the terms of the German Exemptions should be extended to 'qualifying distributions of actively traded domestic securities of substantial U.S. issuers.'[165] Certainly the effect of the exemptions appears to enhance the competitiveness of the U.S. capital markets by reducing costs, whilst also protecting the investing public with specific safeguards incorporated as conditions to their use.[166] Furthermore the Commission would continue to apply the general antifraud and antimanipulation provisions of the federal securities laws to transactions effected in reliance upon the exemptions.[167]

Ultimately however these are mere ad hoc solutions to the more pressing issue of the complete reevaluation of the regulation of trading activities during distributions of securities. Indeed in 1994 the Commission published a concept release suggesting a comprehensive review of the Trading Rules in light of the transformation of the securities markets and seeking public comment on the issue.[168] The case for simplification of the rules, especially in situations in which the risk of market manipulation is 'highly attenuated',[169] is compelling:

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160. Roberts, above n 159, 4.
161. Ibid.
162. Ibid.
163. Ibid.
164. Ibid.
165. Ibid 39.
166. These safeguards relate to the disclosure, notice, reporting, record keeping and record production obligations referred to at n 160–161 above.
167. Roberts, above n 159, 33.
168. Ibid 33–4.
169. Ibid 34.

> The Trading Rules were promulgated in 1955. While the rules have since been amended, they are premised on an understanding of securities markets, trading practices, and surveillance capabilities that existed almost forty years ago. In the concept release, the Commission recognizes that securities markets and trading practices have undergone enormous changes since the time the Trading Rules were implemented . . .[170]

Section 10(b) Securities Exchange Act 1934 and Rule 10b-5

Congress realised that section 9(a) would not cover all methods of securities manipulation. Accordingly it enacted section 10(b) to act as a catchall to section 9(a), empowering the SEC to protect the market from new and innovative manipulative strategies that might be devised in the future.[171] Indeed history has demonstrated that, despite the plethora of provisions in both the 1933 and 1934 Acts covering various types of criminal conduct, the section 'employed most frequently in criminal prosecution for fraud in the purchase or sale of securities is section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder.'[172] It has been observed that these provisions might be paraphrased: '"thou shalt not commit fraud in connection with the purchase or sale of any security".'[173] Applicable to a wide range of fraudulent conduct, section 10(b) and rule 10b-5 have been used in countless cases alleging manipulation of securities prices.[174]

Section 10(b) provides in relevant part as follows:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 promulgated by the Securities Exchange Commission pursuant to the grant of authority thereunder provides in relevant part:

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170. Ibid 33.
171. McCabe, above n 129, 223–4.
172. Jason Brennan, Mike Jerstad, Kimberly Jenkins and Opher Shweiki, 'Securities Fraud' (1995) 32 *American Criminal Law Review* 597, 599; Poser, Stock Market Manipulation, above n 113, 705–11.
173. Wang, above n 116, 61.
174. The most prominent of the s 10(b) and rule 10b-5 cases are: *Affiliated Ute Citizens* v *United States*, 406 U.S. 128 (1972); *Blue Chip Stamps* v *Manor Drug Stores*, 421 U.S. 723 (1975); *Ernst & Ernst* v *Hochfelder*, 96 S. Ct. 1375 (1976); *Sante Fe Industries, Inc.* v *Green*, 430 U.S. 462, 477 (1977);); *Aaron* v *SEC*, 446 U.S. 680 (1980); *Herman & MacLean* v *Huddleston*, 459 U.S. 375 (1983); *Basic Inc.* v *Levinson*, 485 U.S. 224 (1988); *Lampf, Pleva, Lipkind, et al.* v *Gilbertson*, 111 S. Ct. 2773 (1991); *Musick, Peeler & Garrett* v *Employers Ins.*, 113 S. Ct. 2085 (1993); *Central Bank of Denver* v *First Interstate Bank of Denver*, 114 S. Ct. 1439 (1994). These cases are referred to at n 188 below.

    Other well-known cases brought under s 10(b) and rule 10b-5 include: *Schlick* v *Penn-Dixie Cement Corporation*, 507 F. 2d 374 (2d cir. 1974) and *United States* v *Regan*, 937 F. 2d 823 (2d cir. 1991). These cases are discussed in Black, above n 8, 994. Also *United States* v *GAF Corporation*, 928 F. 2d 1253 (2nd Cir. 1991); *United States* v *Milken*, 759 F. Supp. 109 (S.D.N.Y. 1990); and *United States* v *Mulheren*, 938 F. 2d 364 (2d cir. 1991). These latter cases are discussed in Ch 4 below.

> Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact . . .
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.[175]

The generic nature of section 10(b) contrasts significantly with the relatively elaborate structure erected by Congress with respect to section 9. Moreover, the word 'manipulative' is actually used in section 10(b) — and for that matter in section 15(c)(1) and (2) — and the Supreme Court, in an often quoted passage, has stated *obiter* that it is designed to reflect Congress's intention 'to prohibit the full range of ingenious devices that might be used to manipulate securities prices.'[176] In addition, some of the rules promulgated under these sections have 'a distinctly antimanipulative flavor.'[177]

Professor Thel has offered a thought-provoking reevaluation of the 'original conception' of section 10(b) of the Securities Exchange Act.[178] The argument advanced is essentially a response to the Supreme Court's prevailing construction of the provision 'without reference to its legislative history or the historical context in which it was enacted.'[179] Unlike the Court, which has suggested that Congress did not intend section 10(b) to confer expansive SEC regulatory power, Professor Thel argues that the provision was intended to empower the SEC 'to regulate *any* practice that might contribute to speculation in securities or tend to move security prices away from investment value, save perhaps those Congress subjected to explicit controls in other parts of the Exchange Act.'[180]

Professor Thel essentially argues for a broad interpretation of section 10(b), based upon the original conception of its drafters for flexibility in the formulation and reshaping of market regulation in the public interest. This notwithstanding a series of significant Supreme Court decisions[181] in which the Court has confined the operation of section 10(b) to 'only

175. Rule 10b-5, the most important provision of the securities laws, is couched in terms of fraud. Although entitled 'Employment of Manipulative and Deceptive Devices' the word manipulative does not appear in the body of the rule itself. 'Most discussion about the reach of the rule have been framed in terms of the law of fraud . . .': Thel, Regulation of Manipulation, above n 127, 381. However, the 'sanction of section 10(b) is the foundation for the tremendous body of law that has grown up around Rule 10b-5. The sanction of section 10(b) may be critical to any effective SEC regulation of the market': Ibid. Of course s 10(b) does specifically contemplate manipulative devices.

176. *Sante Fe Industries, Inc.* v *Green*, 430 U.S. 462, 477 (1977). Neither s 997 nor s 998 of the Corporations Law uses the words manipulative or manipulate.

177. Loss and Seligman, above n 28, 935.

178. Thel, The Original Conception, above n 120.

179. Ibid 385.

180. Ibid 385–6. Emphasis added.

181. Ibid 386: for example *Aaron* v *SEC*, 446 U.S. 680 (1980) (holding that negligent misrepresentations are not actionable under rule 10b-5); *Sante Fe Indus.* v *Green*, 430 U.S. 462 (1977) (requiring proof of manipulation and deception to maintain an action under rule 10b-5); *Ernst & Ernst* v *Hochfelder*, 96 S. Ct. 1375 (1976) (requiring proof of *scienter* — intent to deceive, manipulate or defraud — to maintain a private action under the rule); *Blue Chip Stamps* v *Manor Drug Stores*, 421 U.S. 723 (1975) (limiting the availability of private rule 10b-5 suits to purchasers and sellers of securities). See further Ch 4 below.

knowing and intentional misconduct' and 'bad conduct involving deception.'[182] The original conception on the other hand permits the regulation of devices that are potentially manipulative regardless of the motives of the individuals who employ them.

It is perhaps inevitable that with any subtle piece of legislation such as the Exchange Act problems are created by a purposive approach to their interpretation. Such difficulties reinforce the need for a very clear articulation of the legislative purposes and objectives of market regulation generally, as well as the rationale for the provisions relating to securities misconduct in particular.

What is clear is that 'Congress did not itself proscribe any conduct in section 10(b); at most, it authorized the SEC to proscribe conduct.'[183] Indeed the SEC, pursuant to the mandate conferred by section 10(b), has prohibited a wide variety of conduct under the section 10(b) rules. The parameters of rule 10b-5, the general anti-fraud provision, make it the broadest of the section 10(b) rules.[184] Professor Thel has described it as follows:

> The SEC adopted the rule hastily and without much thought as to its consequences. The rule is hardly the kind of finely tailored regulatory measure the drafters apparently contemplated. Instead it is as broad as almost any statute, a sort of long-arm provision in which the SEC forbids everything the statute gives it power to forbid. Regardless of whether rule 10b-5 was a good idea in the first place, the rule has been given extraordinary prominence, almost eclipsing everything else as a source of federal securities law at least in the courts.[185]

Rule 10b-5 prohibits material misstatements and omissions as well as fraudulent acts in connection with purchases and sales of securities and it supports a broad implied private

182. Ibid 387. Thus careless conduct cannot constitute a violation of the provision even if it injures others. It is interesting to note that the history, as well as the language, of the section is relied upon to support each of the conflicting interpretations offered. The issues of deception and intent are discussed in greater detail in Ch 4 below.

183. Ibid 388. What is more, s 10(b) does not authorise the regulation of manipulation — it authorises the regulation of manipulative devices: Ibid 393–4.

184. Thomas Hazen, *The Law of Securities Regulation* (1985) 406–7: Rule 10b-1 applies the prohibitions against market manipulation contained in s 9(a) to securities exempt from s 12's registration requirements. Rule 10b-2 prohibits persons who are participating in primary and secondary securities distributions from soliciting purchases on an exchange to facilitate the distribution. This rule does not apply to broker-dealers in the normal course of business. Rule 10b-3 prohibits broker-dealers from engaging in manipulative or deceptive acts and practices with regard to securities *not* on a national exchange and thus closes a large part of the gap left by s 9, which applies only to transactions through a national exchange. Rule 10b-4 prohibits short tendering and hedged tendering of securities. Rule 10b-6 prohibits purchases during a distribution of securities by persons interested in the distribution except for stabilising bids in compliance with Rule 10b-7. Rule 10b-8 prohibits manipulative and deceptive devices in connection with a securities distribution through rights held by security holders. Rule 10b-10 requires that brokers confirm all transactions in writing. Rule 10b-13 prohibits a tender offeror from purchasing securities targeted by the tender offer once the tender offer has commenced. Rule 10b-16 requires disclosure of credit terms in connection with margin transactions. Rule 10b-17 prohibits untimely announcements of dividends, stock splits and rights or subscription offerings. Rule 10b-18 sets out a safe harbour rule for issuer purchases of its own shares. Compliance with the rule precludes a finding of manipulative conduct, but does not affect filing obligations under s 13(e).

185. Thel, The Original Conception, above n 120, 463. Professor Loss has described rule 10b-5 as 'a dark horse, of dubious pedigree but very fleet of foot': Loss, Corporate Insiders, above n 118, 40.

right of action.[186] The courts, in the absence of statutory authorisation, created the private right of action almost from the inception of the rule and have defined its parameters ever since. Indeed, the courts have consistently held that private parties can recover for violations of rule 10b-5, 'notwithstanding that the rule and the statute under which it was adopted are silent on the matter.'[187] Such private actions have played a very significant role in deterring the infliction of deliberate fraud on investors and in supplementing the enforcement efforts of the SEC.

In terms of supporting an implied remedy, however, the Supreme Court over the past two decades has limited the relief available to private litigants.[188] Essentially the rule can only be used by purchasers or sellers of securities who have been injured in connection with that purchase or sale due to deceptive conduct by a defendant acting with *scienter*.[189] Thus

186. Rule 10b-5 defines fraud in essentially the same terms as s 17(a) of the Securities Act except that it is applicable to purchases as well as to sales of securities. Whilst broader than s 17(a) in this sense, it is narrower in that it is not applicable to 'offers': Bloomenthal, above n 118, 60–1.

Over 90% of the securities cases brought in federal courts are initiated by private parties: Thel, Does Old Legislation Matter?, below n 187, quoting from the 1990 Director Admin. Office of the U.S. Courts, Annual Report supp. tbl. S-8.

The implied remedy in favour of private parties enables them to sue for damages and/or equitable relief.

187. Steven Thel, 'Section 12(2) of the Securities Act: Does Old Legislation Matter?' (1995) 63 *Fordham Law Review* 1183. (Herein referred to as 'Does Old Legislation Matter?') Professor Thel has observed that when s 10(b) was enacted in 1934, 'no one expected it to serve as a basis for private liability, let alone for a scheme of liability that would supplant most of what the statutes did': Ibid 1192.

188. See for example, *Central Bank of Denver* v *First Interstate Bank of Denver*, 114 S. Ct. 1439 (1994) (holding that a private plaintiff may not maintain an aiding and abetting action under rule 10b-5); *Lampf, Pleva, Lipkind, et al.* v *Gilbertson*, 111 S. Ct. 2773 (1991) (holding that private rule 10b-5 actions are governed by a relatively short one to three year limitations period); *Sante Fe Indus.* v *Green, Hochfelder's case, and Blue Chips Stampsv Manor Drug Stores*, referred to at n 181 above.

On the other hand, there have been a few important decisions favouring plaintiffs: for example, *Basic Inc.* v *Levinson*, 485 U.S. 224 (1988) (adopting 'reasonable investor' standard for materiality element and fraud-on-the-market theory for reliance element under rule 10b-5); *Herman & MacLean* v *Huddleston*, 459 U.S. 375 (1983) (rejecting Fifth Circuit's requirement of a 'clear and convincing evidence' standard in favour of a 'preponderance of the evidence' standard); *Affiliated Ute Citizens* v *United States*, 406 U.S. 128 (1972) (stating that positive proof of reliance is not a prerequisite to recovery under rule 10b-5); *Musick, Peeler & Garrett* v *Employers Ins.*, 113 S. Ct. 2085 (1993) (holding that defendants in a rule 10b-5 action are entitled to seek contribution): Thel, Does Old Legislation Matter?, above n 187, 1184.

189. The U.S. Supreme Court held in *Ernst & Ernst* v *Hochfelder*, 96 S. Ct. 1375 (1976) that proof of *scienter* 'embracing an intent to deceive, manipulate, or defraud' is necessary to support an action for damages under rule 10b-5. These elements are discussed in Ch 4 below.

Professor Thel has noted that, as the Supreme Court has made it more difficult for private litigants to succeed under rule 10b-5, they are increasingly turning to s 12(2) of the Securities Act 1933. Broadly speaking this provision requires anyone who sells a security by means of a prospectus or oral communication, which includes an untrue statement of a material fact, to refund the buyer's money. According to Professor Thel, it was not the intention of Congress to require proof of *scienter* or reliance under s 12(2): Thel, Does Old Legislation Matter?, above n 187, 1185, 1192.

the core requirements are deception and *scienter*.[190] These restrictions notwithstanding, rule 10b-5 has been used 'in a wide variety of situations including insider trading, corporate mismanagement involving deception, manipulative conduct and false SEC filings.'[191] Indeed it would appear that 'any manipulative or fraudulent acts by a defendant acting with scienter under the other 10(b) rules will support a rule 10b-5 action.'[192]

An extensive jurisprudence has developed with respect to the general anti-fraud provision of rule10b-5:

> There are probably more than a thousand reported opinions. Several multi-volume treatises and a substantial part of the securities-law encyclopedias are devoted to the rule, as are uncounted law review articles. Law teachers consider the Supreme Court's rule 10b-5 cases to be so fundamental that they are reproduced in the basic corporations casebooks and discussed at length in many introductory corporations courses.[193]

For half a century the rule has provided a remedy for private investors who have suffered loss as a result of securities fraud.[194] However prior to the mid-1990s, there was a move in some quarters for litigation reform and legislative relief from the feared potential liability of section 10(b) and rule 10b-5.[195] It was claimed that the broad parameters of the rule have encouraged 'meritless suits that have spawned an excess of securities litigation . . . [which] hinders America's global competitiveness and threatens the viability of major financial institutions.'[196]

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190. The elements of an implied claim under the rule are in large part the product of judicial development and have thus changed over time. 'Stripped to bare essentials' the most common requirements include the following: (i) the plaintiff must be a purchaser or seller of a security; (ii) plaintiff must establish a violation of one of the three prohibitory subsections of the rule. For example that the defendant misstated or omitted to state a material fact; (iii) plaintiff must establish the use of interstate commerce, the mails or a facility of a national securities exchange in some part of the transaction; (iv) plaintiff must establish that the violation was 'in connection with the purchase or sale of a security'; (v) plaintiff must establish reliance, although this requirement is relaxed in certain circumstances. For example in cases involving omissions, by a presumption of reliance upon proof of materiality and a duty to disclose, and in some cases where the plaintiff is permitted to establish reliance on the integrity of the market (fraud-on-the-market theory), rather than on the disputed information; (vi) plaintiff must establish *scienter* on the part of the defendant. A showing of negligence is insufficient. Numerous courts have held that reckless conduct is sufficient for liability: O'Hara, above n 117, 329–30.
191. Hazen, above n 184, 408.
192. Ibid.
193. Thel, Does Old Legislation Matter?, above n 187, 1190–1.
194. Adam Ingber, '10b-5 Or Not 10b-5?: Are the Current Efforts to Reform Securities Litigation Misguided?' (1993) 61 *Fordham Law Review* 351.
195. Included in the groups advocating reform were, in particular, 'deep pocket' defendants such as accountants, auditors and other corporate advisers: Thomas Gorman, 'Who's Afraid of 10b-5? The Scope of a Section 10(b) Cause of Action *After Central Bank of Denver*' (1994) 22 *Securities Regulation Law Journal* 247, 260. Professor Langevoort states that: 'Indeed, by the mid-1980s scholars had put forth with confidence a wide-ranging program for redefining or revising Rule 10b-5, and had gained a substantial following at the SEC, in the courts, and (especially) in the business community': Donald Langevoort, 'Rule 10b-5 As An Adaptive Organism' (1993) 61 *Fordham Law Review* 7, 17.
196. Ingber, above n 194, 351. Also refer to Gorman, above n 195, 247–8. He addresses the charge that securities fraud suits have 'clearly gotten out of hand' by arguing that the Supreme Court, in *Central Bank of Denver* and other cases, has significantly reduced the scope of a s 10(b) cause of action in both private suits and SEC enforcement actions.

The supporters of rule 10b-5 mounted a spirited defence of the rule in the face of these claims. In particular it was asserted that the basic premise underlying the reformists' platform — that rule 10b-5 encourages frivolous litigation — was unfounded:

> . . . the putative evils attributed to Rule 10b-5 abuse can be more readily traced to problems identified with class action litigation in general, the dual role of the public accountant, and the development of alternative, overlapping securities fraud remedies.[197]

The great fear of course is that any reforms which make it more difficult for investors to enforce rule 10b-5 through private litigation 'entail a risk that they will diminish the effectiveness of the private attorney general patrol. Such reforms may also undermine confidence in the securities markets because the threat of civil liability is a crucial deterrent to securities fraud.'[198]

Initially, the relief sought by the groups advocating legislative reform was substantially obtained from the Supreme Court instead. In a series of decisions culminating in 1994 in *Central Bank of Denver* v *First Interstate Bank of Denver*,[199] a significant reduction in the scope of rule 10b-5 liability was achieved both with respect to private suits and SEC enforcement actions. According to one authority, the cases 'significantly reduce the potential group of defendants in securities fraud actions, the liability of professionals and other corporate advisors, the amount of damages the remaining defendants may be required to pay, and the time in which plaintiffs may institute suit.'[200]

Despite opposition from numerous plaintiffs' attorneys and the SEC, as well as a veto by President Clinton, legislative reform was achieved when Congress passed the Private Securities Litigation Reform Act in December 1995.[201] The PSLRA is aimed at reducing the number of frivolous class action lawsuits — or 'strike suits' — filed in federal courts

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197. Ingber, above n 194, 352. In particular, whilst uncertainty surrounds rule 10b-5, some plaintiffs are turning to the Racketeer Influenced and Corrupt Organization Act (RICO) to provide an alternative security fraud remedy: Ibid 353.

    Regarding the role of accountants and auditors, they owe duties both to the public (by providing accurate financial information that is used by investors to assess the value of particular enterprises, they perform duties that are essential to the efficient functioning of the free market system), and also to their clients to whom they are financially tied. These conflicts underlie the profession's self-declared liability crisis.

198. Ibid 354.

199. 114 S. Ct. 1439 (1994). In *Denver's case* the Court held that those who aid and abet a securities fraud cannot be held liable for civil damages in an action under s 10(b) and rule 10b-5. The other cases include *Musick, Peeler, & Garrett* v *Employers Ins.*, 113 S. CT. 2085 (1993) (holding that there is a right to contribution. According to Thomas Gorman, the decision really represents a reduction in the net amount of damages to be paid by a defendant by shifting portions of the expense to others); and *Lampf, Pleva, Lipkind, et al.* v *Gilbertson*, 111 S. Ct. 2773 (1991) (reducing the statute of limitations to a one/three year period). *Denver's case* is also discussed in Quinton Seamons, 'The Campaign against Abusive Securities Litigation Receives Assist (or Is It a Home Run?) from Supreme Court' (1995) 7 *Corporate Analyst* 167.

200. Gorman, above n 195, 260.

201. Sharon Glenn and J Allen Maines, 'The Private Securities Litigation Reform Act: Corporations Finally Get Their Day in Court' (1997) 25 *Securities Regulation Law Journal* 276; Marc Steinberg and Christopher Olive, 'The Private Securities Litigation Reform Act: Contribution and Proportionate Liability' (1997) 24 *Securities Regulation Law Journal* 333 (herein referred to as the PSLRA).

that allege fraud or mismanagement when stock prices decline.[202] In the year preceding passage of the statute, 294 such lawsuits were brought against companies and their officers and directors.[203] In order to effect early dismissal of defective securities fraud class actions, numerous measures have been introduced.[204] For example, the pleading requirements for the circumstances constituting fraud and scienter have been strengthened. Thus, in relation to scienter, plaintiffs are required to plead facts demonstrating a 'strong inference' of the requisite state of mind.[205] Each statement giving rise to alleged fraud must now be pled with particularity and reasons must be given as to why the statement is misleading.[206] Plaintiffs basing their allegations on information and belief must now state with particularity all facts giving rise to that belief.[207]

Under the PSLRA, each plaintiff filing a complaint on behalf of a class is required to provide a sworn certification which, among other things, states that the plaintiff did not purchase the security that is the subject of the complaint at the direction of plaintiff's counsel or in order to participate in any private action.[208] This provision 'clearly was enacted to prevent the promulgation of lawsuits filed by "professional plaintiffs" who purchased minimal amounts of stock at the behest of plaintiffs' counsel hoping to reap large fees for serving as the front-person in a frivolous lawsuit whenever the stock precipitously dropped.'[209]

Although a significant advance by those seeking to curb what they regard as the proliferation of frivolous strike suits against innocent defendants, the ultimate effectiveness of the PSLRA 'lies not in the words of its drafters, but rather in the construction of its terms by the courts.'[210] However the decisions that have been handed down since the enactment of the statute reveal no consistent judicial approach.[211] Indeed it would be premature to anticipate the future direction of judicial interpretation of the Act's provisions.

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202. 'Strike suits' are class action lawsuits, commonly thought to be brought by professional plaintiffs' attorneys representing shareholders owning very small amounts of stock in a company, that allege mismanagement and fraud when the price of stock declines: Glenn and Maines, above n 201, 276, 277.
203. Ibid.
204. These are discussed in detail in the article by Glenn and Maines, above n 201.
205. Ibid 278.
206. Ibid 279.
207. Ibid.
208. Ibid 283.
209. Ibid 284.
210. Ibid 277.
211. For example, in *In re Silicon Graphics, Inc. Sec. Litig.*, Fed. Sec. L. Rep. (CCH) 99,325 (N.D.Cal. 1996) the US District Court for the Northern District of California had occasion to analyse the PSLRA's provisions regarding *scienter*. The court concluded that a 'strong inference' of *scienter* can only be shown by alleging strong circumstantial evidence of conscious behaviour, and not by motive and opportunity to commit fraud. Allegations of recklessness do not establish *scienter*. This conclusion expressly rejected pre-Act law in most circuits permitting a showing of recklessness to prove *scienter*. Subsequent cases, however, have not been as consistently pro-defendant as *Silicon Graphics* and it has been impliedly disapproved of by at least one federal district court — in *Rehm* v. *Eagle Finance Corp.* 1997 WL 43037 (N.D. Ill. 1997). Other federal district courts, while acknowledging that the PSLRA mandates a higher pleading standard, have impliedly adopted the 'motive and opportunity' approach employed by the Second Circuit and permitted a showing of recklessness to satisfy the test: Glenn and Maines, above n 201, 281–3.

