November 2001

Journal of

Financial Crime

The official journal of the Cambridge International Symposium on Economic Crime

Volume Nine *Number Two*

CIDOEC

INSTITUTE OF ADVANCED LEGAL STUDIES

IALS

HENRY STEWART PUBLICATIONS

Journal of Financial Crime is the official journal of the International Symposium on Economic Crime held annually at Jesus College, Cambridge.

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Manipulation

Marvin G. Pickholz and Jason Pickholz

INTRODUCTION

The last decade of the prior millennium witnessed many revolutionary, not evolutionary, changes in the way business is done and information is exchanged globally. The Internet has changed and speeded up the ways we exchange and use information and the time necessary for doing so. This revolution has the potential to reshape the world we live in; to draw us closer together in a global community; and to allow businesses to sell products and services and to raise capital on a global basis simultaneously. Instantaneous satellite transmission of television news coverage informs us of critical events, including financial developments, in distant lands. E-mail allows us to establish business and personal relationships and communicate ideas rapidly with foreign individuals. And we have also seen increased interest among businessmen and others in investing capital in foreign nations and in the securities of companies publicly traded in foreign or international markets. The Internet allows investors to create 'chat rooms' to exchange information and ideas about issuers.

Yet, while these advancements help us to recognise our similarities and share our common hopes and dreams for better lives, they also illuminate our differences, be they cultural, political, or otherwise. These differences have frequently contributed to perceptions of the same events or ideas differing from one country to the next. What individuals in one country might consider immoral or illegal, individuals in other countries might deem acceptable or even admirable. Regrettably, throughout human history the recognition of these differences has often led to fear, distrust, prejudice and even hatred of that which we find strange or do not understand, or with which we disagree.

How then, in this age of international business and investment, are we to alleviate those fears and instil confidence in international securities markets? On the one hand, the answer is very simple; on the other, it is quite complicated and still unresolved. Investors need to feel comfortable that the foreign markets they invest in operate according to established laws and regulations, however those may be defined by the governments of the various nations. They need to know that those laws and principles apply to all participants in the markets, regardless of whether they are foreign or domestic. They need to know that issuers engaged in the same types of businesses based on different countries report their results of financial operations, recognise sales and profits and deal with contingencies and liabilities in the same manner for accounting purposes. And they need to know that they can enforce those principles and regulations through fair and efficient access to impartial courts of law.

But, with different historical experiences, different cultures and different levels of economic development, are there any basic laws or rules pertaining to securities transactions that can be applied universally, so as to afford investors the level of comfort they need to invest money in foreign securities markets and, likewise, to enable developing nations to attract foreign capital? Few if any would disagree with the notion that the unfair 'manipulation' of securities markets by unscrupulous individuals or entities can ruin the personal savings of law-abiding individual investors; cause the bankruptcy or stunt the economic growth of companies whose stock is traded publicly; and, if widespread enough, have severe economic consequences for entire nations, with corollary political ramifications for their respective governments. Therefore market activity must be regulated to prevent such manipulations.

But this only begs the question: what is market 'manipulation'? The answer is that no one can define it in advance, with exactness, but everyone knows it when it has occurred. Attempts to define 'manipulation' result in no more than enunciation of broad, normative conduct. In truth, 'manipulation' is more aptly described in moral concepts than with the precision expected of 'law'. This paper discusses various attempts in the USA to define market manipulation, all of them fact-specific or 'results-oriented' and none of them completely satisfactory. But if we are correct in thinking that a nation with perhaps the largest and most extensively regulated securities markets has no satisfactory definition of 'manipulation' upon which its market participants can rely to ensure compliance with the law, is it possible to establish a universal definition that can

Journal of Financial Crime
Vol. 9, No. 2; 2001, pp. 117–133

ISSN 1359-0790

be applied to all international securities markets? In the end, we posit that it is not the literal definition of 'manipulation' that is nearly so important as the commitment of each nation (1) to adhere to a uniform, internationally recognised system for soliciting, conducting, recording and accounting for transactions; (2) to seek out and prosecute unscrupulous 'manipulative' activity — however that nation defines it — and (3) to allow foreign and domestic market participants equal and impartial access to its courts to prove violations and obtain redress for their injuries.

WHAT IS THE STATUTORY DEFINITION OF MANIPULATION?