Despite the fact that many of the recent pronouncements of the Supreme Court on the parameters of rule 10b-5 have been received with less than universal enthusiasm, and a great deal of trepidation, it would be a mistake to suppose that the viability of the rule is in serious doubt. Repeal of the rule is unlikely.[212] Moreover the rule has not outlived its usefulness and should not be repealed. Another shift in the jurisprudence of rule 10b-5 may well be on the horizon. Over the course of its long history rule 10b-5 has embraced many different ideological shifts in social perceptions of the securities markets and the securities business, yet 'just as quickly abandons them without serious damage when these new ideas lose currency.'[213] As Professor Langevoort has observed:

> Indeed, the rule's jurisprudence has thus far been broad enough to encompass aggressive investor protection, protection against strike suits, flexibility and clarity — all roughly at the same time, and without much apology for the inconsistency. Few statutory or rule-based reforms would offer such promise to all the affected parties . . .[214]

The rule is capable of infinite permutation by virtue of its open-endedness. To anticipate the rule's demise is to deny its remarkable adaptive qualities. Indeed rule 10b-5 deserves to operate 'as a centerpiece in securities regulation precisely because we as a culture have not yet created a consistent, persuasive story of what the business of investing is all about.'[215] Thus the virtues of adaptation are unlikely to be sacrificed in favour of more precise statutory and regulatory initiatives, at least as long as there is so little understanding about the objective reality of investing.

Section 15(c) Securities Exchange Act 1934

In 1936 Congress amended the Securities Exchange Act by adding what is the present section 15(c), under which brokers and dealers are prohibited from using any means of interstate commerce or the mails to effect any transaction (otherwise than on a national securities exchange) by means of manipulative, deceptive or fraudulent acts and practices.[216] The Securities Exchange Act empowers the SEC to promulgate rules to define such practices, as well as conduct that would interfere with a market maker's activities in creating a fair and orderly market.[217] The rules adopted under section 15(c), although limited to the over-the-counter markets, nevertheless apply, like those pursuant to section 10(b), to a broad range of conduct.[218] In particular rule 15c1-2 prohibits misrepresentation and fraud

212. Apart from other considerations, the daunting nature of the task militates against repeal of rule 10b-5. 'Do the policymakers really know enough about the investing process to do much more than guess at the costs and benefits of reform?': Langevoort, above n 195, 16.
213. Ibid 8.
214. Ibid 21.
215. Ibid 8.
216. Robbins, above n 107, 92; Hazen, above n 184, 408.
217. Hazen, above n 184, 408.
218. The prohibitions and disclosure requirements supplement rules of the National Association of Securities Dealers and national exchanges: Hazen, above n 184, 410. These prohibitions and disclosure requirements are outlined in Hazen, above n 184, 409–10.

by defining 'manipulative, deceptive or otherwise fraudulent' practices within the ambit of section 15(c) to include material misstatements and omissions, and any practice that operates or would operate as a fraud or deceit upon any person.[219]

Concluding remarks

The elaborate formulation of section 9 of the Securities Exchange Act 1934 and the rules promulgated thereunder highlight the difficulty of reconciling detailed and rigid rules with the ever-changing strategies of the business people subject to them. In recent years, attempts to manipulate have undoubtedly become 'more subtle and complex'[220] and the utility of section 9 — once described by the SEC as 'the very heart of the act'[221] — has waned.

The grant of rule-making authority to the SEC by sections 10(b) and 15(c) of the Exchange Act reflected 'congressional recognition of the difficulties of defining fraud, deception, and manipulation.'[222] The wisdom of Congress in thus vesting the Commission with broad rule-making authority has been vindicated by the SEC's long history of success in dealing flexibly and effectively with the infinite varieties of fraud within the securities markets. The Commission's use of such authority, a combination of general prohibitions as well as precise definitions and prohibitions of various types of manipulative activity, reflects its view that:

> even rules and regulations lack the precision and scope needed to deal effectively with innovations in fraud. The most important of its rules under Sections 10(b) and 15(c) — Rules 10b-5 and 15c1-2, respectively — are merely general proscriptions of fraud, no more specific than those found in Section 17(a) of the Securities Act.[223]

The sweeping parameters of rule 10b-5, which implements the mandate conferred by section 10(b), have proved particularly useful in the regulation of securities misconduct. In the context of securities fraud, by categorically prohibiting deceptive and manipulative practices in securities transactions both with respect to the sale and the purchase of securities and broadly applying to transactions in 'any security' by 'any person', it has the most extensive jurisdictional application.[224]

For nearly fifty years the courts have 'painstakingly defined, honed and developed the Rule, thereby establishing it as a proven weapon to counter securities fraud violations.'[225] The Supreme Court's rule 10b-5 jurisprudence, however, has not always attracted universal approbation. There are those who take the view, on the basis of the statutory language

219. Hazen, above n 184, 409; Bloomenthal, above n 118, 61.
220. Loss, above n 123, 859.
221. Loss and Seligman, above n 28, 938; McCabe, above n 129, 221.
222. Wolfson, Phillips and Russo, above n 105, 2.01.
223. Ibid.
224. Section 17(a), as stated earlier, is limited to the sale of securities and rule 15c1-2 applies only to over-the-counter transactions by broker-dealers.
225. Ingber, above n 194, 351.

of section 10(b), its history and legislative purpose, that the Court was wrong to imply the private right of action in the first place. The Court has come under further criticism in recent times from some quarters for curtailing the parameters of rule 10b-5 by requiring proof of *scienter*. In many stock market transactions the elements of *scienter*, deceit and intent are difficult to find.

However ambiguity can be found in any statutory language. Ultimately experience has shown that provisions defined with a great degree of particularity and precision, such as section 9 of the Securities Exchange Act and rules adopted thereunder, as well as our own sections 997 and 998 of the Corporations Law and their legislative predecessors, have proved to be largely ineffectual in dealing with the problem of stock market manipulation. On the other hand the unique inherent adaptive capacities of the broadly formulated provisions — section 10(b) and rule 10b-5 — some interpretive difficulties notwithstanding, have ensured not only their continued survival but also their relative success in dealing with abusive stock market practices.

Chapter 4

Defining Manipulation

Introduction

Any discussion of securities manipulation must confront the definitional problem. The absence of a clear statutory definition, and the lack of agreement amongst courts and commentators as to what conduct constitutes market manipulation, are explored in this chapter. In particular the elements of intent and, in the United States, of deception as prerequisites of the offence are examined. The same trade may be carried out with different motives, and since it is usually impossible to say with certainty what motivates a particular trade, the conclusion is inescapable that if motive or intent to induce people to trade a security or force its price to an artificial level (or, in the US, the intent to deceive) is treated as the key in defining manipulation, the result is uncertainty as to what is and what is not manipulative conduct.

Three U.S. cases involving allegations of manipulation are described in order to demonstrate the ambiguous nature of the objective evidence regarding allegations of manipulation. These cases illustrate that manipulative intent is often hard to identify and price-affecting trades may cause damage by undermining the integrity of trading on a market for securities, regardless of the reason for which they are undertaken. These problems account for the difficulties associated with identifying manipulative trades in light of the current statutory requirements of the offence of stock market manipulation.

Nowhere is the uncertainty surrounding manipulative intent more apparent than in the debate about computerised program trading. The issues raised by the program trading controversy — whether it ought to be regarded as manipulative *per se* and regulated accordingly under the anti-manipulation provisions — are discussed in order to highlight the deficiencies in current notions of what conduct constitutes securities manipulation. There follows a discussion as to whether a regime of permitted stabilisation should be introduced in Australia. This debate has largely proceeded upon the assumption that the Corporations Law currently prohibits stabilisation. It is argued that this assumption is misplaced. As long as the current formulation of section 997 requires a subjective intent to induce others to trade, the intent must govern in each individual case and *a priori* assumptions that stabilisation is necessarily manipulative are inappropriate.

Finally it is suggested that the solution to the problem lies in a broad and flexible anti-manipulation provision, rather than in highly detailed redefined definitions of manipulation.

The Definitional Problem

Defining manipulation is no simple task. Indeed despite the recent focus on manipulation in overseas jurisdictions and its long history in world financial markets, 'no satisfactory

definition of the term exists.'[1] The Corporations Law, like the U.S. Securities Exchange Act 1934, prohibits manipulation and several of its provisions have been crafted to achieve this purpose, yet neither statute attempts to define it with any precision. The result is that the meaning and scope of manipulation is a matter of sharp controversy. Furthermore:

> An inability to define a type of prohibited conduct frequently reflects conceptual confusion, and the concept of manipulation is no exception. As one commentator has noted, "the law governing manipulations has become an embarrassment — confusing, contradictory, complex and unsophisticated."[2]

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1. Daniel Fischel and David Ross, 'Should the Law Prohibit "Manipulation" in Financial Markets?' (1991) 105 *Harvard Law Review* 503, 506.
2. Fischel and Ross, above n 1, 506. They also make the point that insider trading is another example of prohibited conduct reflecting conceptual confusion.

   As a term of art stock market manipulation broadly describes a variety of schemes which 'may arise out of an intentional interference with the free forces of supply and demand for marketable securities': Australian Stock Exchange, Circular to Member Organisations, 21 June 1990. The U.S. Supreme Court has said, *obiter*, that the word 'manipulative' is 'virtually a term of art' reflecting Congress's intention 'to prohibit the full range of ingenious devices that might be used to manipulate securities prices': *Santa Fe Industries, Inc.* v *Green* 430 U.S. 462, 477 (1977). It has been said that manipulation 'connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities': *Ernst & Ernst* v *Hochfelder* 425 US 185,199 (1976). See further Jack Treynor, 'Market Manipulation' (1992) *Financial Analysts Journal* 6; Fischel and Ross posit that only dishonest intent to move stock prices can be called manipulation: Daniel Fischel and David Ross, 'Should the Law Prohibit "Manipulation" in Financial Markets?' (1991) 105 *Harvard Law Review* 503; Professor Thel uses the word manipulation to mean 'buying a security for the purpose of increasing the reported price or selling a security for the purpose of decreasing the reported price': Steve Thel, '$850,000 in Six Minutes — The Mechanics of Securities Manipulation' (1994) 79 *Cornell Law Review* 219, 221 n 17. (Herein referred to as 'The Mechanics of Securities Manipulation'). Jarrow states that a market manipulation trading strategy is one that generates positive real wealth with no risk: Robert Jarrow, 'Market Manipulation, Bubbles, Corners, and Short Squeezes' (1992) 27 *Journal of Financial and Quantitative Analysis* 311.

   Professor Thel states that it is 'hard to define the word manipulative concisely for the purpose of the Act. It is not simply "a general term comprising a range of misleading practices" . . . manipulative practices are those that undermine the proper functioning of the securities markets': Steve Thel, 'Regulation of Manipulation under Section 10(b): Security Prices and the Text of the Securities Exchange Act of 1934' (1988) *Columbia Business Law Review* 359. (Herein referred to as 'Regulation of Manipulation'). Professor Thel further states that, although he is at odds with Norman Poser's view that the Supreme Court is correct in holding that deception is an essential element of manipulation under s 10(b), ' . . . in his book on insider trading, Henry Manne used the word manipulation in the way it is defined in this article': Ibid 361. In a later part of the article, Professor Thel suggests that the word manipulative 'may not even mean the same thing in every place that it appears in these statutes. For example, it seems particularly inappropriate to give the word the same meaning in section 14(e), which makes manipulative conduct illegal, as one would give to it in section 10(b), under which nothing is illegal unless it contravenes an SEC rule': Ibid 378. And again, referring to the amendments introducing s 14(e) and s 15(c), Professor Thel states that the 'language enacted in these amendments and the record of their adoption provides evidence to support almost any reading of the word manipulative. For example the language of s 15(c)(1) of the Act, first adopted in 1936, suggests that manipulative devices are a subgroup of fraudulent devices. The language of s 15(c)(2) of the Act, first adopted in 1938, is closer to that of ss 10(b) and 14(e) of the Act, and suggests that manipulation and fraud are distinct problems': Ibid 380.

   Professor Loss, after an extensive analysis of the regulation of market manipulation, concludes that the word manipulative has no precise meaning in s 10(b). He states that the matter of market manipulation is '[r]elated to the field of fraud — but not altogether a part of it as a matter of legal analysis': Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (3rd ed, 1995) 843. It has also been said that manipulation, like fraud, takes a variety of forms and cannot be exactly defined: Thel, Regulation of Manipulation, 361.

This situation has led another commentator to remark that it 'may seem surprising that, more than fifty years after the inception of federal securities regulation, the meaning of so basic a concept as manipulation should require clarification.'[3] However, the grant of authority to the SEC by section 10(b) of the Securities Exchange Act 1934 to make unlawful *new* manipulative practices, strongly suggests that Congress did not intend to limit the definition of manipulation to those practices such as pool operations that were known and acknowledged to be manipulative at that time:

> Congress regarded manipulation as a *flexible* concept that could encompass schemes that might hatch in the future from the fertile and creative brains of dishonest market operators.[4]

Thus section 10(b) was designed to act as a catch-all to section 9(a) — which contains a number of specific prohibitions and the more general provision in section 9(a)(2) — by protecting against future and unforeseen manipulative schemes and strategies that had not been devised at the time of the 1934 Act's conception. This interpretation has been confirmed on countless occasions by the United States Supreme Court which has stated *obiter* that the word 'manipulative' is 'virtually a term of art' reflecting Congress's intention 'to prohibit the full range of ingenious devices that might be used to manipulate securities prices.'[5]

The merits of versatility notwithstanding, the uncertainty inherent in flexibility has become manifest in the debate surrounding the meaning of manipulation. Nevertheless there are those who take the view that there has to be 'a limit to the flexibility of this concept'[6] — otherwise section 10(b) could be interpreted as conferring upon the SEC unlimited discretionary authority to forbid *any* practice, in connection with the sale or purchase of a security, of which it disapproved. Thus the debate has essentially focused on the search for the 'central core of meaning'[7] of manipulation.

There has thus far been relatively little theoretical discussion of the concept of manipulation in the Australian context. However the Australian Stock Exchange, in a somewhat vague explanation of the offence,[8] has stated that stock market manipulation '*may* arise out

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Interestingly, although rule 10b-5 — the most important provision of the U.S. securities laws — is entitled 'Employment of Manipulative and Deceptive Devices', the rule speaks in terms of fraud. The word manipulative does not appear in the rule except in its title: Thel, Regulation of Manipulation, 381.

3. Norman Poser, 'Stock Market Manipulation and Corporate Control Transactions' (1986) 40 *University of Miami Law Review* 671, 672. (Herein referred to as 'Stock Market Manipulation'). In fact for many years, 'the absence of a definition did not seem to create major interpretive problems. By and large, courts, regulators, and commentators agreed on what was meant by manipulation': Ibid. Professor Poser notes that, during the period in which there was no controversy surrounding the meaning of manipulation, it 'does not appear that a single article dealing with stock market manipulation appeared in any major law review between 1952 and 1981': Ibid.
4. Ibid 691. Emphasis added. In view of the decision in *Schreiber*, below n 22, it is pertinent to observe that deceit was also an essential requirement of the early manipulative operations of pools: Ibid 692.
5. *Santa Fe Industries, Inc.* v *Green* 430 U.S. 462, 477 (1977).
6. Poser, Stock Market Manipulation, above n 3, 691. *Contra* Professor Thel, The Original Conception, below n 13.
7. Poser, Stock Market Manipulation, above n 3, 691.
8. Perhaps in keeping with an expansive philosophy in order to create maximum flexibility.

of an intentional interference with the free forces of supply and demand for marketable securities.'[9]

Although the Australian statutory provisions relating to stock market manipulation are (broadly speaking) predicated upon proof of a specific intent,[10] it should be noted at the outset that there is no explicit reference either in the Corporations Law or in the literature on the subject to any requirement of deceit or dishonesty.[11] As will be seen, the Australian provisions may thus presuppose a broader definition of manipulation than the U.S. securities cases. However the two issues of manipulative intent and deceit are clearly closely interrelated,[12] and there are undeniably undercurrents of the notion of deceit or dishonesty in the formulation of the Australian market manipulation offences. Indeed it is suggested that deception, though not a specific requirement, is implicit in the offences.

9. Australian Stock Exchange, Circular to Member Organisations, 21 June 1990. Emphasis added. Along very similar lines, manipulation has been defined by some authorities as the 'deliberate interference with the free play of supply and demand in the security markets': Fischel and Ross, above n 1, 507. Fischel and Ross argue that this formulation is unsatisfactory because the term 'interference' is undefined; presumably manipulative conduct constitutes interference, but this is circular absent a definition of manipulation, and does not advance the inquiry.

10. A specific intent (to induce other persons to sell, buy or subscribe for securities — ie to induce people to trade a security) is a necessary element of the s 997 manipulation offences. Another specific intent (to create a false or misleading appearance of active trading or with respect to the market for, or the price of, the securities — ie an intent to force the price of a security to an artificial level) is one of the possible elements of the s 998(1) false trading offences. These matters are discussed in greater detail in Ch 3 above.

11. Interestingly the two major U.S. markets for investment — commodities and securities — define manipulation differently. The U.S. commodities markets define manipulation as the intentional creation of an artificial price (effectively in terms similar to the s 1259 offence under the Corporations Law). 'Thus, although intent is required in both securities and commodities cases, *intent to defraud* is required only in securities cases': Lawrence McCabe, 'Puppet Masters or Marionettes: Is Program Trading Manipulative as Defined by the Securities Exchange Act of 1934?' (1993) 61 *Fordham Law Review* 207, 226. Emphasis added.

12. The Oxford English Dictionary defines manipulate as 'to manage by dexterous contrivance or influence; especially to treat unfairly or insidiously for one's own advantage': Oxford English Dictionary, prepared by J A Simpson and E S C Weiner, Vol. 9, 2nd ed. 1989.

    Professor Thel has defined the term as follows: 'In common and legal usage, "manipulation" is a broad term that refers to skilful handling or treatment. When the word is used perjoratively, it describes a use of force that is somehow inappropriate. False statements can apply inappropriate force to security prices, but so can many other things, including trading . . .': Thel, The Original Conception, below n 13.

    It is interesting to note the U.K. anti-manipulation formulation. Section 47(2) of the Financial Services Act 1986, like s 997 of the Corporations Law, requires an intent to induce. Similarly there is no specific ingredient of dishonesty or intent to defraud. This has led one commentator to conclude that 'dishonesty need not be established because it is not specifically made an ingredient of the offence nor is an intent to defraud': How Chih Lee, 'Market Manipulation in the US and UK: Part 2' (1993) 14 *Company Lawyer* 123, 124. Nevertheless it is always open to the courts to do what the U.S. Supreme Court has done, which is to equate and correlate manipulation with deception. See further n 23–5 below and Ch 5 below.

Deception and Intent as Elements of Manipulation

In the absence of a satisfactory definition in the regulatory statutes, courts and academic commentators in the United States have suggested various formulations. In a series of mid-1970s decisions, most notably *Ernst & Ernst* v *Hochfelder* and *Sante Fe Industries, Inc.* v *Green,*[13] the United States Supreme Court held that *scienter*, meaning 'an intent to deceive, manipulate or defraud' was an essential element of a private cause of action under section 10(b) of the Securities Exchange Act 1934 and rule 10b-5.[14] In interpreting the language of section 10(b), the Court stated that:

> Use of the word 'manipulative' is especially significant. It is and was virtually a term of art when used in connection with the securities markets. It connotes *intentional* or willful conduct designed to *deceive or defraud* investors by controlling or artificially affecting the price of securities.[15]

Since, according to this interpretation, 'a person violates section 10(b) only if he knows (or perhaps if he should know) what he is doing is wrong, careless conduct cannot constitute a violation of the section even if it injures others.'[16] This judicial interpretation has come under strong criticism from Professor Thel who argues that, apart from the fact that section 10(b) does not itself proscribe any conduct at all (at most it authorises the SEC to proscribe conduct), the provision confers broad expansive powers on the SEC to regulate *any* practice that contributes to disorder in the securities markets:

> Section 10(b) does not authorize the regulation of manipulation, but rather, regulation of the use of manipulative devices. Just as the Commission can regulate the use of deceptive devices by people who do not intend to deceive, it can regulate devices that are potentially manipulative regardless of the motives of individuals who employ them.[17]

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13. *Ernst & Ernst* v *Hochfelder,* 425 U.S. 185 (1976) and *Sante Fe Industries* v *Green,* 430 U.S. 462 (1977). In *Hochfelder's case* it was said that manipulation 'connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities': 425 US 185,199 (1976); also see below n 15. This formulation has remained the Court's starting point for examinations of section 10(b): Steve Thel, 'The Original Conception of Section 10(b) of the Securities Exchange Act' (1990) 42 *Stanford Law Review* 385, 386–7 n 9. (Herein referred to as 'The Original Conception').
14. Poser, above n 3, 681.
15. 425 U.S. 185, 199 (1976). Emphasis added. In *Sante Fe* the Court, in discussing the manipulative element of section 10(b) again stated that the term 'refers to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting the market activity . . .': 430 U.S. 462, 476–7.

    Professor Thel has offered the following observation: 'Most discussion of section 10(b) has been in connection with Rule 10b-5, and perhaps because the rule principally addresses deception, section 10(b) has usually been discussed in terms of deception': Thel, Regulation of Manipulation, above n 2, 381.
16. Thel, The Original Conception, above n 13, 387. Professor Thel makes the point that a broad range of conduct, including some innocent — if not innocuous — conduct, is contemplated by the term manipulative in s 10(b), 'or Congress would have outlawed the use of all manipulative devices itself rather than leaving it to the SEC to decide which ones to regulate and how to do so': Thel, Regulation of Manipulation, above n 2, 378.
17. Ibid 394. Clearly Professor Thel is arguing for a considerably more extensive view of manipulation than that held by the Supreme Court over the past several decades. Also refer generally to Thel, Regulation of Manipulation, above n 2. It should further be noted that, in the interests of complete accuracy, s 10(b) does not *explicitly* authorise the SEC to promulgate rules. It 'simply makes it unlawful to employ [any] manipulative or deceptive device or contrivance in contravention of such rules as the SEC may prescribe': Thel, Regulation of Manipulation, above n 2, 383.

Following *Hochfelder* and *Sante Fe,* the Supreme Court eventually extended its narrow definition of manipulation (requiring an intent to deceive) to all cases arising under the Securities Exchange Act 1934. In particular a series of U.S. cases concerning corporate control transactions[18] in the early 1980s raised the issue whether deception was an essential element of manipulation under section 14(e).[19] In *Mobil Corp* v *Marathon Oil Co.*[20] which touched off the controversy concerning deception in this context, it was held that a target company's defensive tactic against a takeover was 'a manipulative act or practice' in contravention of s 14(e) of the 1934 Act, although the action was fully disclosed and did not contain any element of deception.

This broad view of manipulation was generally unpopular however[21] and the matter was finally resolved by the Supreme Court in *Schreiber* v *Burlington Northern, Inc.*[22] in favour of the narrow interpretation of the term 'manipulation' initially canvassed in *Hochfelder* and *Sante Fe.* The Court in *Schreiber* held that the term 'manipulative' as used in section 14(e) of the 1934 Securities Exchange Act, necessarily involves misrepresentation or nondisclosure. Furthermore according to the Court, deceptive acts and manipulative acts are not different kinds of behaviour. Indeed it was said that the presence of the word 'deceptive' in the statute reinforces rather than negates the idea that manipulative conduct is itself deceptive conduct.[23]

Therefore, although section 10(b)'s language appears open to expansive interpretation as Professor Thel suggests, the Supreme Court has limited its scope to those manipulative devices that are intended to deceive or defraud. Accordingly, under the Supreme Court's definition, an investor who suffers loss as a result of the effects of a manipulative scheme, but who is unable to show deception, 'will find no recourse in the '34 Act's manipulation sections.'[24] The Court's adoption of such a narrow definition of manipulation, which

18. Takeovers, mergers and acquisitions have become known as 'the market for corporate control.' The phrase was originally coined by Henry Manne in his influential article, 'Mergers and the Market for Corporate Control' (1965) 73 *Journal of Political Economy* 110.
19. Section 14(e) forbids manipulative, fraudulent or deceptive acts or practices in connection with any tender offer.
20. 669 F.2d 366 (6th Cir. 1981).
21. Poser, Stock Market Manipulation, above n 3, 677–8.
22. 105 S. Ct. 2458 (1985). *Schreiber* has now overruled *Mobil*: Poser, Stock Market Manipulation, above n 3, 687.
23. Poser, Stock Market Manipulation, above n 3, 682. Note that with respect to churning claims (Appendix A below), which are essentially based on the breach of fiduciary duty committed by the broker against the customer, federal courts in the United States continue to recognise churning as actionable under s 10(b) and rule 10b-5 by characterising the conduct as also involving the necessary element of deception: Patricia O'Hara, 'Churning Claims under Federal Securities Law' in Marc Steinberg (ed), *Contemporary Issues in Securities Regulation* (1988) 333.
24. McCabe, above n 11, 225. The point is made in the article that, in applying the Supreme Court's definition, lower courts have struggled in their attempt to reconcile the broad language of section 10(b) and rule 10b-5 with the requirement of deception: Ibid. To meet the deception requirement, the SEC has also 'expanded its definition of "intent to deceive" to bizarre and often counter-intuitive limits': Ibid 225–6. Thus in *SEC* v *Choset* 28 S.E.C. Docket 172 (S.D.N.Y. June 15, 1983), where Choset had no intention to deceive investors, although he did intend to deceive his employers in order to receive a larger bonus, the SEC concluded that his acts were nevertheless manipulative. The fictitious trades could, if entered into often enough, induce investors to purchase or sell securities.

correlates manipulation with deception, has in turn led to the charge by Professor Thel that the Supreme Court has 'deprived the word manipulative of any independent significance.'[25]

In reaching its determination in *Schreiber*, the Supreme Court followed 'its now-familiar procedure of first examining the language of the statute, then reviewing its purpose and legislative history, and finally discussing questions of policy.'[26] With respect to the statutory language, the Court based its opinion that misrepresentation or nondisclosure was an essential element of manipulation on the views it had expressed in *Sante Fe* with regard to section 10(b).[27] There was little significance, the Court stated, in the differences between the wording of sections 10(b) and 14(e).[28] Furthermore this meaning was consistent with the use of the term at common law and with its traditional dictionary meaning.[29] The Court noted that all three species of conduct — ie. fraudulent, deceptive or manipulative — were directed at failures to disclose.[30]

Significantly the Court ruled that the actual primary purpose of the federal securities laws generally is disclosure. Although the protection of investors is ostensibly their primary concern, nevertheless 'conduct that adversely affects investors is not necessarily covered by the securities laws. Such conduct, *if nondeceptive*, is traditionally the province of state corporate law.'[31] This interpretation echoes the views previously expressed by the Court in *Sante Fe:*

> No doubt Congress meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices. But we do not think it would have chosen this "term of art" if it had

25. Thel, Regulation of Manipulation, above n 2, 384. Professor Thel argues that since manipulation is a term of art now, it encompasses only a few trading practices that the SEC could forbid as deceptive devices even if it had no power over manipulative ones: Ibid.
26. Poser, Stock Market Manipulation, above n 3, 680. The Court found support in all areas for its findings.
27. Ibid 682. In *Sante Fe* the court had said that nondisclosure was usually essential to the success of a manipulative scheme: 430 U.S. 462, 476–7 (1977).
28. *Contra* Thel, Regulation of Manipulation, above n 2, 378 who argues that it is inappropriate to give the word manipulative the same meaning in the two contexts, given that s 14(e) makes manipulative conduct illegal whereas s 10(b) makes nothing illegal unless it contravenes an SEC rule.
29. The dictionary definition quoted by the Court from Webster's Third New International Dictionary 1376 (1971), is as follows: manipulation is 'management with use of unfair, scheming, or underhanded methods.' Professor Poser has observed that it is 'not clear how this definition supports the Court's conclusion that manipulation requires deception, because the definition appears to encompass unfair, though fully disclosed, actions': Poser, above n 3, 683 n 68. Nevertheless Professor Poser is in general agreement with the decision in *Schreiber*, saying that it is entirely consistent with the intention of Congress in 1934 when the Securities Exchange Act was enacted, as well as in 1968 when it enacted the Williams Act: Ibid 686. (The Williams Act 1968 was designed to regulate tender offers and corporate repurchases of stock. It added s 14(e) to the 1934 Act. It is discussed in some detail in Poser, Stock Market Manipulation, above n 3, 711–5; and Thel, Regulation of Manipulation, above n 2, 380).
30. *Schreiber's case* 105 S. Ct. 2458, 2463 (1985). Again Professor Thel challenges the Court's interpretation of the purpose of the Securities Exchange Act. He states that '. . . if the Exchange Act has any fundamental purpose, it is not "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* . . .': Thel, The Original Conception, above n 13, 388. Most of the Exchange Act, he argues, concerns market regulation and has little to do with disclosure. The theme that ties the Act together is a concern with security prices: Ibid 390–1. Also refer to Thel, Regulation of Manipulation, above n 2, which pursues the same theory.
31. Poser, Stock Market Manipulation, above n 3, 686. Emphasis added.

> meant to bring within the scope of 10(b) instances of corporate mismanagement such as this, in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary.[32]

The finding in *Schreiber* has led Professor Poser to conclude that, although the decision went no further than to hold that misrepresentation or nondisclosure is a requirement for manipulation under section 14(e) and by extension section 10(b), 'it is plain that manipulation also requires a specific *intent* to influence the market price of the security and to do so in a *deceptive* manner.'[33] Academic and judicial controversy has characterised the discussion about the specific requirements of manipulative intent and deception ever since.

Deception explained

Schreiber's case left some important issues unresolved, and in particular the nature of the deception and the intent that must be proved. With respect to deception, it is settled that the deceit need not be verbal. Falsification of the market may be achieved by acts such as fictitious or even real trading.[34] The more difficult issue is what must be the subject of the deception. Traditionally the deception involved in a manipulative scheme related either to the company or to the market itself. In *Sante Fe* for example the Court defined manipulation as practices that are intended to mislead investors by artificially affecting market activity. However there is also judicial authority for the view that nondisclosure as to the defendant's motives, or as to the likely effects of the actions in question, may provide the necessary deception in a manipulation case, though this matter is far from settled.[35]

Reliance and causation are complex subjects under section 10(b) and rule 10b-5. The question that arises in this context is, given that sections 10(b) and 14(e) — and for that matter section 995 of the Corporations Law — prohibit deceptive conduct, what does alleging manipulation add to a plaintiff's claim? Indeed:

> in many situations, particularly where the allegedly improper conduct consists of false or misleading statements or omissions, an allegation of deception will suffice and alleging manipulation does not add anything to the plaintiff's claim. If the plaintiff is, however, unable to prove that he actually relied on the defendant's deception, the question of whether there was manipulation becomes important.[36]

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32. 430 U.S. 462, 477 (1977).
33. Poser, Stock Market Manipulation, above n 3, 735. Emphasis added. Thus in *United States* v *Mulheren*, 938 F.2d 364, 370–1 (2d Cir. 1991), it was held that the defendant's activities in using a floor broker not often used, and the floor broker's failure to reveal the purchaser, were not sufficient proof of the *deceptive intent* required for a s 10(b) manipulation charge: McCabe, above n 11, 225 n 140.

    Professor Thel concedes that, in view of the Supreme Court's heavy reliance in *Schreiber* on its rule 10b-5 decisions, the case 'unquestionably defines the term "manipulative" for the purpose of section 10(b)': Thel, Regulation of Manipulation, above n 2, 387.
34. Poser, Stock Market Manipulation, above n 3, 722.
35. Ibid 722–6, referring at 723 to *Panter* v *Marshall Field & Co.*, 646 F.2d 271, 288 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); and *Vaughn* v *Teledyne, Inc.*, 628 F.2d 1214, 1220 (9th Cir. 1980); cf *Alabama Farm Bureau Mutual Casualty Co.* v *American Fidelity Life Insurance Co.*, 606 F. 2d. 602 (5th Cir. 1979), *reh'g denied*, 610 F.2d 818 (5th Cir.), *cert. denied*, 449 U.S. 820 (1980).
36. Ibid 716.

The answer in the U.S. context (and possibly also in the Australian one) thus hinges upon the requirement, in the case of deceptive conduct, of proof of *personal reliance* on the defendant's deception and the absence or dilution of the equivalent requirement in the case of alleged manipulative conduct. In the latter case, (and although deception appears to be a specific pre-requisite of the offence in the United States although not in Australia), *the causal connection* in both jurisdictions is provided not by reliance, but by the manipulation's *effect on the market*.

In the United States, in a deception case based on affirmative misstatements, reliance must be specifically pleaded and proved in all those jurisdictions that have not adopted the fraud-on-the-market theory.[37] In any event the theory — namely that the plaintiff relied on the integrity of the market to reflect the free interplay of supply and demand, and that the defendant's misstatements interfered with that integrity — establishes only a presumption of reliance which may be rebutted by evidence that the material misrepresentation or omission did not substantially contribute to the plaintiff's investment decision.

On the other hand in a manipulation case based on misleading misstatements or omissions, 'the causal link between the defendant's misconduct and the plaintiff's harm is provided by the manipulation's effect on the market.'[38] For these reasons there may well be many situations in which it is more advantageous for a plaintiff to plead manipulation 'where he may have difficulty proving that *he* relied on the defendant's misrepresentations *that affected the market*, rather than only to plead deception, with its traditional reliance requirement.'[39]

In the Australian context, section 995(2) — the prohibition on actual or likely misleading or deceptive conduct in relation to dealings in securities — also requires that there must be some causal link between the plaintiff's loss and the defendant's misleading or deceptive

37. Ibid 716. The fraud-on-the-market theory has not been accepted by some federal circuit courts of appeal and the Supreme Court has not yet ruled on its validity. Furthermore it is said only to apply to securities which have 'efficient' markets, ie. those in which security prices reflect all available public information about the economy, about financial markets, and about the specific company involved: Ibid 717. Its ambit of operation is therefore somewhat circumscribed.

    Note that in a deception case based on *omissions* of material facts by the defendant, the plaintiff need not prove actual reliance if he or she can show that the omissions were material: *Affiliated Ute Citizens of Utah* v *United States*, 406 U.S. 128 (1972): Ibid; Larry Soderquist, *Understanding the Securities Laws* (1987) 257.

38. Poser, Stock Market Manipulation, above n 3, 716. By way of summary, in a rule 10b-5 action, there need not be privity between the plaintiff and the defendant, and the reliance requirement between the defendant's wrongful act and the plaintiff's loss that would normally provide the causative link in a fraud action has been substantially diluted. On the other hand, the courts have imposed certain restrictions on actions under the rule. Thus the plaintiff must be the purchaser or seller of a security (there is no valid cause of action if the defendant's fraud deterred the plaintiff from buying or selling); the plaintiff must prove that the defendant is guilty of some form of deception (unfair conduct or breach of fiduciary duty will not suffice) and has acted with *scienter* (intent to deceive, manipulate or defraud). Despite these limitations on liability, rule 10b-5 'has proved to be a powerful tool in the hands of plaintiffs': Norman Poser, *International Securities Regulation — London's "Big Bang" and the European Securities Markets* (1991) 299–300.

39. Poser, Stock Market Manipulation, above n 3, 717. Emphasis added. One of the major drawbacks to pleading manipulation, of course, is that the plaintiff must prove that the defendant acted with the requisite manipulative intent. See further n 38 above.

conduct.[40] The word 'by' in section 1005 shows the need for some sufficient causal link,[41] and one way of showing this connection is to prove inducement. Authorities have suggested that, under section 52(1) of the Trade Practices Act on which section 995(2) is based, the requisite statutory causal connection is not necessarily limited by the notion of inducement which is central to the common law of deceit.[42] It has been said that the required causal connection is not that of 'the strict logician but is to be understood according to common sense concepts.'[43] Therefore:

> proof that a careful representee would have checked the accuracy of the representation will not always be enough to show that the representee's loss did not arise from the representation . . . But there might be cases where plaintiffs were so negligent in protecting their own interests as to justify a finding of fact that the misstatement or omission was not in the circumstances a real inducement to the plaintiffs to contract . . . Much may depend on the composition of a particular class of persons to whom a representation was directed.[44]

There are as yet no decided Australian cases on the issue of the precise nature of the causal connection required for deception under sections 995(2) and 1005, although it may well be that the court would follow the section 52(1) approach.

Equally there are no Australian authorities on the causal link required in a case of alleged manipulation under section 997 of the Corporations Law. Yet causation is clearly one of the elements of the offence.[45] The transactions must have, or be likely to have, the effects described in subsections (1), (4) or (7), ie. the creation of an artificial price by increasing, reducing or stabilising the price of the relevant securities:

> It is therefore insufficient to establish merely that an artificial price situation existed: it must additionally be demonstrated that the transaction[s], of the prescribed type, caused that situation.[46]

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40. Robert Baxt, HAJ Ford and Ashley Black, *Securities Industry Law* (5th ed, 1996) 82, 94. The word 'by' in s 1005 is said to telescope concepts that the common law knows as 'causation', 'remoteness' and 'measure of damages': Ibid 82. One way of establishing a causal link is to prove inducement, which may be assisted by the court's willingness to draw inferences. The inference may be rebutted for example, upon proof that the representee, before entering the contract, knew the true facts or made it plain that no reliance was being placed upon the representation: Ibid 95. Also see *Australian Corporations & Securities Law Reporter* (CCH looseleaf service, 1995) 231–620 which refers to causation 'most probably' having to exist under section 995 'as is the case in actions under sec 52 of the *Trade Practices Act*'.
41. The Corporations Law provides a civil remedy to any person who suffers loss as a result of breach of any of the market manipulation or false trading provisions. Such liability primarily arises under the general liability provisions of s 1005 and is extended by the additional head of civil liability imposed by s 1014.
42. The common law of deceit requires the plaintiff to show that the misstatement induced entry into the transaction, although it need not be the sole inducement: Baxt, Ford and Black, above n 40, 95. See also Donna Croker, *Prospectus Liability Under the Corporations Law* (Centre for Corporate Law and Securities Regulation, The University of Melbourne, 1998).
43. *Argy* v *Blunts & Lane Cove Real Estate Pty Ltd* (1990) 94 ALR 719, 744 citing *Kewside Pty Ltd* v *Warman International Ltd* (FC, French J, WAG 86 of 1987, 18 Jan 1990, unreported).
44. Baxt, Ford and Black, above n 40, 95. Authorities cited omitted.
45. The other elements of the s 997 offence are the manipulative act; the requisite intent and the creation of an artificial price. Although the word 'artificial' is not specifically used in s 997 (it is in the context of the equivalent s 1259 offence of manipulation in the futures industry), it is submitted that artificial is precisely what is being referred to by the words 'increasing', 'reducing' or 'maintaining' the price as a result of the manipulative act committed with the required intent.
46. John Currie, *Australian Futures Regulation* (1994) 227.

Thus the causal link between the defendant's misconduct and the plaintiff's harm, as is the case in the United States, is essentially provided by the manipulation's effect or potential effect on the market and its valuation of the price of the securities. Personal reliance or inducement on the defendant's misconduct is not required for manipulation under section 997. The same arguments regarding causation apply equally in the case of the false trading and market rigging offences under section 998. A person must not do anything which has the effects described in section 998(1) ie. creating or potentially creating a false or misleading appearance either of active trading or with respect to the market for, or the price of, the securities; or, by means of any fictitious transactions, the effects described in section 998(3) ie. creating an artificial market price for the securities.

It is difficult to know just how far we should rely upon the United States experience in the interpretation of our statutory offences.[47] There are undeniably problems in the absence of a satisfactory U.S. (and for that matter Australian) statutory definition of manipulation. Nevertheless it is submitted that (following the U.S. example) broad prohibitions should be retained against both deceptive and manipulative conduct, notwithstanding that deception itself may well be an element of manipulation, or indeed that deceptive acts and manipulative acts are not different kinds of behaviour as the U.S. caselaw and much of its literature suggest.[48]

It is not only that stock market manipulation defrauds investors and undermines the market's integrity by falsifying the public's valuation of securities[49] and should therefore be the subject of a separate and distinct prohibition. It is also that, in the uncertainty created by the absence of relevant Australian caselaw and literature, an injured investor may well in certain circumstances find it easier to plead manipulation (and rely on the manipulation's effect on the market) rather than deception under section 995 (which may yet require proof of personal inducement or reliance on the defendant's deception).

By the same token, a plaintiff who purchases in a market affected by deceptive conduct, but who is unable to prove that the defendant acted with the requisite manipulative intent, should be able to proceed by pleading deceptive conduct rather than manipulation. Thus broad prohibitions against both deceptive and manipulative conduct are mandated although the precise formulation of our prohibition against manipulation requires extensive modification in view of the deficiencies of the current regime. The overall aim of our securities laws should be to provide flexibility and to expand, not restrict, the avenues legitimately available to persons seeking redress for serious securities violations.

Intent explained

The line between legitimate and manipulative trading is a very thin one. The distinction depends upon proof of the requisite intent on the part of the defendant. Fischel and Ross

47. In connection with the futures industry, it has been argued that the U.S. experience can only be of limited assistance in interpreting the s 1259 offence of manipulation: Currie, above n 46, 224. However the arguments put forward in support of this position do not necessarily apply in the context of stock market manipulation.

48. *Schreiber's case*, above n 22.

49. Poser, Stock Market Manipulation, above n 3, 734.

argue that, as a result, there is no objective definition of manipulation. Since manipulative trades must be defined with respect to the intent of the trader only dishonest intent to move stock prices can be called manipulation.[50] In other words, manipulative intent plays the pivotal role in asserted manipulation that reliance or inducement plays in alleged deception.[51]

Where manipulation is effected by trading, the conceptual distinctions between proper market participation and improper manipulative activity are blurred and uncertain.[52] The problem with respect to actual trades (as opposed to fictitious transactions) is that such trading activities — the purchase and sale of securities in the open market — 'are in themselves consistent with the perfectly innocuous (if not praiseworthy, in our capitalist system) purpose of making a profit.'[53]

It would clearly be impractical in these circumstances to impose a broad definition of intent. Indeed the federal securities laws of both Australia and the United States have narrowed the definition of manipulation in this context by requiring a narrowly circumscribed specific intent. Thus under section 997 of the Corporations Law (which deals with transactions that have, *or are likely to have*, an effect on the price of securities, by increasing, reducing or stabilising the price), the specific intent required is 'to induce other persons' to sell, buy or subscribe for the relevant securities. A similar position obtains with respect to the analogous provision in the United States. Proof of a section 9(a)(2) manipulation requires evidence that a series of transactions was entered into whose effect was *either* the creation of actual or apparent active trading, *or* raising or depressing the price, for the purpose of inducing others to purchase or sell the security. Thus, as in the case of a section 997 manipulation (although for somewhat different reasons arising out of the particular wording of the respective provisions)[54]:

50. Fischel and Ross, above n 1, 506.
51. Manipulative intent, though critical and pivotal, is not the only factor to be taken into consideration in the context of stock market manipulation. As previously stated the manipulative act is relevant, as is the manipulation's effect on the market (causation being an element of the manipulation offences).
52. Nicholas Wolfson, Richard Phillips and Thomas Russo, *Regulation of Brokers, Dealers and Securities Markets* (1977) 2.12.
53. Poser, Stock Market Manipulation, above n 3, 729. Fischel and Ross argue that with actual trades, since the only act is trading and desirable trading cannot be distinguished from undesirable trading by using objective measures, the only distinction in this context is the intent of the trader. By contrast in the case of fraud, whether conduct is undesirable or not 'depends on objective criteria — whether there has been a false statement — and not solely on the speaker's intent': Ibid 511. Therefore fictitious trades should be analysed as a species of fraud, whilst actual trades should not be prohibited as manipulative regardless of the intent of the trader: Fischel and Ross, above n 1, 507. Professor Thel, who refutes the analysis offered by Fischel and Ross, has described this as a 'provocative reexamination of the subject of manipulation': Thel, The Mechanics of Securities Manipulation, above n 2, 220.
54. Under s 997, the transactions do not actually have to affect the price of the securities as long as they are likely to have that effect. Under s 9(a)(2), it is clear that the creation of trading and changing the price are alternative requirements: Loss and Seligman, above n 2, 939.

> Liability for Section 9(a)(2) manipulation does not depend upon whether the series of transactions actually raised or lowered the price of the security involved. It is the intention to affect prices for the purpose of inducing others to buy or sell that determines liability.[55]

The presence of an improper purpose either 'to induce others to buy or sell at an artificial price or to unduly influence the market in a particular stock is [therefore] necessary to determine whether the activity should be condemned as unlawful manipulation.'[56]

A significant problem with this of course is the inherent difficulty in proving the *intention* to produce the forbidden result.[57] This has been a recurring theme in all the literature on the subject of market manipulation. Thus it has been pointed out that:

> Finding a series of transactions and the creation of an artificial price are not the difficult part of a securities manipulation claim; rather, the challenge has been finding the requisite manipulative purpose [ie. intent].[58]

Professor Loss has also stated that most of the litigation under section 9(a)(2) 'not surprisingly, has involved the troublesome requirement of showing a purpose to *induce others* to buy or sell.'[59] With theoretical controversy continuing to surround the kind of intent or purpose that is required for manipulation under the provision, he has suggested that it is a question better left to the metaphysicians.[60] Fundamentally, there are difficulties 'with the

55. Wolfson, Phillips and Russo, above n 52, 2.13. Note that it is not necessary, in showing a breach of s 995 of the Corporations Law, to show an intention on the part of the defendant to engage in misleading or deceptive conduct with respect to the securities: *Australian Corporations & Securities Law Reporter* (CCH looseleaf service, 1995) 231–620.
56. McCabe, above n 11, S223.
57. This matter is further dealt with in Ch 3 above.

    The difficulties in establishing the requisite manipulative intent are illustrated by the statutory rules introduced by the First Corporate Law Simplification Act 1995 (Cth) governing maintenance of capital by limited companies having a share capital — which substitute new rules regulating their buy-backs of shares.

    On the one hand if the intention of the directors, in deciding that the company should undertake a buy-back, is primarily to affect the market price, the question arises whether they are guilty of market manipulation. According to the majority in *North* v *Marra Developments Ltd* (1981) 148 CLR 42, even a plan to effect a real sale or purchase on the stock exchange with the sole or primary object of setting and maintaining a market price could be a common law conspiracy to deceive. There may also be statutory offences under ss 997 and 998. On the other hand, an equally plausible explanation for the decision to undertake the buy-back may be that the directors believe in good faith that the shares are undervalued on the market and that a purchase of the shares would be a good use of company funds by way of investment. This is referred to as the 'signalling theory' of buy-backs: directors signal to shareholders that their shares are undervalued. Since a company may have a legitimate interest in seeing that the ruling price of its shares reflects their true worth, the directors' decision to effect the buy-back is arguably one made for a legitimate purpose: H A J Ford and Ian Ramsay, *Guide to the First Corporate Law Simplification Act* (1996) 25–6.
58. McCabe, above n 11, 222.
59. Loss and Seligman, above n 2, 939. Original emphasis.
60. Ibid 940. Professor Loss believes it is more fruitful to consider what evidence has sufficed to prove purpose in specific cases under s 9(a)(2). Refer to Ch. 3 above for a discussion of these matters, and in particular that a finding of manipulative purpose may be based upon inferences drawn from circumstantial evidence. In other words, a motive to manipulate combined with the requisite series of transactions, *prima facie* establishes the manipulative purpose.

concept of a crime that supposedly exists entirely inside the defendant's head.'[61] This accounts for the fact that, absent an admission from the defendant,[62] which occurs rarely, the manipulative purpose is established through circumstantial evidence.[63]

Another significant difficulty with the requirement of proof of 'intention or purpose of inducing others to purchase or sell' is that it can be argued that 'it is the object of *every* bid or offer on the stock market to raise the price to induce another to sell, or to reduce the price to induce another to buy.'[64] '[M]any completely legitimate stock purchases may be at successively higher prices, or on plus ticks[65] at or near the close of trading. Similarly, simply bringing about a price rise . . . is not unlawful in itself.'[66] Consequently, it has been argued that there should be nothing wrongful in such actions *per se*. Rather problems arise 'when transactions are entered into (real or fictional) for the purpose of creating a false or misleading appearance with respect to the price or volume of securities.'[67]

The creation, or likely creation, of a false or misleading appearance of active trading or with respect to the price or volume of securities is covered by the false trading offences under section 998 of the Corporations Law. However the issue of the requisite intent here is also a vexed one.[68] Perhaps the only comment that may be offered with any degree of certainty is that manipulative techniques such as fictitious transactions, which are deceptive or at least wrongful *per se*, rely less heavily on intent to make them manipulative than actual trades.[69] Certainly with respect to section 998(1) intent, although clearly one of the possible elements in the commission of the offence, is not an essential element. Thus a person who *by objective measures* creates, or does anything that is likely to create, a false or misleading

61. Thel, The Mechanics of Securities Manipulation, above n 2, 294. The Second Circuit, in reversing Mulheren's conviction in *United States* v *Mulheren*, 938 F.2d 364, (2d Cir.1991), displayed its uneasiness with this concept: Ibid. However Professor Thel argues that *objective* evidence may demonstrate that a defendant acted with an intent to induce others to trade or to mislead traders. See further n 71 below.
62. Loss and Seligman, above n 2, 940.
63. See further Ch 3 above.
64. Peter Meyer, 'Fraud and Manipulation in Securities Markets: A Critical Analysis of Sections 123 to 127 of the Securities Industry Codes' (1986) *Company and Securities Law Journal* 92, 96. This matter is discussed in greater detail in Ch 3 above. Emphasis added.
65. When stock is sold, the seller is said to be either long or short. A long seller owns the shares and will deliver them to the buyer. A short seller on the other hand does not intend to deliver his own stock, but will deliver borrowed shares. A long seller can sell at any price; a short seller can only sell on a plus tick or a zero plus tick. The plus tick rule is embodied in SEC Rules 10a-1 and 10a-2. The rule effectively states that all short sales on stock exchanges must be made at a price higher than the last sale or last different sale. When an order to sell stock short on the exchange floor is entered, it must be clearly marked as a short sale. This informs the broker on the floor that execution of the order requires a plus tick: Joseph Walker, *Selling Short — Risks, Rewards, and Strategies for Short Selling Stocks, Options, and Futures* (1991) 34, 38.
66. McCabe, above n 11, 223.
67. Ibid.
68. As discussed in Ch 3 above, the formulation of s 998 makes it necessary *inter alia* to delve into difficult questions of intent. In particular there is confusion as to whether s 998(1) presupposes an overriding intentional element in the commission of the offence.
69. Cf. Poser, Stock Market Manipulation, above n 3, 729 who refers to fictitious transactions requiring 'a less specific intent' to make them manipulative.

appearance is as guilty of the offence as a person who intends to bring about this result. Similarly under section 998(3), intent is only partially relevant under the first limb of the subsection, and is not at all relevant under the second limb. Ultimately therefore the concept of intent is a variable, whose meaning depends upon the language of the particular statutory provision in question and the context in which it is used.[70]

The Ambiguous Nature of Alleged Manipulations

Overview

Arguably the most fundamental issue in market manipulation is the difficulty associated with identifying manipulative trades in light of the statutory requirements of the offence. The problem arises principally because manipulation is a concept that relies upon establishing the defendant's state of mind.[71] Since it is usually impossible to say with certainty what motivates a particular trade, the evidence required to prove an offence or substantiate a claim, absent a fortuitous admission by the defendant, will be circumstantial evidence which may itself be inconclusive.