> '*Manipulation* — to manage or control artfully or by shrewd use of influence, often in an unfair or fraudulent way'.[1]

Perhaps the best starting point for an inquiry into what 'manipulation' means is to look to how it is defined in ordinary usage. Employing the dictionary definition cited above, it is apparent that 'manipulation' is as old as mankind itself. The manipulation of commercial data, information, facts and figures, has been part of human endeavours, good and evil, for thousands of years. For example, military and intelligence units and governments 'manipulate' information and data, in what are supposed to be the interests of national security. National banks adjusting interest rates 'manipulate' markets and economies. Politicians running for election 'manipulate' the media. Corporations contemplating public offerings increase their business announcements and conduct 'road shows', another form of manipulation. Prosecutors and police, as all lawyers who participate in an adversarial system, 'manipulate' information, in the sense of partial disclosures with emphasis on facts favourable to their proposition and cause.

As with many words, though, 'manipulation' in the context of securities regulation is often considered a term of art, and has been referred to as such by the United States Supreme Court.[2] It would seem logical, then, to look to the definition of that term of art as set forth in the securities laws and rules. Which leads us to our first dilemma: the Securities Exchange Act of 1934 ('the 1934 Act')[3] does *not* define 'manipulation' or 'manipulative'. The Rules promulgated by the United States Securities and Exchange Commission (SEC) setting forth 'manipulation' actually describe and relate to specific acts or activities that are then proscribed as 'manipulation' or 'manipulative'. The notion of 'manipulate' or 'manipulative' is described in relation to specific acts and, often, only through the overlaying of 'motive' and 'intent' to punish a result deemed societally undesirable. In fact, in the abstract, many acts characterised as 'manipulation' are engaged in regularly by securities professionals and others, although in contexts not predetermined by the legislature to be undesirable. For example, broker-dealers acting as underwriters are permitted to over-allot or sell more shares than advertised on the face of the prospectus. This creates a short position and potential for after-market buying power to hold or increase the price. Yet this is viewed as a 'good' manipulation, because it allows the managing underwriting to maintain (or peg) the secondary market price for a reasonable period of time.[4] Prior to the widespread use of over-allotments, underwriters engaged in 'stabilising' transactions which were designed to peg the market price and keep it from falling. This activity is covered by former Rules 10b-6 and 10b-7, new Rule 104 of Regulation M, under the 1934 Act. Another example of accepted 'manipulation' is the practice of underwriters to impose 'penalty bids' on syndicate members who sell back into the market underwritten shares within less than 30 days of the offering. The seller is penalised by being required to return the commission or selling concession and, in addition, will charge the seller with costs associated with the repurchase.

Often in the USA, when the meanings of certain words are unclear, it falls to the courts to interpret the legislative intent behind the laws in question. This, then, should be the next avenue of inquiry as to the meaning of 'manipulation' as used in the 1934 Act and the SEC Rules. Which leads us to our second dilemma: there is no consensus-definition in the numerous reported court decisions, and even the individual definitions themselves are vague and abstract.

For instance, one United States Court of Appeals tried to define 'manipulation' as 'the creation of an artificial price by planned action'.[5] Another appellate court tried to describe the vacuous expression 'artificial price' to mean a price that does not 'reflect basic forces of supply and demand'.[6] Yet no uncontroversial list of those 'basic forces' exists. Some effort has been made to categorise these 'artificial' factors into

such groupings as: 'corner', 'squeeze', or 'domination and control' manipulation; 'rumor' manipulation; 'investor interest' manipulation; and 'price effect' manipulation. Yet, here again, that which seems to be becomes illusory in application.

By way of example, is 'price-effect' manipulation truly a manipulation or is it, like other 'manipulations', found by *inductive* analyses? In corporate hostile tender offers the raider publicly offers a premium over the market price, at a figure artificially set by the raider. Still, that figure itself is false in many cases because the raider intends to raise it to a level that may not be the fair or 'true value'. If successful, the raider gains control of the issuer and, often, all of this is by 'planned action'. Defending management creates 'poison pills', searches for 'white knights', makes acquisitions or divests corporate assets designed for the purpose of blocking the takeover — all 'artificial planned acts' designed to depress the price of the stock, or at least to dissuade the raider from continuing to offer the premium price to the investors. Speculators frequently perceive these efforts, or anticipate them, and by purchasing the target company's stock, or by exercising their right to state that the company is 'worth more', 'should be broken up', or 'shareholder value added', they put upward pressure on the market price *after* they have already gained a large position in the company's stock, thereby increasing its value. According to the courts, none of the above actions are considered unlawful 'manipulation'.[7]

Many other activities may or may not be considered 'manipulation', depending on how that term is eventually defined, and whether they are committed with the requisite mental intent. Such activities include, among others, the following:

(1) stock-exchange floor specialists and NASDAQ market-makers setting prices for securities; 'market breakers' and 'stabilising' transactions;[8]
(2) the choice of methods used by corporations to record inventories and sales, revenue recognition, and capitalisation of expenses to produce desired financial results;
(3) major financial institutions' activities with bonds, including 'repurchase agreements';
(4) 'lock bids';
(5) 'naked short selling' by OTC market-makers;
(6) 'stock loan/stock borrow' activities by a clearing agent which loans stock owned by customers of a firm for which it clears to third parties who wish to borrow it to 'cover' short sales of these very same stocks;
(7) pre-opening trading, and trades at the close of the day for the purpose of 'marking the close', or 'painting the tape'; and
(8) failure by broker-dealers (in the USA) to report short positions.