The ambiguous nature of the objective evidence regarding allegations of manipulation is amply demonstrated by three U.S. cases involving allegations of manipulation: *United States* v *GAF Corporation*,[72] the Wickes transaction in *United States* v *Milken*,[73] and *United States* v *Mulheren*.[74] Two of the cases (*GAF* and *Mulheren*) resulted in criminal convictions that were reversed on appeal,[75] and the Wickes transaction ultimately had little

70. Professor Thel also heavily qualifies his definition of the term. He states that '*When used in this article, unless the context otherwise requires*, the word "manipulation" means buying a security for the purpose of increasing the reported price or selling a security for the purpose of decreasing the reported price': Thel, The Mechanics of Securities Manipulation, above n 2, 221 n 17. Emphasis added.

    In his earlier article, Professor Thel regards manipulation as 'conduct intended to induce people to trade a security or force its price to an artificial level': Thel, The Original Conception, above n 13, 393. According to Fischel and Ross, this formulation is unhelpful because the phrase 'inducing others to trade' is 'hopelessly overbroad' and encompasses 'value-maximizing exchanges in which the transaction makes each party better off': Fischel and Ross, above n 1, 507.

71. As seen earlier, Professor Thel refers to manipulation as being '. . . a crime that supposedly exists entirely inside the defendant's head': Thel, The Mechanics of Securities Manipulation, above n 2, 294. See above n 61. The Second Circuit, in reversing Mulheren's conviction in *United States* v *Mulheren*, 938 F.2d 364, (2d Cir.1991), expressed its uneasiness with this concept: Ibid. However Professor Thel argues that *objective* evidence may demonstrate that a defendant acted with the requisite intent to induce others to trade or to mislead traders. In each of the *Milken, Mulheren, GAF* and Princeton/ Newport cases, he states that 'the government offered objective evidence of manipulative intent that was not equally consistent with innocent trading': Ibid 293–4. There were witnesses to conversations in which the defendants were understood to have ordered or authorised manipulations of stock. 'Perhaps the witnesses lacked credibility, or perhaps the conversations were innocent; regardless, it is clear that probative, objective evidence of state of mind may be available in manipulation cases': Ibid 294.

72. 928 F. 2d 1253 (2nd Cir. 1991).

73. 759 F. Supp.109 (S.D.N.Y. 1990).

74. 928 F. 2d 364 (2nd Cir. 1991).

75. Fischel and Ross, above n 1, 527.

impact on Milken. Although the government charged Milken with manipulating the price of the common stock of the Wickes companies, the charge was dropped as part of a plea bargain agreement.[76] The matter was then raised at an evidentiary hearing prior to Milken's sentencing, but the judge eventually decided not to consider the Wickes manipulation charge in her sentencing decision.[77] Nevertheless the circumstances of the case 'do show that manipulation can sometimes be successful and quite profitable'[78] — and carried out with impunity.[79]

United States v *GAF Corporation*

GAF Corporation, its vice chairman James Sherwin and certain subsidiaries were indicted on multiple felony counts relating to false entries in books and records, improper margin loans and securities law violations for allegedly manipulating the stock price of Union Carbide Corporation in 1986 to facilitate a negotiated transaction.

In October 1986, GAF held almost 9.6 million shares of Union Carbide common stock after an unsuccessful tender offer. The price of Union Carbide stock had been falling for several months, and GAF began to solicit buyers for all or part of its block of stock. Knowledge of the availability of GAF's block threatened to depress the price of Union Carbide further. It was alleged that Sherwin asked the chief executive officer of Jefferies & Co., a registered broker-dealer that specialised in trading large blocks for institutional investors, whether it could make Union Carbide stock close at or above a specified price for several days in a row. On October 29 and 30, 1986, Jefferies bought significant blocks of Union Carbide shares near the close of trading which it sold on November 3 and 4 at a loss. On November 6 and 7, Jefferies purchased additional blocks of Union Carbide shares shortly before the close of trading. These it sold on November 10–12 without incurring any loss. GAF sold five million shares (approximately half its holding) in a negotiated transaction on November 10.[80]

There were three trials arising out of these events: after two mistrials, GAF and James Sherwin were convicted by a jury in federal court in December 1989. However a federal appeals court reversed those convictions ruling that the defendants had been denied a fair trial because of errors by the trial judge. GAF prosecutors decided, in the interests of serving justice, not to seek a fourth trial.[81]

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76. Milken agreed to plead guilty to other charges.
77. Thel, The Mechanics of Securities Manipulation, above n 2, 248–9.
78. Ibid 249.
79. Professor Thel points out that, although we do not know what Milken did, he does not appear to have disputed the fact that someone at his firm, Drexel Burnham Lambert, manipulated the price of Wickes stock; he simply denied that he did it: Ibid. However legal liability was sheeted home to no-one.
80. Professor Thel points out that 'manipulative schemes are often most interesting — and, for the manipulator, most attractive — when the profit comes not from trading at the manipulated price, but from a contract or other arrangement that will provide the manipulator with a profit if price moves in a particular direction or reaches a certain level': Thel, The Mechanics of Securities Manipulation, above n 2, 247–8.
81. Milo Geyelin and Arthur Hayes, 'Legal Beat', *Wall Street Journal* (New York), 12 August 1991.

The interpretation of the sequence of events has been widely divergent and this is reflected in the academic literature. Fischel and Ross argue that the facts of *GAF* illustrate 'the ambiguous nature of alleged manipulations.'[82] The government had argued that Jefferies manipulative intent was obvious because it made the purchases at the end of the trading day. Fischel and Ross counter that 'end-of-day trades are common and therefore do not distinguish manipulative trades from non-manipulative trades.'[83] Furthermore the small price increases accompanying the trades on October 29 and 30 do not establish manipulative intent. These increases might be explained by other factors such as liquidity costs, the bid-ask spread or a rise in the overall market.[84] Finally the existence of the guarantee against loss, which the government alleged proved manipulative intent, 'proves nothing because such a guarantee might merely have been a means to allow Jefferies & Co. to trade as GAF's agent.'[85]

Fischel and Ross argue that the purpose of the alleged manipulation is unclear. They consider the government's claim — that the scheme was designed to increase the price of Union Carbide common stock in order to attract buyers and increase GAF's profit in a negotiated sale — implausible.[86] Small changes in the price of the stock at the end of trading on 29 and 30 October could not reasonably be expected to have any effect on the sale price of a large block of shares eleven days later.[87] Furthermore, parties negotiating a price on 10 November would have taken into account all relevant information including all past price movements. The closing price on a particular day, let alone a day some two weeks earlier, 'would have been of no particular significance.'[88] Finally the shares purchased at the end of October were sold at a loss on November 3 and 4, a week prior to the block sale. Consequently this sale 'negated any possibility of profit from the alleged scheme, which suggests that there was never a scheme in the first place.'[89]

Professor Thel challenges these arguments on all fronts. Jefferies, he states, *probably did cause* the price of Union Carbide to close higher on 29 and 30 October, notwithstanding Fischel and Ross' suggestion that there might be other explanations.[90] Furthermore GAF was trying to sell its stock as Jefferies was trading. Thus the market's collective judgment and that of the eventual buyer might have been influenced by earlier prices when valuating the Union Carbide stock.[91] In any event the critical issue was not what GAF did after Jefferies sold, but what it wanted to do when Sherwin approached Jefferies to buy. GAF

82. Fischel and Ross, above n 1, 528.
83. Ibid.
84. Ibid 529.
85. Ibid.
86. Ibid.
87. Ibid.
88. Ibid.
89. Ibid.
90. Thel, The Mechanics of Securities Manipulation, above n 2, 269–70. Emphasis added.
91. Ibid 270.

had an interest in the price of Union Carbide stock in late October and it stood to benefit from a scheme such as the one the government alleged.[92]

Ultimately Professor Thel's conclusion that 'Jefferies' trades *might indeed* have been designed to get a better price for GAF'[93] merely suggests a possibility. This does not satisfy the criminal standard of establishing the elements of the offence, including manipulative intent, beyond a reasonable doubt. In all the circumstances the prosecutors' decision not to proceed further to a fourth trial appears to have been the correct one.

The Wickes transaction in United States v *Milken*

At the relevant time, Wickes had over US$200,000,000 of exchangeable preferred stock outstanding, paying a 10% dividend. It wished to redeem this stock as soon as possible but was constrained by a redemption feature that stipulated that it could not do so until 1 May 1988, unless the closing price of Wickes common stock equalled or exceeded $6 1/8 (the threshold price) on twenty of thirty consecutive trading days. Milken and Drexel, Wickes' investment banker, stood to receive substantial fees in connection with a redemption.[94]

As of the close of trading on 22 April 1986, Wickes common stock had closed at or above the threshold price for nineteen of twenty-eight consecutive days. A closing price at or above the threshold price on either of the next two days would trigger the necessary condition for redemption. It was alleged that Milken asked Ivan Boesky to purchase enough Wickes stock to cause it to close at or above the threshold price and allegedly guaranteed Boesky against loss. During the last half hour of trading on the American Stock Exchange on 23 April 1986, the Boesky organisation purchased 1.9 million shares of Wickes common stock, which closed at the threshold price. Wickes then redeemed the preferred stock and Drexel received a fee of US$2.3 million for underwriting the redemption. Thereafter Wickes stock price declined and Boesky sold his shares at a loss.

Fischel and Ross argue that these facts 'demonstrate that alleged contract-based manipulations, like trade-based manipulations, can also be ambiguous.'[95] A number of interpretations for the trading are equally plausible. On the one hand, because the price movement necessary for the manipulation to succeed was small ($1/8), the manipulator might have reasonably expected to be able to sell the shares at approximately the price paid for them. Since the purpose of the alleged manipulation was to profit from the contractual redemption provision, any trading losses thus incurred would be small and might not have deterred this conduct.[96] Thus, '[o]n one level, the alleged scheme appears plausible.'[97]

However, according to Fischel and Ross, an alternative explanation for the trading is also plausible. Milken, Boesky or both might simply have believed that the Wickes stock

92. Ibid.
93. Ibid 269. Emphasis added.
94. Thel, The Mechanics of Securities Manipulation, above n 2, 248–51; Fischel and Ross, above n 1, 530–1.
95. Fischel and Ross, above n 1, 530.
96. Ibid 530–1.
97. Ibid.

represented a good investment opportunity.[98] Or they might have believed that the threshold condition for redemption was likely to occur in any event and the price of the stock would rise as a result.[99] At the time, it may therefore have seemed likely that Milken and Drexel would receive the underwriting and advisory fees from redemption without manipulating the stock. Thus Fischel and Ross conclude that it is 'impossible using objective evidence to distinguish between the manipulative and non-manipulative explanations for the trading.'[100]

Professor Thel is unwilling to place such a generous interpretation on the events. Wickes was an important client that generated over US$118 million in fees and commissions for Drexel. Milken and Drexel wanted to keep the client happy and the client wanted to redeem the preferred stock.[101] Further 'Milken and Drexel stood to reap another, albeit unquantifiable, benefit if the redemption right was triggered, because they would be able to tell potential clients of their success with the Wickes preferred.'[102] Milken might therefore have opted for the certain profits of a redemption triggered by manipulation rather than rely on the vagaries of the market rising on its own.[103] Overall, according to Professor Thel, the Wickes transaction presented Milken and Drexel with a profitable opportunity for manipulation and if the allegations were true, 'the scheme could hardly have been anything else.'[104]

United States v *Mulheren*

John Mulheren, the chief trader and general partner of Jamie Securities Co., was indicted on parking and market manipulation charges in relation to Gulf & Western Industries, Inc. common stock.[105] In 1985 Ivan Boesky's companies had purchased some 3.4 million shares of Gulf & Western, which represented approximately 4.9% of the outstanding stock.[106] Later that year Boesky had discussions with Martin Davis, Gulf's chairman, in which he canvassed various ideas including taking control of the company, increasing his position or selling his shares back to Gulf at $45 per share.[107]

After the close of trading on 16 October 1985, Boesky again offered to sell his shareholding at $45 per share. Davis replied that the company would repurchase his shares,

98. Ibid 531.
99. Ibid.
100. Ibid.
101. Thel, The Mechanics of Securities Manipulation, above n 2, 249 n 147.
102. Ibid.
103. Ibid 251.
104. Ibid 250.
105. James Stewart, *Den of Thieves* (1992) 426.
106. Fischel and Ross, above n 1, 532.
107. Ibid.

but only at the price at which Gulf's stock last traded on the New York Stock Exchange at the time of the transaction.[108]

Boesky spoke to Mulheren before 11:00 a.m. on 17 October. Boesky testified that he told Mulheren that he 'liked' Gulf's stock but 'would not pay more than 45 for it' and 'it would be great if it traded at 45.' Mulheren replied, 'I understand.'[109] Shortly thereafter Jamie Securities placed two orders through a floor broker for the purchase of a total of 75,000 shares of Gulf stock. The latter block of 25,000 shares was purchased at $45 per share at 11:10 a.m. Seven minutes later, Boesky sold his stock back to Gulf & Western at $45 per share. The value of the stock declined during the course of the afternoon and Jamie sold its position at the end of the day for a loss of US$64,406.[110]

Mulheren was indicted for, among other things, purchasing 75,000 shares of Gulf & Western stock for the purpose of raising its price to $45 per share.[111] The government claimed that Mulheren's sole intent was to affect the price of Gulf's stock in order to help Boesky.[112] The jury at first instance agreed with the government's argument that Boesky conveyed in their telephone conversation that he wanted Mulheren to trade in such a way that the price of Gulf' stock would move to $45 and that Mulheren did what he was asked to do.[113] On appeal the Second Circuit concluded that the government had failed to carry its burden of proof, and that no rational jury could have found guilt beyond a reasonable doubt. The meaning of Boesky's cryptic conversation was ambiguous at best.[114] The court then concluded 'that the observable characteristics of Jamie's transactions — including their size, their method of execution, and their lack of profitability — were at least as consistent with investment intent as with manipulative intent.'[115] The court reversed Mulheren's conviction.

Fischel and Ross support the court's analysis as being consistent with their own thesis that 'the observable characteristics of trades cannot distinguish trades made with bad intent

108. Ibid.

109. Ibid 533.

110. Ibid; Thel, The Mechanics of Securities Manipulation, above n 2, 254–5. The further financial ramifications of the transactions are explained by Professor Thel. Although Jamie lost some sixty four thousand dollars on its trades, 'Boesky made a much larger profit on the price change those trades occasioned. The 1/4 point rise in the reported price of Gulf & Western . . . resulted in Boesly receiving about $850,000 more than he would have received had Jamie not traded. This figure may in fact understate the profit Boesky stood to realize from moving the price, because he might not have been able to sell at all if the price had stayed below $45 . . . The $850,000 figure certainly understates the total profit that resulted from the price change that Mulheren's trades occasioned, because Icahn [a prominent arbitrageur and long-time friend of Boesky] sold his stock to the company at the same time Boesky did. Together, Boesky and Icahn realized $1,678,925 more than they would have if they had sold at the price that prevailed before Mulheren's purchases. Leaving aside the cost of the subsequent litigation, the profit from the price change greatly exceeded the costs associated with the trades that produced it': Ibid.

111. Thel, The Mechanics of Securities Manipulation, above n 2, 253.

112. Fischel and Ross, above n 1, 533.

113. Thel, The Mechanics of Securities Manipulation, above n 2, 253.

114. Ibid; Fischel and Ross, above n 1, 533.

115. Fischel and Ross, above n 1, 533.

from trades made with good intent.'[116] Professor Thel concedes that as 'in the case of the Wickes allegations, we do not know why Mulheren had his firm trade.'[117] In all, a disappointing result for the government which had considered the case a relatively straightforward one:

> The Mulheren case, unlike Freeman's or Milken's, was considered one of the most straightforward cases coming out of the Boesky agreement, and a comparatively easy one to try. The government had two major cooperating witnesses in Boesky and Davidoff. During January, Boesky had given the grand jury an incriminating account of his dealings with Mulheren, including the parking allegations and numerous instances of stock manipulation and of stock tips suggesting insider trading. For example, Boesky had testified that he had told Mulheren to "push up the price" of Gulf & Western, and that Mulheren had replied, "I understand what you're saying."[118]

Concluding remarks

An examination of recent market manipulation cases gives a concrete sense of the density and complexity of the issue of manipulative intent. These cases of alleged manipulation leave the status of intention vague. They illustrate that manipulative intent is often hard to identify and price-affecting trades may cause damage to the integrity of the market regardless of the reason for which they are undertaken.[119] The debate between Fischel/Ross and Professor Thel as to the interpretation to be placed upon alleged manipulations is itself testament to the ambiguity surrounding manipulative intent. Consequently if the law continues to treat motive or intent to induce people to trade a security or force its price to an artificial level as the key in defining manipulation, the result will be uncertainty as to what is and what is not manipulative conduct. Ultimately this leads to unsuccessful attempts at prosecution for manipulation offences.

The Controversy Surrounding Computerised Program Trading — Should it be Defined as Stock Market Manipulation?

Statutory and theoretical descriptions of the offence apart, stock market manipulation has traditionally been understood to involve certain distinct market practices identified in the United States and more recently in Australia. These practices were documented by the Australian Senate Select Committee on Securities and Exchanges which reported over the

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116. Ibid.
117. Thel, The Mechanics of Securities Manipulation, above n 2, 253. However it is implicit in Professor Thel's account of the case that there was manipulative intent. He states: 'Jamie's trades caused the market price of Gulf & Western stock to increase 1/4 point in about six minutes . . . Not only did Jamie's purchases boost the price, Mulheren could have predicted that they would do so': Ibid 254. Professor Thel subsequently refers to *Milken* and *Mulheren* as being 'prominent examples of recent manipulation schemes': Ibid 255. This assumes manipulative intent, contrary to the findings of the court.
118. Stewart, above n 105, 425.
119. Thel, The Mechanics of Securities Manipulation, above n 2, 223.

period 1971 to 1974.[120] The Rae Committee described three particular market practices as manipulative. These were 'pools',[121] 'churning' in shares, and organised 'runs' on shares — all of which have been discussed in an earlier chapter.[122]

In more recent times, computerised program trading has occupied a prominent place in discussions and debates about market practices in the United States' securities industry.[123] Program trading and its associated strategies, index arbitrage and portfolio insurance, have all been associated with the stock market crash of 1987 and also the market break of 1989. In the view of many observers, these trading practices caused these crashes and need to be restricted.[124] The interesting question thus arises whether, in the aftermath of the 1987 stock market break, such trading is properly to be regarded as manipulative and should be regulated accordingly:

> Many commentators attribute the stock market break of October 1987 at least in part to the concerted selling of institutional investors, especially those engaged in program trading or following reactive portfolio insurance plans.[125]

Program trading

> Computerized trading and its offspring *program trading*, have been the major topic of discussion and debate in the securities industry for many years. Some participants see them as necessary; others call for their banishment. Computer trading programs have been blamed for everything from the market crashes of October 1987 and October 1989 to the crash of the New York Yankees in 1990.[126]

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120. Report of the Senate Select Committee on Securities and Exchange (AGPS, 1974), commonly referred to as the Rae Committee Report.
121. Reminiscent of the typical 'bull' pools of the years before the SEC: Loss and Seligman, above n 2, 844.
122. Refer to Ch 2 above and Appendix A below.
123. It should be noted at the outset that neither the Australian Securities and Investments Commission nor the Australian Stock Exchange Limited has formulated its own policy on computerised program trading: confirmed in conversation with Jim Berry, Head of the ASX Surveillance Division; and by Malcolm Rodgers, Special Policy Adviser, Regulatory Policy Branch, Office of the Chairman, ASIC, Facsimile Transmission. Malcolm Rodgers advised that ASIC has not formulated a policy on program trading as this issue has not arisen in Australia, but it is following the U.S. debate on the matter. As to whether program trading would be regarded as manipulative under s 997 of the Corporations Law, see n 127 below.
124. Henry McMillan, 'Regulatory Responses to Program Trading and Index Arbitrage: Circuit Breakers and Rule 80A' in Kenneth Lehn and Robert Kamphuis (eds), *Modernizing US Securities Regulation* (1992) 439.
125. Thel, The Mechanics of Securities Manipulation, above n 2, 225 n 31. The comment has been made that computer trading programs have been blamed for 'everything from the market crashes of October 1987 and October 1989 to the crash of the New York Yankees in 1990': Walker, above n 65, 153. Again, Fischel and Ross state: 'More generally, the stock market crash of October 1987 raised anew the question whether certain trading practices, such as program trading, manipulated the market by causing a severe decline in securities prices': Fischel and Ross, above n 1, 505.

    See generally, SEC Staff Report, 'The October 1987 Market Break' (February 9, 1988) *Federal Securities Law Reports* (No. 1271, extra ed). This is a Report by the Division of Market Regulation, U.S. Securities and Exchange Commission. The Report commented that it may never be known what precise combination of investor psychology, economic developments and trading technologies caused the events of October 1987: Ibid xi.
126. Walker, above n 65, 153.

Program trading highlights the subtleties and complexities — and practical ramifications — inherent in the controversy surrounding the meaning of manipulation. If the intentional use of trading to influence price is called 'manipulation'[127] then the authority granted to the SEC by section 10(b) would undoubtedly extend to 'contemporary practices as diverse as program trading, arbitrage, poison pills, stock-parking, and corporate abuses of control over dividend policy.'[128] On the other hand, if manipulation requires deception as the U.S. Supreme Court has ruled — in other words if manipulation is not 'independently significant'[129] — then the SEC under section 10(b) cannot regulate disruptive practices unless they can properly be characterised as deceptive. Inasmuch as program traders are not normally intent on misleading anyone, it is difficult to describe their actions as deceptive.[130] Thus program trading, according to this interpretation, cannot be regarded as manipulative *per se* and is outside the ambit of SEC regulatory authority.

Program trading is a generic term used to describe 'a market technique in which common stocks and stock index futures are simultaneously purchased and sold when a disparity in their value is determined by a computer program.'[131] The New York Stock Exchange, Inc. has defined program trading as 'any trading strategy involving the related purchase or sale of a "Basket" or group of 15 or more stocks having a total market value of $1 million or more.'[132] Program trading therefore 'is not a monolithic strategy, but rather encompasses several distinct trading strategies,'[133] the two predominant ones being index arbitrage and portfolio insurance.

The genesis of program trading is to be found in the early 1980s when major institutional investors in the United States, such as pension funds, universities and investment companies, together with some of the larger brokerage firms, 'sought to apply the advances in modern computer technology to the art of timing investments.'[134] Program trading, closely allied to and dependent upon computerised trading, is also inextricably linked to stock index futures which were introduced in the United States in 1982 and have since

127. Thel, Regulation of Manipulation, above n 2, 429 who notes that the Securities Exchange Act does not forbid trading that changes price, only the intentional use of trading to influence price. The effect of the s 997 formulation should be noted here. It is arguable that program trading would *not* be regarded as manipulative under s 997 of the Corporations Law for the reason that, although a price effect may occur, or be likely, or may even be intended, program traders typically lack the intent to induce other persons to come onto the market as required by s 997.
128. Thel, Regulation of Manipulation, above n 2, 360.
129. Ibid 427.
130. Ibid 428. Apart from program traders, others who move price are often motivated to do so in order to avoid their contractual obligations or to trigger those of other parties. Such contractual obligations are frequently defined by reference to market price: Ibid 370.
131. Walker, above n 65, 181.
132. New York Stock Exchange, Inc., The Official Constitution and Rules of the New York Stock Exchange Inc. 2080a, Rule 80(A)(C)(i), at 2656 (1990): McCabe, above n 11, 207 n 7.
133. McCabe, above n 11, 216; also see SEC Staff Report, above n 125, 1–1 to 1–17 which describes some of the basic strategies employed by participants in the index markets, including asset re-allocation, hedging, portfolio insurance amd index arbitrage or substitution. It also discusses other forms of 'program' trading such as buying or selling baskets of stocks without related transactions in futures or options.
134. Walker, above n 65, 153.

become one of the most actively traded products in the futures markets.[135] With the inception of index futures and index options trading, the challenge was to find a method for maximising the potential of these derivative instruments by implementing trading strategies that would encompass both the securities and the derivatives markets.[136] The 'best known (and perhaps least understood) of these strategies is program trading.'[137] Thus the true growth of computer trading programs began 'when the futures were combined with the actual market for stocks to implement programs dictated by a computer.'[138]

Although the small investor rarely participates directly in program trading, he or she is certainly affected by it. An understanding of program trading is therefore important to investors and to all those interested in the operations of securities markets:

> All investors must have some understanding of this market strategy. As with other strategies, you may never apply it to your own investing, but you must know what it is. It affects the market, and you as well, on a daily basis.[139]

Two predominant types of program trading: index arbitrage and portfolio insurance

As stated earlier, the success of futures contracts depended upon the creation of trading strategies which would encompass both the futures and the equities markets. The two predominant strategies that were devised for this purpose were index arbitrage and portfolio insurance.[140] Both rely on specific mathematical formulae and computer programs to determine the timing and profitability of each transaction.[141] However, although both strategies have been subsumed together under the general rubric 'program trading', they each serve different and distinct functions.[142]

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135. Ibid 152–3. An index is an instrument used to trace the price movement of a large group of stocks. It provides a more accurate reading of general market trends than would the price changes in a single stock. While contracts are available on many indexes, the most popular one is the Standard & Poor's 500 Stock Index. The S&P 500 is traded on the Chicago Mercantile Exchange. Settlement of futures contracts is made in cash rather than by delivery of the underlying securities: Walker, above n 65, 147, 177. This text provides a useful description of the trading mechanisms and the applications of index futures: Ibid Ch 10. Also see McCabe, above n 11, 210–5 in relation to the origins of index futures trading.
136. McCabe, above n 11, 216.
137. Ibid.
138. Walker, above n 65, 152. Thus, essentially, program trading is an offspring of computerised trading and involves the implementation of programs dictated by a computer. It was developed in the early 1980s when, using a variety of sophisticated systems, computerised programs were created 'that emitted signals that the time to buy or sell had arrived': Ibid 153. For the history of the methodology employed in program trading, see Walker, above n 65, 153–4.
139. Ibid 153. It should be noted that short selling plays a major role in computerised trading.
140. McCabe, above n 11, 215.
141. Ibid 218.
142. Ibid 215.

Index arbitrage

Program trading and index arbitrage are terms frequently used synonymously.[143] The idea is simple enough: if a security 'trades for different prices on different markets, then arbitragers can profit by buying on the low-priced market and simultaneously selling on the high-priced market. They will continue to do so until prices on the two markets come together.'[144] In reality index arbitrage is a sophisticated hedging process which combines buy or sell orders in particular stocks with an offsetting position in index futures.[145] Whichever direction is being followed, the trader will purchase one of the products and sell the other short.[146] The theory of index arbitrage essentially 'holds that participants in the markets who are fast on their feet can take advantage of discrepancies that open up between the price of the futures contract and the prices of the underlying stock.'[147] Thus, put simply, program arbitrage trading is 'large-scale trading in response to price discrepancies between markets.'[148]

The best publicised of such 'anomalies' between markets is index arbitrage between the futures contract for the S&P 500 stocks and the cash market for these stocks on the New York Stock Exchange.[149] The basic principle of an arbitrage between a futures index, perhaps the S&P 500, and the actual stocks included in the index is straightforward:

> ... the basic principle can be stated very simply: if a trader finds a discrepancy between the value of the index and the total value of the underlying securities, and the proper orders are entered, an index arbitrage is made.[150]

The index arbitrage can work in either direction. Therefore, if the value of the index future is greater than that of the underlying stocks, the trader would purchase the stocks and sell the index futures short.[151] Furthermore, the profits on individual trades do not have to be very large in order for the strategy to be successful:

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143. Indeed, when the term program trading is used today, it generally refers to the hedging process known as index arbitrage: Walker, above n 65, 155.
145. Walker, above n 65, 155. In order to implement the arbitrage, the arbitrageur must initiate either a sell or buy program. A sell program, based on trigger information, simultaneously sells the underlying securities and buys the index options or futures. A buy program simultaneously buys the underlying securities and sells index options or futures: McCabe, above n 11, 216.
146. Walker, above n 65, 155. Selling short is a technique used to take advantage of an anticipated decline in the price of a security or commodity futures contract, or to protect a profit in a long position. Essentially, selling short is the sale of a security or commodity futures contract that is not owned by the seller. Instead the investor borrows stock certificates for delivery at the time of the short sale. If the seller can buy that stock later at a lower price, a profit results; if the price rises, on the other hand, a loss results.
147. Martin Mayer, *Stealing the Market* (1992) 94. (Herein referred to as 'Stealing the Market').
148. Thel, Regulation of Manipulation, above n 2, 426.
149. Martin Mayer, *Nightmare on Wall Street — Salomon Brothers and the Corruption of the Marketplace* (1993) 69. (Herein referred to as 'Nightmare on Wall Street').
150. Walker, above n 65, 156.
151. Ibid 157. There is no doubt that 'program trading has opened up vast new avenues for the short seller. Each arbitrage finds one side to be a short sale': Ibid 158.

> . . . understand that the users of these programs are large institutions, banks, pension funds, universities, and corporations. They do not need huge profits on single trades to be successful. If they can improve on the return provided by U.S. Treasury bills, they have done their job.[152]

In other words, by 'using computers to calculate premiums and to order trades quickly, arbitragers can realize significant profits by trading large amounts of securities which trade at only a small premium to each other.'[153] Much of the concern about program arbitrage trading thus arises because of the effects which follow from the enormous scale on which it is done.[154]

Irrespective of the particular direction of the index arbitrage and the profit margin involved, 'a cascade of buy or sell orders descends on the . . . trading floor':[155]

> Prices move up or down sharply, possibly in a matter of minutes. The variation was not instigated by analysis of financial statements, government economic reports, or any other standard measurement of market condition. Charlie the computer made the decision. If he said sell, then the price of your General Motors stock may be driven lower. If Charlie said buy, your short position in Exxon might be in jeopardy.[156]

Index arbitrage is considered by some market analysts to make the market more efficient. The argument proceeds as follows.[157] Although the individual arbitrageur profits, the futures markets' inherent sensitivity to economic news creates a more efficient market. Furthermore, due to the relative inefficiency in the equities market, the arbitrageur corrects the pricing errors of the specialists and market makers in equities:

> Essentially, the arbitrageur levels the discrepancy between prices on the stock exchange and on the futures exchange and speeds the stock exchanges' reaction to economic information and news.[158]

It is further contended by supporters of program trading that it adds to the marketability of securities by increasing the volume of trading.[159] As its effects are generally short-term, it plays no part in the determination of a stock's underlying value.[160]

These program trading strategies do however have negative side effects. In the first place, the precipitousness and size of the market moves attributed to index arbitrage

152. Ibid 156. In addition, many dealers engage in index arbitrage for their own accounts.
153. Thel, Regulation of Manipulation, above n 2, 426.
154. Ibid.
155. Walker, above n 65, 157.
156. Ibid.
157. McCabe, above n 11, 216–7.
158. Ibid 217.
159. Walker, above n 65, 157–8.
160. The point has also been made that 'computers are the modern method of analysis. If you outlaw the computer as a decision maker, you must also outlaw the automatic transmission in your car and the dishwasher in your kitchen': Ibid 158.

indicate that some of the movements may be planned and manipulative.[161] Furthermore not only does index arbitrage decrease reaction time[162] but, significantly, it transfers selling pressure from the futures exchanges to the stock markets.[163] This transfer of selling pressure in turn 'is often read by individual investors as a lack of confidence in the overall market.'[164] A snowball effect may then be triggered with individual investors joining in the selling, causing 'a downward spike'[165] in the market's prices which may precipitate further index arbitrages. In addition, some critics allege that index arbitrage causes excess volatility by generating surges of one-sided market orders (either buy orders or sell orders) straining cash market liquidity.[166]

There is no general consensus amongst market analysts as to whether computerised program trading caused the October market crashes in 1987 and 1989,[167] nor as to its

161. Mayer, Stealing the Market, above n 147, 95. Referring to the five firms repeatedly engaging in index arbitrage in heavy volume by 1991, and noting how difficult it is to take advantage of the discrepancies that open up between the price of the futures contract and that of the basket of underlying stock, Mayer argues that it is virtually impossible 'to believe that they were in fact earning their returns from this activity by passively reacting to differences in the movements of the futures contract and the calculated index . . .': Ibid. Mayer also quotes James Coxon, chairman of the investment policy committee at CIGNA, the giant insurance company, who is reported as having told a House of Representatives committee in 1990: 'The truth today is that stock-index futures are used by a small group that had determined how to game the system and benefit from volatility that is excessive, unnecessary, and perhaps induced': Ibid. I W Burnham, former chairman of Drexel Burnham and of the Securities Industry Association, is also quoted as having written in The Wall Street Journal, 3 October 1988: 'Those who really handle the large amounts of institutional money have the discretion to buy and sell whenever they wish and increase the volatility on both sides': Ibid. However, admittedly, it is not clear how much of all program trading falls into the category of planned manipulation.
162. 'It is of the essence of index arbitrage that the other leg of the transaction be executed immediately, which means that nobody has time to stop and look at ticks. There is virtually no chance that all or even most of the four hundred or so stocks traded in the basket designed to match the index will be sold on up-ticks in a day of rapidly declining prices': Ibid 104.
163. McCabe, above n 11, 217; McMillan, above n 124, 441 noting that the 1988 Report of the Presidential Task Force on Market Mechanisms (the Brady Report), convened after the market break of 1987, and the Report of the Division of Market Regulation of the SEC, convened after the market break of 1989, both pointed to anecdotal evidence suggesting a tendency for program trading and especially index arbitrage to transfer excess volatility from the futures market to the stock market.
164. McCabe, above n 11, 217. No doubt if such trading were to systematically lead to a lack of investor confidence, it would not be allowed to continue.
165. Ibid.
166. McMillan, above n 124, 441.
167. Professor Thel states that '. . . at least some of the official reports put a substantial part of the blame on program trading': Thel, Regulation of Manipulation, above n 2, 425.

A contrary view as to the relationship between program trading and the crash is expressed by Jonathan Macey, Mark Mitchell and Jeffry Netter, 'Restrictions on Short Sales: An Analysis of the Uptick Rule and Its Role in View of the October 1987 Stock Market Crash' (1989) 74 *Cornell Law Review* 799, 829–31. The authors disagree with the commentators and major reports that analysed the crash, including the Brady Report and the SEC Division of Market Regulation Report, and concluded that program trading had become a significant factor in increasing overall market volatility and turning a market decline into the crash. They argue that recent empirical evidence on the effects of program trading is not consistent with the popular view that program trading caused the crash. Indeed the evidence is such, they argue, that much program trading was more a consequence of the crash than a cause of it: Ibid 831. McMillan, above n 124, is of a similar view.

ultimate potential to distort the market by causing inordinate market rises or falls. However there is no doubt that it can contribute to their severity, thus undermining confidence in the market on the part of investors:

> A market begins to decline for some unrelated reason, and the computers flash the sell signal. As the orders pour in, the velocity of the decline increases. The process follows one of the basic laws of mechanics: an object in motion tends to remain in motion unless acted on by a superior force. Perhaps the securities industry should supply that superior force. [168]

This situation has led to the observation that '[w]hether or not there is a problem, there continues to be pressure to respond to what is seen as a problem, perhaps by discouraging computerized trading or by changing the markets in order to minimize the effects.'[169]

Portfolio insurance

Although there are numerous strategies encompassed by the term portfolio insurance, the core of these is disciplined buying or selling triggered by pre-set parameters relating to substantial market movements (and usually in the same direction as those market movements).[170] This type of hedging system was devised and implemented by large brokerage firms with a view to protecting the equity holdings of their large institutional clients from sudden market shifts, thereby encouraging their continued participation in the market.[171] The strategy, referred to as portfolio insurance, involves the use of stock index options and stock index futures to correct and hedge the institutional clients' security positions:[172]

> Similar to index arbitrage, perceived value differentials between stocks and futures trigger the program's activity as the portfolio managers attempt to reallocate assets before they are hit by a stock market decline. Portfolio insurance is a purely reactionary strategy. As the stock portfolio loses value in comparison to the index futures, the insurance mechanism is triggered. At this point, a manager fearing losses will sell index futures or options to avoid taking a bath in the securities market. Portfolio insurance can only achieve its goals if it meets two prerequisites: (i) the disciplined selling (or buying) of futures contracts at trigger points in a declining market: and (ii) the presence of liquid futures markets.[173]

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168. Walker, above n 65, 155.
169. Thel, Regulation of Manipulation, above n 2, 425–6.
170. SEC Staff Report, above n 125, 1–2. The Report notes that portfolio insurance strategies are roughly analogous to the use of 'stop-loss' orders in individual securities where a sell order is created if the market price of the security falls to the 'stop' price. Traditional stop-loss orders, however, are generally placed with an exchange specialist, providing him and indirectly the market as a whole with an indication of potential selling activity. Portfolio insurance, on the other hand, is handled by an upstairs firm and does not provide any prior warning of the amount of potential selling activity that it represents — either to the specialist or to other market participants generally: Ibid.
171. Walker, above n 65, 158. Walker notes that portfolio insurance, as the term is understood today, replaced an earlier system that proved to be insufficient to cope with the crash of 1987: Ibid.
172. Ibid; McCabe, above n 11, 217–8: 'Portfolio insurance uses computer generated models to compute the optimum stock-to-cash ratios of particular equity holdings.' Before the introduction of index futures and options, hedging usually consisted of asset reallocation. This is the shifting of percentages of the portfolio back and forth from stocks to bonds as the markets shift: Ibid 217 n 77.
173. McCabe, above n 11, 218.

The brokerage firm may also sell stocks as the market declines to protect its position still further.[174] Since these protective measures are only utilised during periods of market decline, 'the sales by the broker will exacerbate the fall, causing increased losses to holders of the stocks so affected.'[175] These are frequently small investors whose 'position in the market, always risky, becomes further threatened by these machinations of the professional traders.'[176] Thus, as in the case of index arbitrage, portfolio insurance may lead to the transference of selling pressure from the futures to the securities markets, significantly increasing the volatility of the latter.[177]

Circuit breakers and other controls on program trading

Circuit breaker is a generic term attached to a variety of mechanisms that alter trading rules under specified circumstances.[178] The 1988 Report of the Presidential Task Force on Market Mechanisms,[179] convened following the market break of October 1987, made the recommendation that circuit-breaker mechanisms should be established to shut down panicked markets.[180] The Brady Report argued that circuit breakers confer three major benefits. First they can limit credit risks and loss of financial confidence by providing a 'time-out' amid frenetic trading to settle up and ensure that everyone is solvent. Secondly, they are able to formalise the economic fact of life that markets have a limited capacity to absorb massive one-sided volume. Finally, circuit breakers facilitate price discovery by providing 'time-out' to pause, evaluate, inhibit panic, and publicise order imbalances to attract value traders to cushion violent movements in the market.[181]

The Chicago Mercantile Exchange instituted circuit breakers for its S&P futures contract effective 20 October 1988.[182] At the same time, the New York Stock Exchange implemented controls that have the effect of halting trading in securities if the market rises or falls more than a stated amount within a particular trading session.[183] These circuit

174. Walker, above n 65, 159.
175. Ibid.
176. Ibid.
177. McCabe, above n 11, 218: on the Friday before Black Monday, 'portfolio insurers were responsible for approximately $2.1 billion in transactions on the futures markets which, in turn, transferred nearly $1.7 billion in selling pressure to the stock exchanges': Ibid. McCabe also points out that, after Black Monday, the shortcomings of portfolio insurance as a hedging device became obvious in that whoever pulled the trigger first might be the only one insured: Ibid.
178. McMillan, above n 124, 443.
179. Commonly referred to as the Brady Report.
180. See generally McMillan, above n 124, 442.
181. The Brady Report, above n 179, 66.
182. McMillan, above n 124, 443. The CME's circuit breakers for the S&P futures contract were first triggered on October 1989: Ibid 444. There is little empirical evidence on these breakers largely because the limits have been triggered only a few times: Ibid 445.
183. Thus if the Dow Jones Industrial Average falls below 250 points, trading in stocks is halted for one hour. The cessation of trading is extended for an additional two hours following a fall of another 150 points on the same day: Walker, above n 65, 159; McMillan, above n 124, 444, noting that the NYSE circuit breakers have never been triggered.

breakers are, as stated above, designed to 'remove the immediate stress and allow traders and investors time to regroup.'[184] In an attempt to decrease the volatility of markets, the U.S. exchanges and their regulators had earlier responded 'by modifying trading practices and by defining futures and options in a way that has now made trading less disruptive.'[185] Some market structures have also been modified, with exchanges staggering the hours of expiration and trading.[186] More recently Congress has, by virtue of the Market Reform Act of 1990, added section 9(h) to the Securities Exchange Act 1934. This provision is also designed to prohibit or constrain certain trading practices during periods of extraordinary market volatility.[187]

The SEC too has been mindful of the disruptions caused by temporary price changes and imbalances of supply and demand. Its approach thus far has been described in the following way:

> It has used Rule 10b-5 to challenge the purposeful creation of temporary price changes, and it has considered regulating the trading patterns that are used to produce temporary price changes. It has sought, through informal arrangements with the exchanges and through various rules, to minimize the disruption thought likely to result from program trading. It is likely to come under increasing pressure to regulate or even forbid such trading.[188]

Despite the many efforts at control, however, market volatility continues:

> ... there are strong indications that program trading still contributes to market volatility today. *As a result, some have seen fit to label program trading manipulative.*[189]

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184. Walker, above n 65, 159.
185. Thel, Regulation of Manipulation, above n 2, 427: 'For example, on October 21, 1987, the NYSE limited the use of computers to execute trades in the wake of the collapse of prices on October 19. The Exchange said that it acted to protect its facilities, but it may also have intended to reduce volatility and to restore confidence.'

    Professor Thel argues that although program trading does not differ in quality from other arbitrage trading, it differs in the enormous scale on which it is conducted: Thel, Regulation of Manipulation, above n 2, 426.
144. Thel, Regulation of Manipulation, above n 2, 426. Arbitrage consists of 'the near simultaneous purchase and sale of the same or exchangeable securities in the hope of making a profit due to a difference in markets.' Walker, above n 65, 155. An example of arbitrage is the purchase of gold at $360 an ounce in London and, at the same time, the sale of the same ounce at $362 in Zurich: Ibid 155–6.
186. McCabe, above n 11, 220: settlement hours for index-related derivatives were shifted to the opening rather than the close, relieving some of the price pressure. Professor Thel states that some futures and options are now settled at opening rather than closing prices 'on the theory that supply or demand to offset any imbalance can be mobilized more easily during the morning (before the market opens) than during the hectic minutes before closing': Thel, Regulation of Manipulation , above n 2, 427.
187. Loss and Seligman, above n 2, 937–8. The full text of s 9(h) is set out in Loss and Seligman, above n 2, 602. Rule 80A, which restricts index arbitrage trades that link stock and futures markets, has also had the effect of reducing the profitability of index arbitrage by raising its costs and increases its risk by slowing execution time: see generally McMillan, above n 124, 446–8.
188. Thel, Regulation of Manipulation, above n 2, 427.
189. McCabe, above n 11, 220. Emphasis added. Professor Thel argues that concerted program trading is 'inappropriate because it manipulates market prices away from the prices that would prevail if the market worked perfectly or if all market participants traded for reasons and in manners considered appropriate': Thel, Regulation of Manipulation, above n 2, 438. Cf McMillan, above n 124, 448, who argues that the evidence as a whole indicates that index arbitrage is not destabilising.

Essentially the SEC's authority in this area rests on section 10(b).[190] If, as *Schreiber* suggests, nothing is manipulative unless it is deceptive, and the SEC has no authority to regulate non-deceptive conduct under section 10(b),[191] then program trading is beyond the reach of the SEC's regulatory authority. Concerted program trading practices are non-deceptive — they are considered inappropriate 'for reasons that have nothing to do with deception'[192] although they offer ample opportunities for manipulation.[193] Hence the conundrum. The Supreme Court's current interpretation of section 10(b) and rule 10b-5 confers no authority upon the SEC to regulate novel trading practices such as computerised program trading, that are nevertheless believed by some authorities to have a detrimental effect on the public.[194] It has therefore been suggested that:

> The best answer to the SEC's authority problem is to reconsider section 10(b)'s manipulation language and to give it the independent interpretive significance that it deserves.[195]

Market Stabilisation — Should a Regime of Regulated Stabilisation be Introduced into Australia?

Overview

Market stabilisation is designed to smooth out potentially large or sudden swings in price during the first month after listing, but does not guarantee a minimum floor price. Stabilisation of the price of newly issued securities occurs where underwriters take action to ensure that a share price does not suffer an immediate decline at the commencement of trading, so that the initial trade in the securities will take place at an appropriate premium

190. Thel, Regulation of Manipulation, above n 2, 428. It is also possible for the SEC to regulate program trading under s 10(a) 'when it involves the use of short sales or as the functional equivalent of a set of stop-loss orders. The NYSE can effectively regulate the practice by controlling access to its facilities': Ibid 428, n 293.

191. Ibid 388.

192. Ibid 428. In fact, 'they are objectionable precisely because they move market prices even though they do not disclose information': Ibid 428; and again, if 'program trading is objectionable it is not because it deceives anybody, but because it produces damaging dislocations': Ibid 438.

193. It should also be noted that stabilisation, discussed in Ch 3 above, 'seems to be another practice that is manipulative even if not deceptive': Ibid 432. Furthermore, according to Professor Thel, short sales 'are another non-deceptive trading practice that Congress has labeled manipulative': Ibid 435.

It is interesting to note that Professor Berle posed the question in 1938, 'Do mere continuous purchases in volume constitute "manipulation?": Adolphe Berle, 'Stock Market Manipulation' (1938) 38 *Columbia Law Review* 393, 405. His answer: 'It was the view of the writer in 1931 that such purchases did not constitute manipulation, provided they were made with the desire to acquire the security in good faith. There is no law prohibiting a purchaser from buying as much of a security as he can get, at any price he chooses to pay, provided he does so not to influence the actions of others, but to buy the security for himself': Ibid 406.

194. Thel, Regulation of Manipulation, above n 2, 388; McMillan notes that, contrary to his own view, some market participants 'most definitely believe that program trading and index arbitrage increase market volatility and are destabilising': McMillan, above n 124, 448.

195. Thel, Regulation of Manipulation, above n 2, 428.

over the issue price. Where there has been a shortfall — securities not subscribed for at the end of the offer period of an issue of new securities — there may be a desire to maintain the price until the shortfall has been distributed to longer term investors.[196]

The extent to which stabilisation occurs in Australia is not clear, but it is 'generally suspected that some underwriters do engage in stabilising activities.'[197] However under section 997(7) of the Corporations Law, persons are prohibited from taking part in two or more transactions likely to have the effect of maintaining or stabilising the price of the securities with the requisite intent.[198] The Australian formulation of the prohibition against market stabilisation stands at odds with the approach adopted in the United States and the United Kingdom, where stabilising securities prices to facilitate offerings of securities is permitted subject to certain specific guidelines and controls.

In its submission to the House of Representatives Standing Committee on Legal and Constitutional Affairs,[199] the ASX 'observed that different market stabilisation practices constitute an impediment to simultaneous multi-national issues of securities'[200] and recommended that:

> the Australian law should be altered to permit stabilisation, subject to certain clearly identified guidelines, which will ensure adequate disclosure of the stabilisation activities to the market.[201]

The Lavarch Committee recommended that the matter be referred to the Companies and Securities Advisory Committee for further consideration on ways in which market practices, including market stabilisation activities, could be brought into harmony with practices in the U.S. and the United Kingdom.[202]

However in December 1992 a report released by the Australian Securities and Investments Commission recommended against permitting regulated stabilisation in Australia. This recommendation was based on ASIC's view that the lack of stabilisation rules had had no adverse effect on the efficiency of the securities markets, nor was it causing Australian markets to be excluded from international issues.[203] Thus the Australian position on stabilisation continues to remain at odds with the position in major overseas markets.

The regulation of stabilisation in the United States and the United Kingdom

There are leading overseas markets where stabilisation in the period immediately following a float or allotment is permitted, subject to strict compliance with regulatory controls. Such

196. Australian Securities and Investments Commission, *Public Hearing into Underwriting Practices Report*, December 1992, Ch 7 (Herein referred to as 'ASIC Report into Underwriting Practices').
197. Ibid.
198. The intent to induce others to sell, purchase or subscribe for the securities.
199. AGPS, 1991 (Herein referred to as 'the Lavarch Committee').
200. Ibid 2.7.7.
201. Ibid.
202. The Report of the Lavarch Committee, above n 199, 2.7.10.
203. ASIC Report into Underwriting Practices, above n 196, 45; Emma Armson, 'Market Stabilisation in Australia' (1995) 13 *Company and Securities Law Journal* 81, 83.

regulations were first introduced in the United States where stabilisation was common, but where there was concern that it constituted a contravention of the market manipulation prohibitions.[204] In the United States, where nearly all underwriting is US-style or 'secondary sale' underwriting — involving an underwriter or a syndicate purchasing the whole issue and then distributing it to the purchasing public — it was considered desirable to prevent excessive volatility in the distribution period as distribution would be occurring at the same time as the shares were being traded.[205]

The US legislature has empowered the SEC to regulate stabilisation.[206] Hence stabilisation is permitted only if carried out strictly in compliance with the rules and regulations prescribed by the SEC. The current US stabilising rules are contained in Rule 10b-7 of the Exchange Act General Rules and Regulations adopted in 1954. A stabilising bid must be fully disclosed and may only be made for the purpose of preventing or retarding a decline in the open market price of a security. There are strict limits on the price at which such a bid may be made, depending upon the price at which the shares are trading independently.[207]

Stabilisation is permitted in the United Kingdom under section 48(7) of the Financial Services Act 1986 which provides that stabilisation conducted according to the Conduct of Business Rules laid down by the Securities and Investment Board[208] does not constitute a contravention of the market manipulation provisions. The UK Rules, adopted in 1988–89, were largely modelled on the US provisions.[209] Stabilising purchases may be made by a designated stabilisation manager, usually not the underwriter, within strict time limits. As in the US, the price range within which the bid can be made is stricly contolled and there must be full disclosure of the stabilising nature of the bid.[210]

The competing policy considerations

In December 1992 a survey was undertaken of leading participants in the Australian underwriting industry relating to issues raised by ASIC's review of underwriting practices.[211] A total of 20 organisations — prominent merchant and investment banks, stockbrokers and accountants — responded and although the sample was small, it clearly indicated that the majority of respondents were in favour of the introduction of stabilisation rules. A number of strong objections to stabilisation were also expressed:

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204. ASIC Report into Underwriting Practices, above n 196, 42.
205. Ibid. It should be noted that in Australia, traditional underwriting is the predominant form. This involves an underwriter agreeing to take up those securities not subscribed for at the end of the offer period of an issue of new securities (the 'shortfall'). The term 'underwriting' is not defined in the Corporations Law.
206. See Ch 3 above.
207. ASIC Report into Underwriting Practices, above n 196, 42.
208. Referred to as the SIB. See further Ch 5 below.
209. ASIC Report into Underwriting Practices, above n 196, 43.
210. Ibid.
211. Freehill Hollingdale & Page, *Questionnaire on Underwriting Practices*, January 1993.