Like the honourable judges on the courts, learned scholars have been frustrated with the lack of an adequate statutory definition for manipulation. One scholar has described the result of there not being a general definition of manipulation as 'a murky miasma of questionable analysis and unclear effect' and concluded that '[t]he law governing manipulations has become an embarrassment — confusing, contradictory, complex and unsophisticated'.[9]

Perhaps the best that can be said is that the concept of 'manipulation' is constantly evolving, resulting in a definition like Justice Stewart's famous statement about pornography: he knows it when he sees it.[10] Of course, this definition amounts to somewhat less than a rigid objective standard.

DO THE SPECIFIC MANIPULATION STATUTES AND RULES PROVIDE GUIDANCE ON DEFINING 'MANIPULATION'?

Given that a statutory definition of market 'manipulation' eludes us, it would make sense to try to determine how courts and others have interpreted the specific statutory sections and rules to identify 'manipulative' market activity. Then perhaps we can obtain a general understanding of what manipulation 'looks like' (to paraphrase Justice Stewart) that can be of practical use to regulators and market participants alike.

Section 10(b) and Rule 10b-5

By way of overview, the 1934 Act contains broad 'catch-all' anti-fraud provisions in section 10 and SEC rule 10b-5.[11] Section 10(b) applies in manipulation cases to all securities, whether traded on a national exchange or not, including those traded over-the-counter (OTC) or on NASDAQ. Section 10 and Rule 10b-5 are broad provisions designed to outlaw and catch all manipulations, deceptive devices, or contrivances, however small or atypical, or however ingenious.[12]

Yet, as with the difficulties in defining 'manipulation' generally, the United States Supreme Court and the lower federal courts seem bedevilled by trying to define 'manipulation' specifically under section 10(b) and Rule 10b-5 in any way other than by results-oriented decisions. For example, in *Ernst & Ernst v Hochfelder*[13] the Supreme Court referred to 'manipulation' as 'virtually a term of art when used in connection with the securities markets' (itself a phrase that is a 'term of art'), adding that, '[i]t connotes intentional or wilful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities'. But in *Schreiber*,[14] *Trane Co.*[15] and other hostile tender offers this is precisely what occurs; so, too, in a 'bear raid' or concentrated short selling.

Moreover, what in one context might be considered to be 'conduct designed to deceive or defraud', might in another context be perfectly legitimate behaviour. For instance, while the securities laws generally proscribe the use and transmission of inside information, the Supreme Court held in *Chiarella v United States*[16] that one does not commit fraud even when trading on undisclosed inside information unless the trader 'is under a duty to do so' (ie, is under a duty to disclose the inside information). Absent a fiduciary relationship or one of trust and confidence between the parties, there is no duty to disclose such information. Similarly, in *Schreiber v Burlington Northern Inc.*[17] the Supreme Court stated that under section 10(b), the term 'manipulation' requires either a material misstatement or a material nondisclosure. The Supreme Court found no 'manipulation' even though a hostile tender offer was supplanted by a friendly takeover at a lower price to certain shareholders, which had been alleged to have been done to 'artificially' affect the price in a collusion between management and the favoured suitor. At least in section 10(b) cases, then, 'manipulation' would appear to be subsumed in 'fraud'.

Yet, in *United States v Regan*,[18] the Second Circuit upheld a 'manipulation' conviction even though there was no proof of a material misstatement or omission to any person with whom the trader who engaged in short selling had any fiduciary or other duty. The short selling occurred at the request of a trader at another firm who had a reason to depress the price of the stock. The Second Circuit overcame *Chiarella* with the casual statement that *Chiarella* involved insider trading while *Regan* involved market manipulation.[19] The failure to disclose the depressing of the stock's price was a material omission and a deceit on the entire marketplace. The Second Circuit's distinction of Chiarella ignores that 'insider trading', like 'manipulation', is a subset of 'fraud'. Curiously, the SEC to date has not seen fit to prosecute 'short sellers' whose sole purpose is to depress the market price for their own gain.