> Several in the yes camp commented to the effect that if such a policy is acceptable to two of the world's biggest capital markets, it must have some merit.
>
> Several in the no camp believed that the market should be allowed to find its own level and "stabilisation is open to abuse and also prevents a true reflection of price".[212]

As mentioned earlier, ASIC ultimately recommended against the introduction into the Corporations Law of regulation specifically permitting stabilisation of the price of newly issued securities at present. However it considered that the matter should be reviewed in the future in view of the continuing internationalisation of securities markets and the imperatives of harmonisation.[213] The policy debate surrounding this issue is therefore far from settled.

One of the strongest arguments advanced in favour of stabilisation in Australia is that specific stabilisation rules would allow more efficient capital raisings, as the fundraising would not be affected by the volatility of the market associated with the initial flotation of securities.[214] It is argued 'that the deluge of new securities destabilises the market and creates uncertainty. As such, it is assumed that the market does not operate according to the pure forces of supply and demand.'[215]

A further argument in support of a stabilisation regime arises out of the continuing trend towards internationalisation of securities markets.[216] The argument is that the introduction of a stabilisation regime would allow Australia to participate fully in international issues of securities on an equal footing with markets which allow stabilisation. Harmonisation of the regulation of national markets would reduce compliance costs for corporations implementing global issues and encourage the offering of such issues in Australia.[217] It is suggested that Australia may be excluded from such issues if stabilisation were not permitted here.[218] Indeed the ASX has argued that different stabilisation practices represent an impediment to such multinational issues.[219]

Another reason advanced in support of permitted stabilisation is that it encourages the flow of capital to corporations by assisting underwriters in their role of facilitating the successful raising of capital.[220] This benefits investors as well as the corporation. Furthermore,

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212. Ibid 6. 52% of respondents supported a regime of regulated stabilisation; 37% were against and 11% did not respond.
213. ASIC Report into Underwriting Practices, above n 196, 44 and 45. It should be noted that ASIC, in a reversal of policy, subsequently permitted price stabilisation arrangements in the case of the Telstra float, Rocla and the public offering by Winterthur Swiss Insurance Company (WSIC) in mid-1998 of its majority shareholding in HIH International Holdings Australia Limited. Winterthur is the only IPO in which stabilisation trading has been used. This is discussed below.
214. Ibid 43.
215. Armson, above n 203, 85.
216. See generally Vivien Goldwasser, 'Current Issues in the Internationalisation of Securities Markets' (1998) 16 *Company and Securities Law Journal* 464.
217. Armson, above n 203, 85.
218. ASIC Report into Underwriting Practices, above n 196, 43. However ASIC noted that in relation to the News Corporation issue, the Australian market did not suffer as a result of stabilisation not being specifically authorised here: Ibid.
219. See above n 200.
220. Armson, above n 203, 85–6.

in answer to the argument that stabilisation can mask market trends by creating the impression of a greater level of interest in securities than exists, it is said that stabilisation cannot 'prop up' an issue which is a significant failure. This is 'because stabilising bodies are unlikely to be able to keep the market price at or near the offer price where there is intense selling pressure.'[221] Hence stabilisation is thought unlikely to be able to mask a significant market or economic trend.

The opponents of stabilisation point out however that the market should be allowed to operate without action to maintain prices. It is said that the introduction of stabilisation rules effectively defers the operation of the free market for some period of time.[222] It is further argued that stabilisation can lead to the over-pricing of securities.[223] This occurs where, as a result of the impression of market activity created by stabilisation, 'purchasers may be induced to purchase at the artificially high price. They suffer loss where the stabilisation operation ends and the market price dops back to its pre-"pegged" price.'[224]

It is also said that the Australian market differs in significant respects from other jurisdictions. Thus differences in the means by which fundraising occurs, the prospectus procedures and the distribution of securities were much more likely to be the reason that global issues were not offered in Australia, rather than the absence of a stabilisation regime.[225] ASIC's Report on Underwriting Practices noted in particular that the Australian market is relatively small and that the negative effects of stabilisation would be magnified in the Australian context. It concluded that the current legislative regime was neither damaging the efficiency of the markets nor causing international issues to exclude Australian markets from fundraising.[226]

Concluding remarks

The debate as to whether a regime of permitted stabilisation should be introduced in Australia has largely proceeded upon the assumption that the Corporations Law currently prohibits stabilisation. Such an assumption is misplaced. Indeed ASIC's Report on Underwriting Practices notes that the extent to which the current regulations prohibit stabilisation

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221. Ibid 86.
222. ASIC Report on Underwriting Practices, above n 196, 44.
223. Armson, above n 203, 87.
224. Ibid.
225. ASIC Report on Underwriting Practices, above n 196, 44.
226. Ibid 45. Armson argues that ASIC was correct in recommending that regulated stabilisation should not be permitted in the Australian context. She argues that both Australian and US regulators have remained unconvinced that the benefits of stabilisation outweigh its detrimental effects: Ibid 87.

However, in relation to the Telstra float and the market stabilisation facility permitted in relation to it (discussed below), a somewhat different approach is discernible on the part of Alan Cameron, Chairman of ASIC. Referring to ASIC's Report on Underwriting Practices in 1992, he states:

'While we did not recommend permitting stabilisation at that time, our report noted that harmonisation of world securities markets was already under way. Global offerings involving the Australian market, such as Telstra, mean we have to consider the appropriateness of internationally accepted market activities for our own market': *ASIC Digest 1997: ASC Allows Greenshoeing for Telstra,* Media Release 97/221.

action is uncertain.[227] The uncertainty as to whether section 997(7) covers stabilisation activities at all arises because such activities may not be conducted with the requisite *intention to induce* other persons to trade in securities, the crucial mental element required by the provision.[228] For example, 'stabilisation may be undertaken to fulfil an underwriter's obligations under an underwriting agreement, or to persuade other persons not to sell their securities.'[229]

An intention to induce is not required under the equivalent US provision on market stabilisation, section 9(a)(6) of the Securities Exchange Act 1934. However Professor Loss has argued that it cannot be said that stabilisation activities are not for the purpose of inducing other persons to purchase the securities.[230] Interestingly the contrary view was adopted in the context of the Telstra float, in which stabilisation as market manipulation was an issue.[231] Stabilisation bids by the international underwriting syndicate in compliance with agreed procedures were allowed on the premise that they do not constitute market manipulation, subject to an independent valuer's report and disclosure of the nature of the bid to the ASX.[232] Such market stabilisation arrangements, sometimes referred to in the United States as 'greenshoes', require that issuers comply with strict rules about disclosure, bidding and prices that protect market integrity. The Telstra arrangements mirrored the key market stabilisation rules in the United States and the United Kingdom and meant that ASIC would exercise the same supervision in Australia as would major overseas regulators in their markets.

Similarly the public offering by Winterthur Swiss Insurance Company (WSIC) in mid-1998 of its majority shareholding in HIH International Holdings Australia Limited involved a price stabilisation facility. The facility was permitted to operate for a period of 30 days from the date of the purchase agreement between the selling shareholder and the initial purchasers in the international offering.[233] Under the stabilisation arrangements, a US entity was appointed as stabilisation broker with complete discretion, as principal, whether to carry out stabilisation trades and, if so, whether to trade on SEAQ or the ASX. The arrangements also stipulated that the broker was permitted to buy (stabilisation bids) but not sell; that any stabilisation bids would be identified in SEATS as that of Broker 999; that such bids would identify the price and quantity, and would not be higher than the highest

227. ASIC Report on Underwriting Practices, above n 196, 42.

228. Michael Hains, 'Submission to the Australian Securities Commission' (1992) 17 *Butterworths Corporations Law Bulletin.*

229. Armson, above n 203, 82.

230. Ibid. This article proceeds on the assumption, widely-held, that s 997 does cover stabilisation.

231. *ASIC Digest 1997: ASC Allows Greenshoeing for Telstra,* Media Release 97/221.

232. Furthermore any such bids on the ASX must not on any trading day have been higher than the highest independent bid or the first instalment price, with no guaraantee that the market price would not drop below the first instalment price. Note that ASIC had been advised by Senior Counsel that by adopting the agreed procedures, there would be no breach of the Law.

233. That is, from 3 August until 1 September 1998 inclusive.

current independent bid on SEATS.[234] One of the other conditions imposed by ASIC in permitting the 'greenshoe' was that WSIC obtain a report from an independent expert as to its effects. That report having been obtained, it is expected that ASIC will issue a Policy Statement or Practice Note on the operation of greenshoe arrangements.

Whether section 997(7) prohibits stabilisation remains problematic. It is arguable, of course, that stabilisation falls within the broad parameters of the misleading or deceptive conduct provision in section 995 of the Corporations Law. However, by virtue of section 995(3), breach of the section is not an offence and does not lead to the imposition of penalties.

Professor Berle shed light on the conundrum relating to stabilisation some sixty years ago. He pointed out that '[p]ragmatically, support operations may either be solely for the purpose of stock rigging, or solely for the purpose of protection of innocent investors; the fact that the same form may be given to an operation having vastly different purposes and consequences makes the problem a difficult one to handle. Strictly speaking, the intent should govern . . .'[235] It is submitted that, as long as the current formulation of section 997 requires a specific intent to induce, with all the attendant problems of complex psychological analysis, the intent must govern in each individual case and *a priori* assumptions that stabilisation is necessarily manipulative are inappropriate.

Conclusion

In spite of the law's failure to provide a clear definition, the prevention and elimination of various manipulative, deceptive and fraudulent practices were primary objectives of the regulatory system established by the United States securities legislation of the early 1930s[236] as well as the legislative predecessors of sections 997 and 998 of the Corporations Law.[237] It is, however, difficult to evaluate their success in achieving this goal given that

234. Australian Stock Exchange, Circular to Member Organisations 'HIH Winterthur International Holdings Ltd Instalment Receipts — Market Stabilisation Facility and Role of Broker No. 999', 30 July 1998. Apart from requiring a high level of transparency in the dealing, the other main regulatory requirement was that a Chinese Wall exists around the designated stabilisation broker entering orders (as a separate entity for trading purposes). Adequate Chinese Walls were designed to prevent the passage of information between the stabilisation broker and other brokers. For a critique as to the efficacy of Chinese Walls, see Vivien Goldwasser, 'Recent Developments in the Regulation of Chinese Walls and Business Ethics — In Search of a Remedy for a Problem that Persists' (1993) 11 *Company and Securities Law Journal* 227.

235. Adolphe Berle, 'Stock Market Manipulation' (1938) 38 *Columbia Law Review* 393, 407.

236. Securities Act 1933, s 17 (a) and Securities Exchange Act 1934, ss 9, 10 (b) and 15 (c) (1) and (2).

237. Prior to the introduction of the Uniform Securities Industry Code in Australia, there existed in four of the six Australian states (Tasmania and South Australia being the exceptions), Securities Industry legislation governing certain aspects of stock market regulation including activities which come within the ambit of what may be described as 'manipulation of securities'. The legislation was not uniform, but broadly speaking it banned, *inter alia*, the creation of market prices by fictions and by false or misleading statements concerning securities; and all kinds of false trading and market rigging: see further Robert Baxt, *The Rae Report — Quo Vadis?* (1974) 105 *et seq* and 114 *et seq*. These disparate provisions were subsequently replaced by ss 123 and 124 of the Uniform Securities Industry Code, the immediate legislative predecessors of ss 997 and 998 of the Corporations Law. These historical developments are discussed in Ch 2 above.

'[w]e do not know how often prices are manipulated, how much harm manipulation does or how existing manipulation rules influence behaviour.'[238]

Nevertheless studies have shown that manipulation in the securities markets may be common and is probably more prevalent than widely believed.[239] Unlike insider trading which can be detected by observing large or unusual movements in trading patterns preceding the public announcement of a significant corporate event,[240] stock market manipulation reflects the more complex problems in the operation of the market.[241] In essence it is extremely difficult to identify manipulative *intent*[242] — the vital element that distinguishes lawful from abusive trading — and therefore the study of manipulative trading may be necessarily anecdotal.[243]

It follows that if intent or motive is treated as the key in defining manipulation, the result is uncertainty as to what is and what is not manipulative conduct. This uncertainty lies at the heart of the debate surrounding computerised program trading and whether it ought to be regulated under the anti-manipulation provisions:

> The real problem with concerted trading that influences prices is that *regardless of the trader's motivation*, it may undermine the proper functioning of the market and injure people who are not even trading and who have no reason to look at security prices at all.[244]

238. Thel, The Mechanics of Securities Manipulation, above n 2, 287.
239. Ibid 222. Professor Loss contends that the practice of market manipulation is 'probably as old as the securities markets': Loss and Seligman, above n 2, 929.
240. Jonathan Macey and Hideki Kanda, 'The Stock Exchange as a Firm — The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges' (1990) 75 *Cornell Law Review* 1007, 1034.
241. Ibid.
242. Clearly the motive with which trading is conducted may not be apparent, and the same trade may be carried out with different motives. Indeed it has been asserted that share price manipulation is even more difficult to detect than insider trading: Ibid. It may well be the case that the 'central problem posed by the antimanipulative provisions of the Exchange Act lies not in what activities are manipulative, but rather in how to differentiate between what is manipulative and what is legitimate market activity by broker-dealers': Wolfson, Phillips and Russo, above n 52, 2.12.

    The judgment of Mason J in *North* v *Marra Developments Ltd* echoes the same concern. In the course of discussing whether actions are 'calculated to create a false or misleading appearance of active trading' in contravention of s 70 of the Securities Industry Act 1970 (NSW), he observed that the word 'calculated' meant 'designed' or 'intended' and continued: 'It is not altogether easy to translate the generality of this language into a specific prohibition against injurious activity, whilst at the same time leaving people free to engage in legitimate commercial activity which will have an effect on the market and on the price for securities. Purchases or sales are often made for indirect or collateral motives, in circumstances where the transaction will, to the knowledge of the participants, have an effect on the market for, or the price of, shares. Plainly enough it is not the object of the section to outlaw all such transactions': (1981) 148 CLR 42, 58.
243. Thel, The Mechanics of Securities Manipulation, above n 2, 223.
244. Thel, Regulation of Manipulation, above n 2, 438. Emphasis added.

In the related and analogous area of commodity trading regulation, many commentators have suggested that a redefinition of manipulation is the solution.[245] The difficulty with this approach is that:

> Even if the definition of manipulation is altered to the form suggested by commentators, courts and the agencies will still be saddled with determining whether there has been a real "hindrance" or whether particular acts are "uneconomic," "fraudulent," etc. The burden and difficulties of proof remain. Moreover, simply defining manipulation will not correct the problem because, whatever the definition, the same issues and concerns will arise . . . The result will predictably be the same . . . because no one wants to stifle trading and the competitiveness of the markets by punishing traders who may unintentionally affect market prices in some adverse manner.[246]

A similar argument may be advanced in the context of securities manipulation. Experience to date in Australia has shown that the effect of reliance on concepts such as intent (ie. to induce people to trade a security or force its price to an artificial level) and on narrowly circumscribed or undefined legal terms has been to overcomplicate the issue and nullify the prohibition. Furthermore there is little prospect that enforcement of a redefined notion of manipulation will significantly improve the situation and ultimately be any more successful than existing formulations. By raising similar issues and concerns, it is likely to produce a system of regulation as costly and as inefficient as enforcement of existing provisions.

However this does not mean that a broad and flexible prohibition against manipulation is not required. In fact it may well be appropriate to introduce in the Australian context a broad prohibition against manipulation that will sweep up unusual or novel manipulative techniques.[247] Furthermore:

> The definition of manipulation is important . . . because the law of manipulation presumes a free market where prices rise and fall according to genuine supply and demand — an economic model of the securities markets that seldom accords with reality.[248]

The statutory language of the anti-manipulation provision must clearly indicate its constituent elements. An obvious shortcoming with both sections 997 and 998 is that although they are geared towards outlawing certain manipulative practices, they do not provide an all inclusive definition of manipulation. Price manipulation is primarily governed by section 997. Yet the specific intent component used in section 997 — to induce a person to trade a security — is overly restrictive and should be avoided. This approach shifts emphasis away from a person's actions to proof of a specific intention to induce another to sell, buy or

245. Jerry Markham, 'Manipulation of Commodity Futures Prices — The Unprosecutable Crime' (1991) 8 *Yale Journal on Regulation* 281, 358–9. The argument here is that, in order to eliminate the price distortions and economic damage produced by market manipulations, the Commodity Futures Trading Commission should intervene more actively in the marketplace, significantly expand its surveillance to detect potential manipulations and take early action to curtail them. For a critique see Robert Lower, 'Disruptions of the Futures Market: A Comment on Dealing with Market Manipulation' (1991) 8 *Yale Journal on Regulation* 391. The suggestion is made here that the solution lies in developing properly structured and well-conceived trading rules, and in allowing the exchanges to deal with threats of price distortion.

246. Ibid 359–60.

247. Ibid 361.

248. Wolfson, Phillips and Russo, above n 52, 2.12.

subscribe for securities. This has the effect of unduly restricting the operation of the section and permitting unscrupulous trading to escape regulation. For example, program trading would arguably *not* be regarded as manipulative under section 997 of the Corporations Law for the reason that, although an artificial price effect may occur, or be likely, or may even be intended, program traders typically lack the intent to induce other persons to come onto the market as required by section 997. Nevertheless a person who does not have the intention to induce others may be manipulating the market for other purposes.[249] A legislative approach is therefore required which has the capacity to deal with concerted program trading — a practice which, although not invariably manipulative, presents ample opportunities for manipulation.

The 'intent to deceive' approach favoured by the United States Supreme Court is not entirely satisfactory either. It too has hindered the law in dealing with innovative trading strategies such as concerted program trading. Such strategies are beyond the parameters of the prohibition against manipulation because, as stated earlier, they may undermine the proper functioning of the market *regardless of the trader's motivation*. A broad brush approach, guaranteeing maximum flexibility, is therefore to be preferred in any reformulated anti-manipulation provision.[250]

249. Michael Hains, 'Submission to the Australian Securities Commission' (1992) *Butterworths Corporation Law Bulletin* [297].

250. See Ch 6 below and Vivien Goldwasser, 'The Regulation of Stock Market Manipulation — A Blue-Print for Reform' (1998) 9 *Australian Journal of Corporate Law* 109.

Chapter 5

Other International Perspectives on Market Manipulation

Introduction

Comparative analysis is not new to the subject of Australian securities regulation. The Senate Select Committee on Securities and Exchange, whose 1974 report constitutes the seminal study of market manipulation in Australia, recognised the need to keep informed on current thinking and developments within the securities industry world-wide, and accordingly sought and obtained extensive information from overseas countries.[1] The jurisdictions from which advice and information were sought were principally the United Kingdom, South Africa, the United States of America, Canada and Japan. Special attention was paid to the work of bodies such as the U.S. Securities and Exchange Commission and the London and New York Stock Exchanges. Professor Louis Loss, the leading U.S. authority on stock market regulation, was also approached to brief the Committee.[2]

There can be no doubt that in order to improve the performance of our securities markets and maintain public confidence by ensuring adequate protection for investors, due regard must be paid to international trends in securities regulation.[3] Great emphasis has already been placed throughout this study on the U.S. regulatory framework with respect to price manipulation. That this should be so is not surprising given that the United States has the largest and most active securities market. However, as many other countries have had to deal with stock market manipulation, this chapter provides an overview of the regulatory approach in several other jurisdictions to ascertain whether there are any lessons for law reform to be learned from their experience.

1. Report of the Senate Select Committee on Securities and Exchange, *Australian Securities Markets and their Regulation* (AGPS, 1974) vol.1 ix. (Herein referred to as 'the Rae Committee').
2. Ibid x. Even today, experts on securities regulation in the U.S. are asked to advise Australian parliamentary committees: see the Report by the Senate Legal and Constitutional References Committee, 'The Investigatory Powers of the Australian Securities Commission' (AGPS, 1995) 0.29.
3. The role of the Australian Securities and Investments Commission in this context is spelled out in s 1(2) of the Australian Securities and Investments Commission Act 1989 (Cth). It is required to strive to improve the performance of securities markets and to ensure adequate protection for investors. 'If the ASC does not concern itself with international trends the result may be a failure to fulfil this objective': Michael Heffernan and Alan Shaw, 'The Role of the Australian Stock Exchange' in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia and New Zealand* (1994) 472. Furthermore, '[t]here are trade-offs that need to be made to ensure Australia's regulation of the market does not get too far out of step with the rest of the world': Ibid 471.

In determining the choice of laws for comparison, it must be recognised that incomparables cannot usefully be compared. If the comparative approach is to be successfully applied, the systems must be naturally or functionally comparable. In other words it is a pre-requisite that the systems which are to be the subject of comparison are 'those of societies which share a broadly similar cultural and social heritage, and which are at a broadly similar stage of development.'[4] These criteria largely explain the choice of the United Kingdom, Canada and New Zealand for this overview of 'other international perspectives' on the subject of securities price manipulation.[5] In particular the United Kingdom, like the United States, is of special historical relevance in the context of the Australian approach to dealing with securities market abuses. Many of the provisions of the Corporations Law have remained unchanged for years, having been adapted from earlier UK and U.S. legislation.[6]

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4. Robert Drury and Peter Xuereb, 'Introduction' in Robert Drury and Peter Xuereb (eds) *European Company Laws — A Comparative Approach* (1991) 2.
5. It was said many years ago that one of the things that England, Canada and the United States had in common was their securities laws. (The same may also be said of Australian securities laws). This was reflected in their disclosure philosophy, anti-fraud provisions and reliance to some extent on self-regulation by the stock exchanges. In addition their judicial precedents 'are to a considerable extent interchangeable': J Peter Williamson, *Securities Regulation in Canada* (1960) v.

   These nations all share the same common law heritage. The focus on these jurisdictions is further justified on the following bases:

   — London, the largest financial centre in Europe, is one of the world's most important equity markets and has been a financial centre for centuries; furthermore reform of UK laws with respect to market manipulation has taken place within the last ten years — one of the most recent innovations to have taken place. The view of a European commentator as to the significance of UK developments is also instructive:

   'It is probably not an exaggeration to say that . . . in the area of the supervision of securities activities, the UK has consistently been in the forefront of new developments in Western Europe. It has not always immediately found the most effective solutions but its endeavours in these difficult areas are invariably of great interest and bound to have considerable influence elsewhere': Jan Dalhuisen, *The New UK Securities Legislation and the E.C. 1992 Program* (1989) preface;

   — New Zealand is geographically our neighbour within the Australasian sphere, and both nations (ie the UK and NZ) are important trading partners;

   — Proposals for a federal securities market law for Canada published in 1979 incorporated reform of Canada's scheme of regulation of market manipulation. Although the federal scheme has not come to fruition, the Anisman Committee proposals for Canada (see n 43 below) provide useful insights into (relatively) current thinking on the subject of securities market regulation.

   It should be noted that the following comparative study is not intended to be a comprehensive account of the regulation of stock market manipulation in the UK, Canada and New Zealand. That is beyond the scope of this work. Rather it is a summary of the most salient features of regulation in these jurisdictions.
6. Roman Tomasic and Stephen Bottomley, *Corporations Law in Australia* (1995) 660, referring to the U.S. Securities and Exchange Act 1934 and the UK Prevention of Fraud (Investments) Act 1958. Many of the basic techniques for regulating securities misconduct were developed initially in England and refined in other common law countries, especially the United States. See Ch 2 above.