Was *Regan*, then, a results-oriented prosecution and decision because the government was interested in pursuing Drexel Burnham, Ivan Boesky, Dennis Levine, Michael Milken and others who did business with them? The *Regan* reasoning suggests so. The Second Circuit's decision in another case involving a business colleague of Boesky further suggests this view. In *United States v Mulheren*,[20] rendered in the same year as *Regan*, the Second Circuit expressed 'misgivings' about *Regan* and a theory of prosecution that 'when an investor, who is neither a fiduciary nor an insider, engages in securities transactions in the open market with the sole purpose of affecting the price of the security, the transaction is manipulative and violates Rule 10b-5'.

Other courts have done no better. Many courts, regulators and prosecutors speak of 'manipulation' as moving a stock to an 'artificial' level. In *United States v Russo*[21] the trial court charged the jury that in order to find 'manipulation' the jury 'must find that the defendant intended to raise the price of the stock to or maintain the price of the stock at an *artificial level*, that is, to a level above the *investment value* of the stock as determined by *available information* and *market forces*'.[22] But what is meant by 'investment value' and 'market forces'? Investment value to whom? Is not the person buying or selling the securities part of the 'market forces'? Is not that person buying or selling one who is making a judgment on 'investment value'? What obliges that person, or anyone buying or selling in the marketplace, to disclose to and share with the world at large their analyses, their acumen, or their intellectual thoughts? Nothing![23]

In *Sullivan & Long Inc. v Scattered Corp.*[24] Chief Judge Posner, renowned for his economic expertise as much as for his prodigious legal knowledge, rejected a 'manipulation' civil claim because the seller was not a fiduciary to the people with whom he traded in an open, anonymous marketplace and had made no representations to the marketplace regarding the number of shares he would sell. *Sullivan*, therefore, applied *Hochfelder*, *Chiarella* and *Schreiber*. Still, Chief Judge Posner fell into the facility

offered by the linguistic trap 'artificial level' — which he too did not define — and employed a synonymous, equally undefined phrase: 'true value'. In other words, he used one undefined term for another.

Indeed, the Supreme Court's 1985 decision in *Schreiber* underscored the uncertainty created by the use of the word 'artificial' as a legal standard and disapproved of its use.[25] Yet this has not prevented its use by courts, including but not limited to those presiding over the *Regan*, *Russo*, *Hall* and *Sullivan & Long* cases.

Adding to the turgidity of 'manipulation' is the following language in *Hall*:

> 'A company may *lawfully* seek to "manipulate" the market by hiring *legitimate stock promoters* who disseminate information about the company to the public. As a consequence, the price of the stock may be driven up, but the new level is not an artificial one because it is the result of a better educated public.'[26]

Thus, according to *Hall*, 'manipulation' in and of itself is not illegal; neither is the use of 'stock promoters'; nor is the fact that the 'stock promoters' activities in *Hall* constituting 'manipulation' caused the price of the stock to be driven up. Instead, *Hall* would seem to imply that the test (or at least one of the tests) would be to identify those constituting the 'public' and examine whether they were or are 'better educated' — assuming that is even possible.

Section 9

Section 9 of the 1934 Act is an anti-manipulation statute that, at least in subsection 9(a), is limited to transactions on 'a national securities exchange'.[27] Securities not traded on a national securities exchange may be prosecuted for 'manipulation' under the general anti-fraud provision of the 1934 Act and, in the case of OTC securities, under s. 17(a) of the Securities Act of 1933 ('the 1933 Act').[28] The purpose of s. 9(a)(2) 'is to denounce and make unlawful the destruction of a free market in securities'.[29] Section 9(a) violations require proof that the person effected the transactions 'for the purpose of inducing the security's sale or purchase by others'.[30]

Section 9(a)(2) requires proof of three elements to establish a violation. First, the defendant must have 'effected' a 'series of transactions'. A 'series' can be as little as three successively higher bids.[31] Even a *single* bid quote can be enough,[32] if it is done as part of, and in conjunction with, bids by other traders acting together for the purpose of raising the price in order to induce others to buy the security. The 'bids' need not be successful or accepted for a violation to occur.[33] And even if done in a discretionary account, the transaction can be part of a 'series of transactions'.[34]

The second element is the creation of actual or apparent trading activity or an effect on the security's market price. Either aspect suffices.[35] Actual activity can be created by simply generating a sheer volume of purchases.[36] It can also be created by arranging for a market maker to purchase a stock to resell to the defendant.[37] Such an attempt to create an appearance of a 'broad base of interested brokers' to reassure the public to buy or sell is forbidden. Apparent activity can be generated without a large volume merely by raising the bid too closely after the last rise in price. This has the effect of exhausting the supply of stock that was available at the lower bid and forces participants in the market to raise their prices and to pay more.