United Kingdom

The prohibitions governing fraud and manipulation

The present system of UK regulation was established by the Financial Services Act 1986,[7] which set up the Securities and Investment Board[8] to regulate all investment-related activities ranging from dealings in shares and debentures, options and futures to unit trusts and insurance contracts.[9]

The Financial Services Act 1986 is 'a lengthy and complex statute containing many specific requirements and prohibitions'[10] whose primary objective is the establishment of a regulatory framework for the conduct of investment business. Its other objectives are:

> to protect investors, achieve the efficient provision of financial services, promote international competitiveness, enhance confidence in the United Kingdom as a clean place to do business, and provide the flexibility to respond to change. These objectives are to be achieved, however, without imposing undue burdens on individuals or businesses.[11]

Among the provisions of the FSA relating to business conduct are two key prohibitions relating to fraud and manipulation. Broadly speaking section 47(1) covers misleading statements, promises or forecasts whilst section 47(2) concerns market manipulation.[12] The former category of offence makes it illegal for any person to make a statement, promise or forecast that he or she knows to be misleading, false or deceptive; to dishonestly conceal any material facts; or to recklessly make a false, misleading or deceptive statement, promise or forecast. This provision is not new. The language is very similar to section 13 of the Prevention of Frauds (Investments) Act 1958 (UK), which remained in effect until the FSA became operative in 1988. The provision is broadly comparable to section 999 of the Corporations Law which governs false or misleading statements in relation to securities.[13]

Of greater interest and relevance to the present discussion is the anti-manipulation provision of section 47(2), which makes it illegal for any person to commit any act or engage in

7. Herein referred to as the FSA.
8. Herein referred to as the SIB. This is the umbrella agency, a private limited company, organised for the specific purpose of exercising delegated government powers under the FSA.: Poser, below n 10, 88.
9. How Chih Lee, 'Market Manipulation in the US and UK: Part 2' (1993) 14 *Company Lawyer* 123.
10. Norman Poser, *International Securities Regulation — London's "Big Bang" and the European Securities Markets* (1991) 91. The Financial Services Act consists of over 200 sections which are supplemented by seventeen schedules.
11. Ibid. Professor Poser argues, in his critique of the new structure, that the new regulatory system established by the FSA does not appear to be fulfilling many of its objectives, including its ultimate purpose of protecting investors: Ibid 112–8.
12. The s 47 offences are not mutually exclusive. A misleading statement about securities falling within s 47(1) could also create a false or misleading impression as to their value within the terms of s 47(2): Gil Brazier, *Insider Dealing: Law & Regulation* (1996) 258.
13. Section 999 stipulates that a person must not, either recklessly or knowingly, make a statement or disseminate information that is materially false or misleading if it is *either* likely to induce the sale or purchase of securities by other person, *or* is likely to have the effect of increasing, reducing, maintaining or stabilising the market price of securities.

any course of conduct that 'creates a false or misleading impression as to the market in or the price or value of any investments' if the purpose is to create that impression and thereby induce another to trade or refrain from trading.[14] Breach of the provision constitutes a criminal offence. A person found guilty of the section 47(2) offence can be liable, on conviction on indictment, to imprisonment for a maximum term of seven years or to a fine, or both.[15] On summary conviction the maximum penalties are imprisonment for a term not exceeding six months or a fine or both.[16] No civil sanction of contract unenforceability is expressly provided for under section 47.[17] However the issue of the fitness of an authorised person, found guilty of an offence under section 47, to continue to engage in investment business would arise and would presumably be reviewed by the regulators.[18] Furthermore an application to the court could be made under section 61 of the FSA for an injunction to prevent, or for a restitution order relating to profits accruing from, breach of section 47.

An exception to the prohibition against manipulation is made for stabilising activities carried out in conformity with the rules of the Securities and Investment Board.[19] Furthermore there is a defence under section 47(3) if the defendant can show that in the circumstances he or she believed that the actions in question were not creating a false and misleading impression and that such belief was reasonable. This is an objective test and an honest but unreasonable belief is not sufficient.[20] On the other hand, since the burden of proof is on the defendant, he or she does not have to satisfy the criminal standard. Proof on the balance of probabilities is enough.[21] It should also be noted that the defence may not necessarily be applicable simply because a particular course of conduct flows or results from an accepted or established market practice.[22]

The elements of a section 47(2) offence are the following. In the first place, it must be established that the defendant's actions did in fact create a false or misleading impression:

> This is a question of fact and degree in every case. It is therefore always open to the defendant to prove that his actions were so inconsequential that causation has not been proved. A careful study must then be made of the market in that security both before and after the alleged manipulation to demonstrate its effects.'[23]

It might also be open to the defendant to argue that his or her actions simply corrected the price of a security that was seriously undervalued. In a volatile market, this is a forceful

14. Professor Poser summarises the provision and states that the purpose must be 'to create that impression *or* to induce another to trade or refrain from trading': Poser, above n 10, 135. Emphasis added. This is not a correct representation of the specific language of the subsection and perhaps accounts for the difficulties discussed at n 32–35 below.
15. FSA s 47(6)(a).
16. FSA s 47(6)(b).
17. Brazier, above n 12, 258.
18. Ibid.
19. FSA s 48(7).
20. Lee, above n 9, 123.
21. Ibid.
22. Thus it may not be sufficient for this defence to say, effectively, that everyone else does it and has done so for years: Brazier, above n 12, 259.
23. Lee, above n 9, 124.

argument because it may be impossible to ascribe a 'true' value to the security in the circumstances.[24]

Secondly, the transactions must be undertaken for the purpose of creating a false and misleading impression. In this connection, the United States cases ascribe great evidentiary weight to the following matters:

(a) did the defendant use dummy accounts;
(b) did his transactions occur at the end or beginning of the day involving unusually large volumes;
(c) were they accompanied by suspicious circumstances like sending out tip-sheets or bullish newsletters;
(d) were touts or agents employed to push the security.

If the answers are in the affirmative, then the purpose may be presumed.[25]

Thirdly, the transactions must be undertaken for the purpose of inducing another. In this respect section 47(2) is comparable to section 997 of the Corporations Law and section 9(a)(2) of the Securities Exchange Act 1934, in that all require proof of an intent to induce a purchase or sale.[26] As indicated earlier with respect to sections 997 and 9(a)(2), the requisite manipulative purpose can only be proved (absent an outright confession by the defendant) through circumstantial evidence which itself may not be conclusive. Finally, dishonesty may not need to be established because, in common with the Australian anti-manipulation provisions, 'it is not specifically made an ingredient of the offence nor is an intention to defraud.'[27]

The above-mentioned construction of the section 47(2) offence has led one English commentator to observe that 'it would appear that s 47(2) is very strictly defined.'[28] The provision suffers from the inherent disadvantage of requiring proof of the problematic elements of artificial pricing and intent to induce. At the same time, the provision is thought to place undue constraints upon what may be presently acceptable commercial practice by catching some legitimate transactions:

> This will often happen when the activity in question creates a false and misleading impression but the primary purpose is the defence of a legitimate interest, eg share support operations to fend off a hostile take-over or to prevent an unreasonable decline in share prices to stave off creditors. If these operations were disclosed, they would be self-defeating, but any concentrated buying or

24. Ibid.
25. Ibid.
26. Provided the intent to induce is proved, the inducing need not be successful: Ibid. It will be recalled that s 9(a)(2) of the Securities Exchange Act 1934 provides that it is unlawful for any person, directly or indirectly . . . [i] To effect, alone or with one or more persons, a series of transactions in any security registered on a national securities exchange [ii] creating actual or apparent active trading in such security or raising or depressing the price of such security, [iii] for the purpose of inducing the purchase or sale of such security by others.
27. Lee, above n 9, 124; also see Ch 4 n 11–12 above. Cf section 10(b) of the Securities Exchange Act and its implementing rule, SEC rule 10b-5, which require *scienter*.
28. Lee, above n 9, 124.

> selling in a thin market is bound to have a strong impact on the market and inhibit the free interplay of supply and demand.[29]

On the other hand, section 47(2) may not catch certain recognised manipulative devices such as imposing a corner or a squeeze on a security. These 'will involve a limitation of supply but may not necessarily involve an intent 'to induce another' to deal with the securities.'[30] Given these deficiencies in the formulation of the new provision, the suggestion has been made that:

> What is needed is a general anti-fraud provision similar to r 10b-5 which is versatile enough to cope with a corner as well as novel types of manipulation that may appear in the future.[31]

It is therefore surprising to find that Professor Poser has equated section 47 with section 10(b) of the Securities Exchange Act[32] and its implementing rule 10b-5. The position he has taken on this matter is as follows:

> Sections 47(1) and 47(2) of the FSA are roughly comparable to Section 10(b) of the Exchange Act, which prohibits any person from engaging in deceptive or manipulative conduct in connection with the purchase or sale of any security, and its implementing rule, SEC Rule 10b-5, which has become the principal antifraud and antimanipulative rule in the legal armory of the U.S. government and of private litigants. There are three important differences, however, between the UK and the U.S. provisions:
>
> (1) The two FSA provisions, unlike Section 10(b), are self-operative: violation of them is an offense, even in the absence of SIB rules adopted to implement them . . .
> (2) Sections 47(1) and 47(2) are even broader in scope than Rule 10b-5: like the FSA as a whole, they apply to any "investment," which is a more inclusive concept than a "security" (for example, "investment" includes a life insurance or futures contract).

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29. Ibid. Examples of such practices, which may fall foul of s 47, include: '(a) share support operations by a company through another's account to facilitate an exchange offer; (b) an offeree arranges for another (a white knight) to buy its shares to raise the market price beyond a hostile bidder's resources; (c) one bidder sells in a rival bidder to persuade the target company's shareholders to accept their exchange offer instead': Ibid 124.

    It will be recalled that in *North* v *Marra Developments Ltd* (1981) 148 CLR 42, the stockbrokers advising their corporate clients on a reorganisation of share capital as a prelude to taking over and merging with another corporation were held to be in breach of anti-manipulation provisions similar to s 47(2). In this case they devised a scheme to maintain a target price for their client's shares, which were trading at a substantial undervalue of their true worth. Since there was no disclosure of the scheme, a false and misleading appearance of active trading was created.
30. Lee, above n 9, 125.
31. Ibid. The author there suggests that the common law charge of conspiracy to defraud may become a viable alternative to any statutory anti-fraud provision: Ibid. However there are several limitations in this approach to the regulation of securities misconduct. In the first place an individual or company acting alone will escape the net. Furthermore as conspiracy to defraud is a common law crime, with all the attendant problems of criminal proceedings, it will not give rise to any civil liability. A conspiracy to defraud approach therefore offers an incomplete solution to the concerns raised by market manipulation.
32. Section 10(b) provides that it is unlawful: to use or employ [utilising any means or instrumentality of interstate commerce or of the mails], in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

> (3) Unlike Rule 10b-5, Section 47 forbids not only a misstatement or omission that induces a person to enter into a transaction but also one that induces a person to *refrain from* entering into a transaction . . .
>
> It remains to be seen . . . whether the government and private litigants in the United Kingdom will use Section 47 as an all-purpose provision for the prosecution of investment fraud, as Rule 10b-5 has been used.[33]

There is in fact far less resemblance between section 47 of the FSA and section 10(b) of the Securities Exchange Act and its concomitant rule 10b-5 than this argument would suggest. The generality of rule 10b-5 is apparent from its drafting. On the other hand, by incorporating the specific 'intent to induce' requirement — which is not part of the section 10(b) and rule 10b-5 generic formulations — section 47(2) cannot accurately be described as a catch-all provision similar to section 10(b) and rule 10b-5. Indeed the inclusion of the 'intent to induce' component makes section 47(2) roughly comparable with section 997 of the Corporations Law and section 9(a)(2) of the Securities Exchange Act.[34] Both these provisions have in their respective jurisdictions been under-utilised.[35] It is therefore unlikely that section 47(2) will have any future at all as an all-purpose prohibition.

Yet UK regulators are quite able to formulate prohibitions in general terms, as evidenced by the 1987 SIB Rules which prohibit the practice of churning (excessive trading). The SIB had originally conceded that the rule against churning 'is difficult to specify but perpetrators usually know when they are doing it.'[36] Recognising the difficulty in writing detailed rules defining churning, the SIB resorted to a general formulation. Thus a firm may not:

> effect transactions in a discretionary account, nor may it make recommendations to a customer (except one who is a business, experienced or professional investor) that are *likely to lead to* transactions "with unnecessary frequency or in excessive size."[37]

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33. Poser, above n 10, 136–7.
34. Interestingly, in other respects, s 47(2) is similar to s 9(a)(1) of the Securities Exchange Act which in turn is broadly equivalent to our s 998(1). These provisions essentially prohibit wash sales and matched orders when the purpose is to create a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for, or the price of, any such security. The specific purpose requirement has been given a strict meaning: Louis Loss, *Fundamentals of Securities Regulation* (2nd ed, 1988) 851 n 22. *Contra* Norman Poser, 'Stock Market Manipulation and Corporate Control Transactions' (1986) 40 *University of Miami Law Review* 671, 702, who argues that since the only likely purpose of engaging in wash sales and matched orders is to falsify the market, the requirement of specific intent has not been an obstacle to imposing liability for this kind of activity.

    Refer to Ch 3 above for an overview of the way in which the generic nature of s 10(b) contrasts significantly with the relatively elaborate structure erected by Congress with respect to s 9.
35. Professor Loss states that in the more recent cases, the SEC has been deemphasising the s 9(a)(2) approach, although it has never been completely abandoned: Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (3rd ed, 1995) 944. In Australia, there has been only one conviction under s 997.
36. Poser, above n 10, 150.
37. 1987 Rules, Rule 2.08 (2)–(3): Poser, above n 10, 150. Emphasis added. The 1989 Proposal is similar. It simply states that 'a firm shall not (a) deal in the exercise of discretion for any customer, or (b) advise a private investor to deal, if the dealing could in the circumstances reasonably be regarded as too frequent or too large': Ibid. On the other hand Professor Poser predicts that more precise rules relating to churning will eventually be formulated on a case-by-case basis through judicial and administrative interpretation, as they have in the United States: Ibid.

The test here is unambiguously an objective one. Although the remaining elements of the prohibition ie. the likelihood of causing transactions which are *too frequent* or *too large*, are somewhat vague, the advantage of the flexibility thus created is considerable. It can be expected to facilitate the process of judicial and administrative interpretation in fleshing out the threshold requirements of these elements in light of changing circumstances.

Overall it is a matter of some regret that the same broad-brush approach could not have been brought to bear on the drafting of the new anti-manipulation provision in section 47(2). Indeed Professor Poser has acknowledged generally with respect to the FSA that it was political pressure brought about by several major scandals in the UK in the period leading up to the enactment of the FSA and involving insider trading, stock manipulation and other abuses, that succeeded in making 'the new legislation and rules more detailed, more pervasive in their scope, and less flexible than either [Professor] Gower or the DTI had initially contemplated.'[38]

Concluding remarks

The similarities between section 47(2), section 997 of the Corporations Law and section 9(a)(2) of the Securities Exchange Act 1934 are striking. Similar deficiencies exist in the formulation of all three provisions. All are strictly defined, requiring proof of the questionable element of manipulative intent and artificial pricing. The respective Australian and U.S. provisions have proved to be difficult to apply and have been under-utilised. It remains to be seen whether the UK regulators will have any more success with section 47(2).

In terms of Australian law reform, the criticisms levelled against the new UK anti-manipulation provision in section 47(2) should be borne in mind. In particular it is worth recalling the recent observation made by one English commentator that:

> What is [still] needed is a general anti-fraud provision similar to r 10b-5 which is versatile enough to cope with a corner as well as novel types of manipulation that may appear in the future.[39]

Canada

The prohibitions governing manipulation and fictitious trading

Fraudulent market manipulation techniques are dealt with under the Canadian Criminal Code.[40] The problem of wash sales is dealt with in section 382 of the Criminal Code and requires proof of an 'intent to create a false or misleading appearance of active public trading in a security or with intent to create a false or misleading appearance with respect to the

38. Poser, above n 10, 90. Professor Gower was the chief architiect of the new scheme of regulation brought about by the FSA. The DTI refers to the Department of Trade and Industry.
39. Lee, above n 9, 125.
40. Mark Gillen, *Securities Regulation in Canada* (1992) 389.

market price of a security.'[41] This provision, albeit not in identical terms, is the counterpart to the fictitious trading prohibition in section 998(1) of the Corporations Law.[42]

In 1979 the Anisman Committee published its recommendations at the culmination of a lengthy Securities Market Study into the appropriate role of the federal government in the regulation of Canadian securities markets. The recommendations were to take the form of 'proposals' — recommendations to the government, embodied in a draft statute and accompanied by an explanatory commentary. Accordingly a draft Securities Market Act was prepared as part of the Committee's proposals for a comprehensive federal securities market law for Canada.[43]

Section 12.06 of the draft Canadian Act sought to prohibit wash sales and matched orders and appeared to proceed on the basis that specific prohibition of such transactions was sufficient to cover the whole gamut of market manipulation by fictional transactions.[44] The specific prohibition in section 12.06 is 'to create a false or misleading appearance' — ie. wash sales[45] and matched orders[46] are prohibited where it is reasonable to believe that the trade will create a false or misleading appearance of active trading in the security or a false and misleading appearance with respect to the market price of the security.

Section 12.06 was formulated to overcome the difficulty in the source section of the Criminal Code which required proof beyond a reasonable doubt of 'an intent to create a false or misleading appearance of active public trading.'[47] A great deal of concern had been expressed about the effectiveness of the Criminal Code as a means of dealing with wash trading and accordingly section 12.06 avoided the requirement of an intent to create a false or misleading appearance of active trading.[48] Rather it prohibited the specified conduct where it was reasonable to expect that it would have such an effect. The Report stated:

41. Ibid 386. The practice of scalping and other market manipulation frauds are governed by s 380 of the Criminal Code. Scalping involves buying securities just before touting the security in some form of investment news media and then selling the security when the price increases in response to the touting: Ibid 367. In relation to scalping, brokers are required to disclose any intention to trade as principal when they issue a circular, letter or advertisement regarding the security in which they intend to trade: Ibid.
42. The most significant difference is that s 998(1) is predicated upon *either* subjective proof of the requisite intent, *or* upon an objective determination that the misleading appearances were created or likely to be created. The Canadian prohibition only requires proof of subjective intent to manipulate the market.
43. Proposals for a Securities Market Law for Canada (Consumer and Corporate Affairs Canada, 1979). (Herein referred to as 'the Anisman Report'.)
44. Peter Meyer, 'Fraud and Manipulation in Securities Markets: A Critical Analysis of Sections 123 to 127 of the Securities Industry Codes' (1986) *Company and Securities Law Journal* 92, 96.
45. Trades in a security that involve no change in beneficial ownership: s 12.06 (a).
46. An order for the purchase or sale of a security in the knowledge that an order of substantially the same size at substantially the same time and at substantially the same price for the purchase or sale (as the case may be) of the security has been or will be entered: s 12.06 (b) and (c).
47. The Anisman Report states that s 12.06 follows the wording of the Criminal Code which was based on s 9(a)(1) of the Securities Exchange Act 1934: the Anisman Report, above n 43, Vol. 2, 227.
48. Ibid.

> By imposing an objective standard based upon the effect of the prohibited conduct, it removes any possible need to prove a specific intent to manipulate the market. As well, it adopts the approach, reflected elsewhere in part 12, of describing prohibited conduct in objective terms.[49]

In contrast to the analogous provisions in the United States (section 9(a)(1) of the 1934 Securities Exchange Act) and in Australia (section 998(1) of the Corporations Law), section 12.06 only requires the establishment of a reasonable belief that the trade will create a false or misleading appearance. This represents a major alteration in the substance of the fictitious trading prohibition. The draft Canadian provision, by specifying a straightforward objective test and avoiding the difficulties surrounding proof of a specific manipulative intent or purpose, is a significant improvement over section 998(1) of the Corporations Law. It will be recalled that the interpretation of section 998(1) has been beset with controversy.[50] Indeed the argument has earlier been made that the confusion as to whether intent is a necessary element of the offence is hardly surprising given the internal inconsistencies and irregularities of section 998.[51]

Section 12.07 of the draft Act deals with manipulation by trading and is therefore the counterpart to section 997 of the Corporations Law.[52] It is based upon section 9(a)(2) of the U.S. Securities Exchange Act 1934 and the substance of the prohibition is included in section 338(2) of Canada's Criminal Code.[53] In essence section 12.07 states that no person shall purchase (or sell) a security where the effect is to raise (or depress), the price of the security, or where the effect is to create actual or apparent active trading, with intent to induce the purchase or sale of a security of the issuer or its affiliate by another person.

Section 12.07, in contrast to the approach taken with respect to wash trading, does require proof of intent to establish a violation. The Anisman Committee was of the view

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49. Ibid.
50. See Ch 3 n 43–66 above. Much of the difficulty has been created by the deeming approach of s 998(5), which elevates the significance of the element of intent in the operation of the provision and lends credence to the view expressed by Mason J in the High Court decision of *North* v *Marra Developments Ltd*, that the provision presupposes an intentional element. However, a literal interpretation of the subsection makes it clear that the false or misleading appearance must either have been intended or, on a purely objective test, have been the outcome or likely outcome of the actions undertaken. In other words, the section may operate 'wherever a false or misleading appearance was in fact created [or likely to be created], irrespective of the relevant person's intentions.' This has led one commentator to observe that s 998(1) appears to be significantly wider in scope than draft s 12.06, in that an offence is committed whenever a false or misleading appearance is in fact created, notwithstanding that it was not reasonable to believe that a false or misleading appearance would be created: Meyer, above n 44, 96.
51. See Ch 3 above.
52. Meyer has argued that s 12.07 of the draft Act is couched in 'substantially similar terms' to s 997 of the Corporations Law: Meyer, above n 44, 95. However s 12.07 does not cover stabilising purchases (cf s 997(7) Corporations Law). Instead it leaves the matter of stabilising transactions to its proposed Canadian Securities Commission to develop appropriate regulations pursuant to s 12.11: the Anisman Report, above n 43, Vol. 2, 229. It should further be noted that s 12.07 refers to 'purchase a security' and would therefore appear to apply to only one transaction. This is in contrast to s 997 which requires two or more transactions in order to constitute a breach.
53. The Anisman Report, above n 43, Vol. 2, 228.

that while an objective approach was appropriate to wash trading, since the conduct that constitutes the offence necessarily creates a misleading appearance of trading, the same was not true of the activities described in section 12.07.[54] It reasoned that:

> It is possible, in fact likely, that persons often trade in securities for a legitimate purpose in circumstances where it is reasonable to believe that their trades will induce others to trade. Therefore it is necessary to include an intent element in the prohibition of manipulation by trading.[55]

The Committee addressed the issue of proof of manipulative intent by stating that this would depend on the facts of an individual case.[56] There was however assistance to be derived from 'the substantial body of jurisprudence, both judicial and administrative, under the source provision in the Securities Exchange Act of 1934 that can provide Canadian courts with further guidance in the interpretation of the section.'[57]

Overall the draft provision in section 12.07 raises the same problematic issue of intent and artificial pricing as section 997 of the Corporations Law and section 9(a)(2) of the Exchange Act.

Concluding remarks

The 1979 Proposals for a Securities Market Law for Canada have not come to fruition although the hope has been expressed that '[p]erhaps some form of increased federal regulation of securities markets will occur in the near future.'[58] Nevertheless the draft Canadian prohibitions on market manipulation and fictitious trading represent a substantial improvement over the equivalent provisions under the Corporations Law. It has been shown that sections 997 and 998 of the Corporations Law are an unfortunate web of complexity, containing numerous internal deficiencies and creating difficult problems of classification and proof.[59] Another commentator has observed along similar lines that:

> The result of all this is that the legislature has in ss [997] and [998] created an extremely complex set of provisions which overlap to a substantial extent and appear designed to catch manipulative transactions in a haphazard way.[60]

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54. Ibid.
55. Ibid 228–9.
56. Ibid 229.
57. Ibid.
58. Gillen, above n 40, 444. The barriers to federal regulation in Canada mirror those faced in Australia prior to the introduction of the federal Corporations Law in 1991. Increased federal regulation of securities markets in Canada 'will have to address many hurdles such as limitations on the federal power to regulate in the securities area and resistance on the part of provinces to surrendering regulatory power to the federal government, typically articulated as a desire to be able to respond to regional interests and concerns. Continued emphasis on the harmonization of provincial regulation, especially by way of policy statements, is likely to continue, in part to stave off demands for federal regulation': Ibid 444–5.
59. See Ch 3 above.
60. Meyer, above n 44, 98.

This is in contrast to sections 12.06 and 12.07 of the draft Canadian Act. They are drafted in clear and simple language, they are unequivocal as to the elements required to be proved and they operate against the background of a clear articulation of the policy objectives of the legislation.[61] They do not however overcome all problems, in particular subjective manipulative intent remains a requirement of the manipulation by trading offence under section 12.07.

Overall it is curious that the Anisman Committee relied upon sections 9(a)(1) and (2) of the U.S. Securities Exchange Act 1934 as a blue-print for reform of the Canadian manipulation provisions rather than the more popular and more successful section 10(b) and rule 10b-5 formulations. The justification for this particular orientation is not apparent from a reading of the draft documents prepared by the Committee — a surprising omission given that the drafts were prepared for further public discussion and possible adoption as a comprehensive scheme for the regulation of all aspects of the Canadian securities market.

New Zealand

Manipulation and market rigging — the common law

Until very recently, market participants in New Zealand operated within a relatively lax regulatory environment, a fact which may to some extent explain why 'the crash of October 1987 hit the country particularly hard — far harder than it hit Australia.'[62] In the five years following the crash the New Zealand share market, judged by its performance, was very ineffective and furthermore a 1992 opinion survey showed that it was held in very low public esteem[63]:

> A total of forty-four per cent of respondents believed that the share market was manipulated compared to sixteen who did not, and forty per cent said they had no opinion. When asked 'do you think all investors are treated fairly or do you think big investors can manipulate the market?', a total of seventy-seven per cent said that big investors can manipulate the market and only three per cent stated all shareholders were treated fairly.[64]

61. Part 1 of Volume 2 of the Proposals sets out the policy objectives of the draft Act: the Anisman Report, above n 43, Vol. 2, 1.
62. Brian Gaynor, 'Securities Regulation in New Zealand: Crisis and Reform' in Gordon Walker & Brent Fisse (eds), *Securities Regulation in Australia & New Zealand* (1994) 10, quoting Henry Bosch, former Chairman, Australian National Companies and Securities Commission. Another commentator has observed that it would be 'naive to suggest that these [weaknesses in the regulation of the New Zealand share-market] alone were responsible for the impact of the crash . . . ': Peter McKenzie, 'Reforming Securities Regulation in New Zealand' in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia & New Zealand* (1994) 35.
63. Gaynor, above n 62, 10–11.
64. Ibid 11.