The third element involves affecting the price of the stock. Obviously, if read literally, the manipulation laws would render guilty anyone whose transactions affect the market price for a security. Recognising this fact, in enacting s. 9(a) Congress stated that 'If a person is merely trying to acquire a large block of stock for investment, or desires to dispose of a big holding, his knowledge that in doing so he will affect the market price does not make his action unlawful'.[38] Thus, the courts look to the facts of each situation and objective headlands to navigate toward a determination as to whether the purpose of the transaction was to manipulate the price or otherwise.[39] Proof of 'affecting the price' can come through proof of domination and control of the market, with each requiring different proof. Price (ie, bid) leadership can be shown by showing that the market price collapsed after the manipulator withdrew its support efforts.

It should be noted that s. 9(a) requires that the actions be committed with the 'purpose of inducing others'. Hope, belief and even some alleged 'motive' are not, in and of themselves, sufficient to establish this requisite mental state. However, circumstantial evidence may be offered as proof on this issue, since one cannot probe into the actor's mind.

Specifically, section 9(a) prohibits[40] purchases or sales that are:

(1) 'wash sales';[41]
(2) 'matched' or 'crossed' or 'net sales' of the same security at the same time, of the same size, and at substantially the same price;[42]
(3) trading to create volume or generate 'momentum trading'; and
(4) *actual* or apparent trading or *raising or depressing* the price of a security for the *purpose* of inducing others to purchase or sell the security.[43]

There is nothing new about these activities. They were employed in the 1920s by the 'pools' whose actions led to enactment of the federal securities laws.

Examples of proscribed manipulative activities include 'pegging', 'capping', 'fixing', or 'stabilising' transactions in contravention of SEC rules. (As discussed above, the SEC allows underwriters to engage in these activities.) *Pegging* is establishing a substantial short *put* position in an expiring option series trading at or near its strike price (eg, allowing a short put position to expire out of the money while placing large buy orders for the stock at a limit order below the prevailing market price). *Capping* is establishing a substantial short *call* position in an expiring option series trading at or near its strike price (eg, selling substantial amounts of stock or placing large overhang orders for the stock and allowing the short call position to expire out of the money).

Stabilising transactions include 'marking the close' or effecting a trade or entering a quote at or near the close of a trading session in order to affect the closing price of a security and consequently to affect the credit position of a person holding a position in that security (ie, margin or a broker-dealer's net capital calculation for a large position in its house accounts or to dress up a portfolio being managed by an investment adviser). Another stabilising transaction is 'painting the tape', which involves trades reported on the transaction tape which are intentionally not submitted for trade matching and clearance purposes, done to create apparent trading volume of a security, misrepresent a market for the security, or change the reported closing price for credit or other purposes.

Another activity often considered manipulative is 'parking'.[44] However, like a number of the activities described above, 'parking' is not itself illegal. Only when the 'parking' is the method by which ownership of stock is concealed, net capital positions are massaged, or a 'float' is dried up to achieve other ends does it become a 'manipulative' activity.

Unlike s. 9(a), s. 9(h) is another catch-all provision that is *not* confined to securities traded on a 'national securities exchange', and is not confined to brokers or dealers. Section 9(h) encompasses:

(1) '*any person*' engaging in
(2) *any act or practice* 'in connection with the purchase or sale'[45] of
(3) '*any equity security*' to contravene
(4) *any* rules or regulations adopted by the SEC to protect investors and to maintain fair and orderly markets
(5) designed to prevent *manipulation* of *price levels* of the *equity securities market* or a *substantial* segment thereof or
(6) designed to constrain extraordinary market volatility based upon past experience.[46]

Other rules describing manipulation

In attempting to place the concept of market 'manipulation' into context and hopefully gain some sense of what that term means, it is also useful to look at the conduct proscribed by various Rules promulgated by the SEC. While we do not discuss the following Rules in as much detail as the statues and rules set forth above, we list them below and encourage those interested to undertake their own further inquiry. All of the acts described below may or may not be deemed 'manipulation', depending on whether the statutory criteria are met, which include proof of an improper purpose and mental state to engage in wrongful activities. Thus, if a disclosure is not made but there is no evidence that the non-disclosure was intentional or done with knowledge, the requisite mental state for 'manipulation' may be absent.

(1) Rule 10a-2: covers purchases of securities;
(2) Rule 10b-1: expands the definition of 'manipulation' in s. 10(b) to include any act, or omission to act, regarding securities exempt under s. 12(2) but which activities would constitute a violation of s. 9(a) if the securities were registered on a national exchange;
(3) Rule 10b-3: precludes brokers and dealers from acts, or omissions to act, that are included within the ambit of 'manipulative' as used in s. 15(c)(1) of the 1934 Act with regard to muni-

cipal securities and securities not traded on a national exchange;

(4) Rule 10b-5: general 'catch-all' anti-fraud rule promulgated under s. 10(b) (see above);

(5) Regulation M (superseded old Rule 10b-6): generally relates to selling and trading and stabilising transactions of broker-dealers, issuers and selling shareholders during a distribution of securities;

(6) Rule 10b-9: declares it to be a 'manipulative' act falsely to represent that an offering is 'all or none' if the terms of the offering are otherwise;

(7) Rule 10b-13: makes certain market activities by a cash tender offer or outside the tender offer a 'manipulative' activity;

(8) Rule 10b-18: regulates purchases of certain equity securities by the issuer or a person affiliated with the issuer;

(9) Rule 15c1–1: sets forth definitions of certain terms;

(10) Rule 15c1–2: engrafts Rule 10b-5 language into s. 15(c)(1) of the 1934 Act and notes that the term 'manipulative' is not limited to any other definition of that term contained in any other rules adopted pursuant to s. 15(c)(1) of the 1934 Act. This is another 'catch-all' definition;

(11) Rule 15c1–3: makes it a 'manipulative' act for a broker-dealer or municipal securities dealer to state that its registration with the SEC, or the SEC's failure to deny or revoke its registration, is in any way an indication that the SEC has passed upon or approved the financial standing, business or conduct of the broker-dealer, or municipal securities dealer, or any securities or securities transactions;

(12) Rule 15c1–5: makes it a 'manipulative' act for a broker-dealer or municipal securities dealer to enter into a securities transaction for or with a customer involving an issuer which controls, is controlled by, or is under common control with that dealer, unless such is first disclosed to the customer and, if the disclosure was not in writing, then a writing containing such disclosure must be given or sent to the customer before the completion of the transactions (ie, settlement of the trade);

(13) Rule 15c-6: makes it a 'manipulative' act for a broker-dealer in equities or municipal securities not to disclose to its customer at or before completion of a transaction the broker-dealer's economic participation or interest in a distribution;

(14) Rule 15c1–7: renders 'manipulative' certain activities relating to discretionary accounts, in particular engaging in transactions for the customer's account which is excessive in size or frequency in view of the financial resources and character of the customer's account or the failure to make an immediate record after the transaction containing prescribed information;

(15) 15c1–8: makes it a 'manipulative' act to accept for execution or to execute a trade 'at the market' unless there exists a market for the security independent of any market made by the executing broker-dealer; and

(16) Rule 15c1–9: makes it a 'manipulative' act to use and distribute a 'pro forma' balance sheet without that fact being prominently displayed and the assumptions upon which it rests clearly set forth.

ARE THERE TELLTALE SIGNS OF A MARKET MANIPULATION?

Legislative and judicial pronouncements are informative, but they do not necessarily lead to an understanding of how to spot manipulative activity proactively. This is because the courts have been constrained to interpret the legislative prohibitions through hindsight, applying them to factual scenarios presented to them in open court only after the allegedly manipulative acts have been committed and have been uncovered by the government or aggrieved private investors. It is therefore necessary to have a sense of some of the common tactics that are employed in 'manipulation' schemes to determine whether a given transaction falls within one of those scenarios, or is similar enough to warrant investigation or prosecution.

In general

One common element of a market manipulation is that the manipulator obtains domination and control over the market for the security. A manipulator can accomplish this feat by arranging and controlling the issuer's stock distribution and can obtain direct or indirect control of a majority of the trading shares of the security. Often this involves the use of 'nominee' accounts controlled by the manipulator.

Manipulators typically attempt to raise or lower the price of the security through one or more means, including, but not limited to:

(1) inserting, or causing the insertion of, successively higher bids for the security at arbitrary prices set by the manipulator;
(2) the use of 'wash sales', 'matched orders', and other devices to create apparent demand for the security causing an artificial rise in price of the security;
(3) publicly disseminating false and misleading information by news releases and/or shareholder communications portraying a positive image of the issuer; or
(4) reducing the floating supply[47] of the security available to the public.