The Government-appointed Committee of Inquiry into the Sharemarket concluded that:

> . . . the extent of the falls in equity raisings and turnover represents not just difficult economic conditions but also a major loss of confidence by market participants in the rule-making structure, in the observance of ethical standards and in the general integrity of the sharemarket.[65]

Major deficiencies in regulation were identified — inadequate financial reporting, difficulty in enforcing directors' duties, no effective regulation of takeovers, no insider-trading rules, no effective regulation of the futures market, to name a few.[66] Indeed the 'enthusiasm for a minimally regulated market gave place to calls for greater regulation and an improved regime for disclosure and monitoring of the market.'[67] A number of areas of perceived inadequacy have been addressed in subsequent legislation,[68] and further efforts at law reform continue. However conspicuous by its absence from these efforts is the attempt to place the regulation of stock market manipulation and market rigging under statutory control.

Unlike Australia, New Zealand does not have specific legislation aimed directly at market rigging.[69] Under the applicable criminal and civil rules of the common law:

> A criminal conspiracy can be charged if there is a conspiracy to create a false market by means of
>
> (a) false rumours;
> (b) false statements to the Stock Exchange executive, or
> (c) share purchases in the market at a premium.
>
> However, other devices such as pooling, churning, runs, cornering and short selling are not per se unlawful in New Zealand . . .[70]

Furthermore persons engaged in market rigging by making false representations 'may be liable for the tort of deceit by any person who can show that the misrepresentation was made to induce him to buy. It will be sufficient if it is made to the public at large.'[71]

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65. Report to the Minister of Justice from the Committee of Inquiry into the Sharemarket (31 March 1989) 17 (the Russell Committee).
66. McKenzie, above n 62, 35.
67. Ibid 37.
68. For example, progress has been made in areas such as: disclosure of interests; insider trading; futures contracts; Market Surveillance Panel; improved Stock Exchange settlement procedures; Serious Fraud Office Act 1990; Companies Act 1993, which impacts upon the abuse by directors of their fiduciary position; Financial Reporting Act 1993: McKenzie, above n 62, 38.
69. John Farrar, Mark Russell and Lindsay Hampton, *Company Law and Securities Regulation in New Zealand* (1985) 366. Arguably the Fair Trading Act 1986 (NZ) provides the best practical means of attacking market manipulation. Section 9 imposes a general requirement that persons (defined broadly to include any association of persons whether incorporated or not) acting in the course of their trade shall not engage in conduct that is misleading or deceptive or is likely to mislead or deceive. Similar in scope to the broad parameters of s 52 of the Trade Practices Act 1974 (Cth), an aggrieved party could bring an action against an alleged market manipulator or rigger if there was any conduct that could be classified as misleading or deceptive which caused, or gave rise to, the losses incurred.
70. Farrar, Russell and Hampton, above n 69, 366–7. The courts will not enforce an agreement between those who conspire to rig the market: *Scott* v *Brown, Doering, McNab & Co* [1892] 2 Q.B. 724 (CA).
71. Ibid 367.

Concluding remarks

It is apparent that there exists a great disparity between Australia and New Zealand in the area of securities regulation.[72] In securities law, New Zealand has maintained a less prescriptive regime than Australia, relying instead upon a model which aims to provide private enforcement mechanisms and private remedies. A regulatory approach with a central regulatory body such as the Australian Securities and Investments Commission has also been rejected. So wide is the divide that it is 'unlikely that Australian and New Zealand companies and securities law will be harmonised, let alone duplicated in the foreseeable future.'[73]

Conclusion

Sections 9(a)(1) and (2) of the United States' Securities Exchange Act 1934 constitute the source provisions for many of the anti-manipulation prohibitions that have been enacted subsequently in countries with sophisticated securities markets. For example there are similarities between section 47(2) of the Financial Services Act, section 338(2) of Canada's Criminal Code, section 997 of the Corporations Law and section 9(a)(2) of the Securities Exchange Act 1934. The provision in section 382 of the Canadian Criminal Code, albeit not in identical terms, is the counterpart to the fictitious trading prohibition in section 998(1) of the Corporations Law, both of which are based upon section 9(a)(1) of the 1934 Act.

However the similarities in the anti-manipulation regimes of these countries should not be overstated, as the provisions are not identical and there are some significant differences. Moreover, the provisions suffer from the inherent conceptual difficulty of distinguishing legitimate, non-manipulative trading, which alters the volume of market activity or the market price for securities, from manipulative trading, which has an equivalent market or price effect but is undertaken for a prohibited purpose.[74] Overall it is curious that sections 9(a)(1) and (2) of the U.S. Securities Exchange Act 1934 have been used as the blue-print for the anti-manipulation provisions of the United Kingdom, Canada and Australia to the exclusion of the more popular and more successful anti-fraud formulations in section 10(b) and rule 10b-5.

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72. Peter Fitzsimons, 'Disharmony across the Tasman: Australia and New Zealand on Different (Corporate and Securities) Paths' (conference paper presented to the National Corporate Law Teachers Conference, 6–8 February 1994). The same is true to a lesser degree in the area of corporate regulation. For a discussion of the difference in regulatory temperament in the corporate arena between Australia and New Zealand, see Peter McKenzie, 'Corporate Law Reform — The New Zealand Experience' (1994) 4 *Australian Journal of Corporate Law* 129.
73. Fitzsimons, above n 72. Note that the New Zealand Securities Commission (NZSE) has very limited powers — although it has investigatory powers, it has no powers of enforcement — the thrust of NZ companies and securities laws being to facilitate private enforcement: Ibid.
74. Ashley Black, 'Regulating Market Manipulation: Sections 997–999 of the Corporations Law' (1996) 70 *Australian Law Journal* 987, 1005.

Chapter 6

Options for Reform

Stock market manipulation has long been a source of concern and fascination. Despite the considerable resources devoted by governments and exchanges to curb it, it is still only a vaguely understood phenomenon. Australian law proscribes it but does not satisfactorily define it. Not surprisingly given the silence of the statute and the paucity of caselaw, the legislative provisions operate in a conceptual vacuum.

When freed from restraint, share markets are easily corrupted. Manipulation undermines and destroys investor confidence in the fundamental fairness and integrity of the capital formation system. Given that it is axiomatic that the integrity of the market should be protected, the issue of how this protection is to be effectively crafted and how much substantive regulation is appropriate, is far more difficult, but it is the crucial issue.

Various propositions have been advanced during the course of this study of stock market manipulation. These may be summarised as follows:

(i) Market manipulation is among the oldest and most widely-recognised practices in global capital markets. Manipulation victimises individual investors, erodes public confidence in the market's integrity and undermines market efficiency. The recurring themes of the national public interest, which is inextricably linked to the maintenance of an efficient market, and the protection of investors together constitute the theoretical underpinnings of legislative intervention to control abusive trading strategies. These rationales continue to justify regulatory control in this area notwithstanding controversy as to the soundness of basic manipulation theory.

(ii) The potential for complexity is considerable under the current regime of highly refined market manipulation prohibitions. The most significant problem is to determine the meaning of sections 997 and 998 of the Corporations Law. These provisions contain numerous internal deficiencies and create difficult problems of classification and proof. In particular the central element of manipulative intent — *an intention* to affect prices *for the purpose of inducing others* to buy or sell — is especially problematic. The aim is to discover whether conduct has been intentionally engaged in to induce others to trade, which has resulted in a price which does not reflect basic forces of supply and demand. Proof of manipulative intent however is usually based on circumstantial, rather than direct, evidence. Therefore in the context of the current Australian statutory regime governing stock market manipulation, the effect of reliance on concepts such as a specific manipulative *intent to induce* is to require highly complex psychological analysis which overcomplicates the issue and nullifies the effect of the prohibition.

In the United States, despite the plethora of specific provisions in the Securities Act 1933 and the Securities Exchange Act 1934 covering various types of criminal conduct, the most widely-used provision in both civil proceedings and criminal prosecution for fraud in the purchase or sale of securities is the omnibus section 10(b) of the 1934 Act and rule 10b-5 promulgated thereunder. Although the Supreme Court's rule 10b-5 jurisprudence has restricted the ambit of the rule by requiring *scienter*, the generic nature of the rule has nonetheless enabled it to be used in a wide variety of situations, not the least of which is manipulative conduct in the trading of securities.

In Australia traditional attempts to define manipulation with precision have failed to produce an effective and meaningful regime of regulation. Moreover the solution to the problem of effective regulation of abusive stock market practices does not lie with further precise and highly refined reformulations of the provisions. Manipulation is difficult to define, but manipulative practices and schemes are usually readily identifiable. Statutory formulations of the provisions are therefore required which are broad and flexible, conferring upon regulators and the courts a generous discretion in their implementation. The success of the broadly formulated U.S. provisions — section 10(b) and rule 10b-5 — in dealing with abusive stock market practices, some interpretive difficulties notwithstanding, is testament to the need for legislative provisions with inherent adaptive capacities.

(iii) The definitional problem arises principally because of the absence of a clear statutory definition, and the lack of agreement amongst courts and commentators, as to what conduct constitutes market manipulation. The problem is exacerbated by the requirement of intent and, additionally in the U.S., of deception as prerequisites of the market manipulation offence. The same trade may be carried out with different motives, and since it is usually impossible to ascertain with certainty what motivates a particular trade, significant conceptual difficulties exist in distinguishing proper non-manipulative market participation — which leads to an increase in market activity or an alteration in the market price for securities — from improper manipulative trading — which has a corresponding market or price effect but is undertaken for an impermissible purpose. The conclusion is inevitable that if motive or intent to induce people to trade a security or force its price to an artificial level is treated as the key in defining manipulation, the result is uncertainty as to what is and what is not manipulative conduct.

The program trading controversy in the United States — whether computerised program trading ought to be regarded as stock market manipulation and regulated accordingly — highlights these deficiencies in current notions of what conduct constitutes stock market manipulation. Program traders have thus far been able to escape the net of regulation in the United States since they are typically not intent on misleading anyone. They remain outside the ambit of current formulations of manipulation which require, under rule 10b-5, *scienter,* the intent to deceive. It is arguable that program trading would *not* be regarded as manipulative under section 997 of the Corporations Law for the reason that, although a price effect may occur, or be likely, or may even be intended, program traders typically lack the intent to induce other

persons to come onto the market as required by section 997. Nevertheless concerted program trading, in which substantial investors trade large packages of securities as part of numerous investment strategies, presents ample opportunities for manipulation, that is, artificially inflating or depressing the market for, or the reported price of, any securities.

Furthermore, in the context of the debate as to whether a regime of permitted stabilisation should be introduced in Australia, which has largely proceeded upon the assumption that the Corporations Law currently prohibits stabilisation, as long as the current formulation of section 997 requires proof of a subjective intent to induce others to trade, the intent must govern in each individual case and *a priori* assumptions that stabilisation is necessarily manipulative are inappropriate.

(iv) In terms of the international perspectives that may be brought to bear on the regulation of stock market manipulation, what is most striking at the present time is the considerable degree of pluralism amongst the jurisdictions used in this study rather than congruence. Although sections 9(a)(1) and (2) of the United States' Securities Exchange Act 1934 constitute the source provisions for many of the anti-manipulation prohibitions that have been enacted subsequently in these countries with sophisticated securities markets, resulting in broad similarities in their anti-manipulation regimes, the similarities should not be overstated. The provisions that operate in Australia, the United Kingdom and Canada are not identical and there are some significant differences. They also stand in marked contrast with the generic anti-fraud provisions of section 10(b) and rule 10b-5 in the United States. Indeed the omnibus U.S. anti-fraud provisions have not been replicated for market manipulation purposes elsewhere.

Regarding enforcement, the prohibition against market manipulation is enforceable in Australia through a range of sanctions. The principal weapons in the remedial arsenal are criminal sanctions on conviction, applications for court-imposed discretionary injunctive relief and compensation on behalf of investors. These powers, although substantial, fall far short of those available to the United States' SEC. Unlike the SEC, there is no power available to ASIC to issue cease and desist orders which are required when speed is essential, nor is there any power to order civil money penalties. In addition ASIC is not empowered to rely on consent orders without an admission of liability.

In particular the SEC has used the civil remedies available to it both statutorily and at common law to great effect — it brings a few hundred actions each year and in the great majority of cases, the alleged wrongdoer is either found liable or consents to a judgment being entered against him without an admission of liability. The Commission concentrates on its civil and administrative powers, and criminal prosecutions are brought only in the most serious cases. This approach results in very swift and effective action in the case of minor breaches while maintaining a strong deterrent effect in general.

By contrast, in Australia, where almost exclusive reliance is placed upon the criminal process, very few cases of alleged manipulation have ever been prosecuted. Notwithstanding the undisputed need for vigorously enforced securities laws, the intensely dedicated and aggressive spirit that has been sustained by the SEC throughout nearly six decades, together

with the agency's freedom from political influence, responsiveness to new trends, and flexibility in promoting prompt and effective settlements, have not been prominent features of the enforcement landscape in Australia.

Above all the ambiguity and complexity of the issue of manipulative intent has served to frustrate attempts to enforce the prohibition against market manipulation. Recent cases of alleged manipulation abroad illustrate that manipulative intent is often difficult to identify and price-affecting trades may cause damage by undermining the integrity of the market, regardless of the purpose for which they are undertaken.

In terms of making recommendations for reform, it is important not to underestimate the complexity of the issues involved in regulating market manipulation. Nor should Parliament over-react to corporate and securities failure by examining the need for more strict and detailed corporate and securities legislation. The financial markets may in some areas need less not more regulation. Against this background, the following specific recommendations for regulatory reform are suggested:

(i) The wholesale criminalisation of our securities laws should be questioned. Criminal prosecution is an inefficient and cost-ineffective way of dealing with complex commercial cases. Indeed there is little point to legal proscriptions absent their effective enforcement. Broadly the emphasis throughout should be on downgrading reliance on criminal sanctions and concentrating instead on civil and administrative measures. Such measures are a more pragmatic and efficient use of limited regulatory resources and allow the perspectives of victims of corporate and securities violations to assume appropriate significance. Thus criminal enforcement, which is very limited at present, should only be retained for particularly blatant practices. As for the rest, there is much to be said for reliance upon a civil penalty system.

Indeed the Australian Securities and Investments Commission has publicly indicated its preference for civil remedies over criminal sanctions. Moreover the duties of directors and officers under section 232 of the Corporations Law were decriminalised and became civil penalty provisions in 1993. Civil penalties were further expanded on 1 July 1998 to cover matters such as non-compliance with the procedures for capital reductions under section 256B(1); contravention of the provisions relating to self-acquisition and control of shares under section 259A and 259B; contravention of the provisions relating to financial assistance under section 260D; breach of duty by the responsible entity of a managed investment scheme under section 601FC(1); breach of duty by officers and employees of the responsible entity of a managed investment scheme under section 601FD(1) and section 601FE(1); and the misuse of investment powers by the responsible entity under section 601FG.

(ii) Apart from making the penalty structure far more flexible than it is at present, the penalties for manipulation offences are very low. They need to be supplemented by the introduction of substantial monetary penalties (for example by the introduction of the power to impose treble damages) and changes in the rules of procedure and evidence for particularly intractable offences. Streamlining the judicial process itself must be accorded priority given its difficulty in dealing with complex commercial cases in a timely manner.

(iii) A greater commitment in resources is required on the part of the Australian federal government to the enforcement effort. There must also be greater emphasis on international co-operation and, arguably more importantly, an increased willingness on the part of our regulators to pursue securities law violators more aggressively.

(iv) Stock exchange transacting has become too complex and its problems too subtle to be subject to an overly precise and inflexible regulatory regime. Such regimes contribute little to resolving the difficult issues that regulation of manipulation involves. Thus the highly technical and restrictive nature of the legislative rules in this area must be addressed. These have contributed significantly to the lack of effective regulation. Sections 997 and 998 represent the kind of complexity in statutory drafting that has become obsolete. They should be abandoned and replaced by clearer, and simpler, generic provisions. Overall the goal of regulatory reform of this important area should be the enactment of liberal, flexible and responsive securities laws that facilitate the attainment of business objectives whilst curtailing unacceptable securities misconduct.

Flexibility is the hallmark of the unique system of securities regulation and enforcement that has proved remarkably durable and successful in the United States. There is much to be said for the introduction in Australia of a broad and flexible anti-manipulation provision and its exposition by the courts. Freed from excessive legal restrictions in the form of complex statutory provisions that defy enforcement, successful regulation of manipulative abuse would then be possible in accordance with the spirit of the law. The aim throughout would be to achieve a delicate balance in which destructive practices would for the most part be eliminated without undue interference with legitimate and appropriate trading. Experience has shown that intractable difficulties are encountered in attempting to legislate for a complex and continually changing commercial world.

In order to redress the deficiencies in our system of regulating stock market manipulation, two options suggest themselves. One is the enactment of an anti-fraud provision along rule 10b-5 lines. Although theoretically capable of serving as the model for a revised legislative provision against price manipulation under the Corporations Law, as a practical matter the enactment of an anti-fraud provision is not a viable option at this stage of Australia's corporate and securities development. Among its drawbacks is the fact that implementation of such an overarching and generic provision would be duplicative and require the complete overhaul of many areas of corporate and securities regulation. The better strategy is the enactment of a new anti-manipulation provision to replace sections 997 and 998. It is suggested that the proposed generic provision dealing with stock market manipulation should provide as follows:

> A person shall not, in or in connection with any dealing in securities, manipulate the market for, or the price of, any securities.

It is anticipated that the provision would operate as a civil penalty provision along lines similar to, but not identical with, the regime under Part 9.4B of the Corporations Law. Importantly, contravention of a civil penalty provision is not itself an offence. A person is only guilty of an offence if he or she contravenes a civil penalty provision knowingly, intentionally or recklessly and, in addition, either:

(i) was dishonest and intended to gain an advantage for him or herself or any other person; or
(ii) intended to deceive or defraud someone.

Thus criminal consequences flow from dishonest or fraudulent manipulative conduct. It is further recommended that the new anti-manipulation provision in its civil application should cover those contraventions where the person in question knows or ought reasonably to know that he or she is manipulating the market for, or the price of, any securities. Thus actual knowledge, or knowledge objectively determined, *per se* constitutes a sufficient fault element to establish civil liability. Hence the significance of the proposed anti-manipulation provision, in its civil application, is that it obviates the current need to inquire into the subjective intent of the alleged manipulator and in particular whether he or she has acted with 'intent to induce' others to trade. The proposed formulation creates a civil liability regime where objectively formulated rules may be relevant.

The minimum requirements, then, to make our markets a safer haven for investments from superannuation funds and individuals is the introduction of meaningful statutory provisions backed up by appropriate enforcement mechanisms. To these measures must be added the need for a very clear articulation of the legislative purposes and objectives of market regulation generally, as well as the rationale for the provisions relating to securities misconduct such as those pertaining to market manipulation. Defining what purposes the market should serve, and whose interests are to be protected, would lessen uncertainty as to the course market regulation should take. Allowing the provisions relating to securities misconduct to continue to operate in a conceptual vacuum is no longer acceptable — if it ever was.

The capacity of stock market regulation to respond proactively to a changing commercial and economic environment has traditionally been quite limited. Indeed there is still considerable support for the view that the law should continue to respond cautiously to the difficulties associated with the regulation of manipulation and other forms of market abuse. Yet failure to adjust market rules to prevailing conditions can lead to institutional decline, especially as those conditions become more liquid, flexible, innovative and volatile.

Regulators must respond to the fundamental changes in the nature of our trading markets with a commensurate fundamental re-evaluation of the nature of securities regulation. The exponential growth in the opportunities and potential rewards from violating the securities laws, the increasing integration of national markets and their intermediaries into regional, if not global, networks, and the enormous advances in informational and transactional technology, necessitate the adoption and implementation of new and innovative strategies to deal with changing circumstances. In particular reliance upon old and outmoded legal proscriptions in the world of today and beyond is no longer the answer.

The time has come to turn to innovative strategies in the operation of market regulation. The proposal advanced here is essentially an argument in favour of generic rules that regulate securities manipulation under both civil and criminal law. An eminently realistic goal of regulatory reform in this area is to create broadly honest and orderly markets, where blatant excesses and stock manipulations are left to the province and vagaries of the

criminal law, whilst the bulk of manipulative trades are dealt with as civil penalty violations. Such a legislative scheme would be versatile enough to deal with the more mundane and well-known types of manipulation as well as novel variants that may be devised in the future.

The ultimate dilemma is how to preserve not only the appearance of integrity, but also the actual integrity, of the financial markets. In reality of course the creation of perfectly honest and orderly markets is unattainable. There will always be some episodes of manipulation and other forms of abuse — although hopefully not very many. This is, in any event, what we should realistically expect to see. Moreover a good deal of the manipulative and otherwise abusive conduct that has occurred in financial markets could not have been avoided even with a more sophisticated form of regulation. The truth of the matter is that there are no panaceas. Regulation is bound to be imperfect and cannot be counted upon to resolve every securities violation. Nevertheless attempts should be made to minimise the extent of the imperfections and this can be achieved, it is submitted, through implementation of the proposal advanced here.

Appendix A

Techniques of Market Manipulation

Classic Techniques of Market Manipulation

Churning (in the Australian sense)/pass the parcel: churning occurs where the manipulator acquires a holding of shares and then places both buy and sell orders either through one broker or several brokers in order to create an impression of large turnover. These orders are usually placed at progressively higher prices. The technique is also called 'pass the parcel'.

Churning (in the U.S. sense): brokers generally charge a fee on a commission basis. The commission is usually a percentage of the total amount of each trade the broker performs on behalf of the client. The more trades that are generated, the greater the fees that can be earned by the broker. This creates an incentive for the broker to encourage more trades than are strictly in the client's best interests. Churning involves brokers placing excessive buy and sell orders for shares at about the same price or at slightly rising prices in order to build up the turnover, without regard to the customer's investment objectives in order to generate commissions.

Organised runs: these occur where groups of people create activity in a share by spreading rumours and actively 'pushing' a stock to cause a sharp rise in the price of the share. The purpose is to attract buyers at rising prices to enable the organisers of the run to sell their shares for a quick and substantial profit. Note: a 'run' is the term used to describe a spirited rise in one stock.

Pooling: pools occur where a group of investors/manipulators trade shares back and forth among themselves, usually through one broker, thereby raising volume and giving the impression of active trading in a stock in order to create other investor interest. The objective is to raise the price of the shares and so provide the opportunity for the manipulators to sell their shares at a profit. The technique is similar to churning (as understood in the Australian context) and pass the parcel.

Principal Modern Techniques of Market Manipulation

Matched orders/pre-arranged trades and Wash sales: (these practices were first identified in U.S. caselaw). A *matched order* involves associated parties entering an order for the purchase/sale of shares with the knowledge that similar or corresponding orders will be entered into by other associates. *Wash sales* involve transactions in which there is no change in beneficial ownership in order to create a misleading appearance of active trading in the security.

Pump and Dump: this form of manipulation involves the manipulator using devices to drive up the stock he or she owns, then 'dumping' or selling the shares at an artificially high price.

Hype and Dump (and Slur and Slurp): hype and dump refers to talking up the price of stock, using false or exaggerated reports, rumours, brokers recommendations etc. Once the price has risen, the stock is dumped. The converse technique is known as 'slur and slurp' and occurs when the price of a stock is talked down, allowing the manipulator to buy shares at lower prices.

Ramping/marking (up) the close: this is the term applied to transactions resulting in a quick movement in the share price just before the close of trading. A bid is placed or a parcel is purchased at or near the close which changes the closing price (the bid is often dropped the following morning or a day-only bid is used). The aim is to mislead the market by giving the impression of strength or a high degree of interest in the stock, enabling the shares to be sold at an artificial list price the next day or bolstering the price for the purpose of the financial statements of a company as at a particular day.

Window dressing/painting the tape: this is 'ramping' by institutional investors to allow valuation at desired prices.

Short squeeze: this involves purchasing significant amounts of stock, that is 'cornering' the market, in order to force short sellers to purchase shares to cover their short positions at successively higher prices, thereby increasing the price.

Parking and Warehousing: these occur when one party holds shares really controlled by someone else whose identity is not disclosed. *Warehousing* is the purchase of securities by one party for or on behalf of another party. In warehousing, a substantive transaction has occurred accompanied by an informal arrangement or tacit agreement that the manipulator will indemnify the other party against loss. On the other hand, *parking* involves only sham transactions where the broker-dealer temporarily transfers stock to another broker-dealer or to customer's accounts, often without their authorisation, and 'repurchases' them later at no loss. No *bona fide* transaction has occurred.

The practices of parking and warehousing securities have been utilised by broker-dealers and others as part of manipulative schemes to limit the float of a security. By concealing beneficial ownership, these practices are ideally suited to disguising a manipulator's control of a security. The manipulator avoids alerting the market to the fact that he or she holds more than five percent of the outstanding stock. This failure to disclose operates as a fraud on the market due to the concealment of a material fact.

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