Pump/hype and dump manipulations

One of the more common and recognisable types of market manipulation, and therefore a good example to illustrate many of the points set forth above, is what is referred to as 'pump/hype and dump'. This type of manipulation scheme often begins with the formation or acquisition of a corporate entity as a vehicle for the manipulation. The manipulator either will formulate the idea for the new company and arrange the company's formation, or will come across a company whose management lacks administrative or financial skills but has entrepreneurial skills, and which needs help from a management type of individual. The manipulator offers to fulfil that role and, frequently, plays to the ego and vanity of the entrepreneurs by offering to gain money and 'Wall Street' exposure for the entrepreneurs by suggesting that his contacts will get the issuer's 'story' and its 'unique' product public exposure and recognition. Manipulators usually choose an embryonic company with little prior history, or one about which there is no public knowledge but which is in a 'sexy' or 'hot' market segment at the time. This avoids the existence of any negative history to be explained and allows for maximisation of the 'hype' about the company and its future plans.

Another feature of this scheme is that the target company typically has very limited private capitalisation. The company is usually dependent on an initial public offering (IPO) to obtain the financing necessary to engage in business activities and/or to complete a business plan or develop a product to the point of commercial exploitation.

For this type of scheme to succeed, it is necessary for the officers and directors to be involved in the manipulation. Therefore, officers and directors often act with the manipulator, even if they are — or later claim to have been — 'duped' by the manipulator. Officers and directors susceptible to the manipulator's machinations usually have little business experience and less sophistication regarding stock market regulations and proper application of accounting principles. They also often have large blocks of stock obtained for a nominal consideration, earned or bought prior to the IPO, or they exchange their stock for stock of a 'clean shell' located by the manipulator and merged in a 'reverse merger'. The enticement is that the publicly traded stock will have a value and make them wealthy. A fact often overlooked by such officers and directors is that this is in reality wealth 'on paper', and that they will probably remain locked into their share holdings and be unable to sell some or all of their shares, because of various regulations applicable to insiders, while the manipulator sells his or her stocks. In addition, the officers and directors often have agreed with the manipulator to resign at a predetermined time or at the manipulator's request, to be replaced by 'an experienced CEO'.

Once the manipulator has accessed the target company, another step in the scheme involves the thinning of the company's shares. The bulk of the shares usually go to officers and directors, while the remainder frequently go to associates of the manipulator, and often to individuals who have had nothing to do with formation of the new company. The allocation of the shares is usually determined by the manipulator.

Central to the scheme is the sale of the company's shares in the open market during the IPO, which requires a registration statement and prospectus. The basic text of these documents is commonly prepared by the manipulator with little or no input from the nominee officers and directors, who may sign them with a minimal understanding of what they say or, more importantly, what material information they omit. For instance, they may contain false and misleading information regarding the company's assets and prospects and the projected use of the offering proceeds, or they may fail to disclose the identity and involvement of promoters or insiders who have a history of securities violations. The documents may even be reviewed, finalised and filed with the SEC by attorneys and accountants associated with the manipulator.

After the preparatory groundwork has been laid, the IPO is likely to be conducted by an underwriter associated with the manipulator. The securities offered in the IPO are often 'units', each unit consisting of one share of common stock and one or more warrants. Each warrant enables the holder to purchase an additional share of common stock at a specific price within a specific period of time after the IPO.[48] A high percentage of the units in the underwriting may be retained by the lead underwriter for sale to its own customers. These units may be allocated to those registered representatives at the underwriter who are under the manipulator's control.

The IPO in a manipulation is not a *bona fide* public distribution. A majority of the units may be placed in the accounts of nominees and other persons under the manipulator's control. In addition, the manipulator may loan the nominees the money needed to purchase the units, with the understanding that the loan will be repaid with the profits the nominees earn by selling the units. The manipulator may also guarantee the nominees against losses, and/or may provide the nominees with optimistic after-market price projections. The nominees often agree to hold the stock until the manipulator tells them to sell it, and tells them where to sell it, at a profit to the nominees. Often the 'nominees' do not understand that they have a pre-assigned role in the manipulation, but believe they are fortunate to have a friend willing to get them into an IPO. Therefore, they are willing to resell to the broker-dealer, when told, even below the prevailing market, because they will still have a substantial profit and anticipate being offered an allotment in the next deal.

Furthermore, the manipulator and/or the collaborating underwriter may provide loans, guarantees, or other consideration to induce purchases needed to close the offering. The underwriter might even require that to obtain securities in a 'hot issue' offering, the customer must agree to purchase additional securities (of the same or other issuers) at the same time or as soon as the IPO closes. This is a practice that has been engaged in by even leading investment houses; a variant is that the purchaser, often a financial institution or investment company, agrees to return a portion of its profits to the underwriting firm in the form of commission business at higher than usual commission rates.

Although not a necessary component of the scheme, some more sophisticated manipulators will merge a dormant public shell company with a non-public issuer in what is known as a 'reverse merger'. To do this, the manipulator and his associates may purchase the outstanding stock of a dormant public 'shell' company for a nominal amount. The shell may have been created by persons who make it a business to create public shells and sell them to a manipulator. The shell company may then merge into a closely held private company controlled by the manipulator in a 'reverse merger', leaving the manipulator in control of the now public entity.

The manipulator can gain control of a majority of the free-trading stock of the merged entity through several devices. One such device is the gaining of control of the certificates for the shell company's stock from the stock transfer agent, free of all restrictive legends. The manipulator might also cause certificates to be reissued to relatives and associates. Alternatively, the manipulator might engineer a reverse split four-to-one (or more) to reduce the number of shares he does not own, or split forward to increase the number of shares he does own. In this way, the 'public float', not under the manipulator's control, is sharply reduced, so that it becomes only a small percentage of the trading shares of the merged entity and cannot cause a drop in the manipulated price because it is too small an amount to affect the market.

Following the IPO,[49] the manipulator will attempt to influence the after-market in the company's shares through principal trades for the firm's account; through domination and control of the market; and/or through increasing bids. Broker-dealers involved in the manipulation often try to limit sales of the stock by customers, or impose a 'no net-sales policy'. They might also refuse to execute sell orders, match or cross trades (ie, match or cross a sell order with a corresponding buy order by another customer), and/or give artificially high quotes or quotes not backed by legitimate market demand. Confederate market-makers may have the highest bid or the only bid, or will sometimes enter successively higher bids without legitimate underlying demand. Often they will purchase blocks of stock from other broker-dealers at high prices, commonly at prices that are higher than necessary to prevent a drop in price. In addition, they might engage in excessive, undisclosed mark-ups; tout the company to customers and other broker-dealers; circulate false or misleading statements about the company's

operations and prospects; and/or fail to disclose the company's problems to customers.

The lead market-maker and the manipulator may seek other broker-dealers to act as market-makers. Often they will provide those other broker-dealers with inducements, such as free stock, guarantees against loss, or cash payoffs.

They also frequently create the appearance of legitimate demand by trading with, and causing trading among, the nominee accounts. After the initial public offering is closed, nominee accounts may begin trading units, common stock and/or warrants, with the majority of the securities being purchased by the lead market-maker's trading account. That trading account then sells the securities it has purchased to other nominee accounts at increasingly higher prices, set arbitrarily by the lead market-maker and the manipulator. These sales may be accomplished through wash sales, matched orders and other manipulative techniques such as 'free-riding' (ie, buying stock with no intention of paying for it). This pattern continues during the first few days or weeks of after-market trading, the vast majority of trading in the new company's securities often being done through the lead market-maker's trading account. This pattern of trading activity usually results in an appearance of active trading in the new company's securities, and causes a dramatic increase in the price of the securities (sometimes 200–300 per cent or more). The difficulty with declaring all such transactions to be 'manipulation' is that broker-dealers are required to accept customers' sell orders. Thus, if the stock is 'hot' and opens in the after-market at a substantial premium over the offering price, an IPO purchaser may have left instructions to sell immediately in such circumstances. The broker-dealers still engaged in the mechanics of the initial offering and with after-market purchasers, may decide to accept and execute the sell order and do the trade with the broker-dealers' own trading or inventory account.

The warrants sold in the after-market ultimately come within the control of the manipulator at a very nominal cost and are exercised once the security has increased significantly in price. A variant of this is for the manipulator to drive up the price of the stock while obtaining warrants at a low cost. Since warrants usually trade in some tandem with the stock, the warrant will rise in value, often dramatically. The manipulator then sells a warrant bought cheaply at the higher price and in a greater volume than he could have bought the stock.

Obviously, a critical feature of this scheme is the manipulator's ability to 'hype' the stock, which can be accomplished through several means. For example, it can be done through promotional materials disseminated by the company, including professionally printed brochures, fact sheets, news releases, or résumés of officers and directors, containing false or misleading information about contracts, patents, joint ventures, new product being developed, sales order backlog, and/or the novelty of the issuer's product. In addition, financial industry publications and financial programmes on television are fed articles on the company which are disseminated without adequate verification.[50]

Other popular media for the dissemination of hype are tout sheets and 'infomercials'. Newsletters and 'news shows' that appear on their face to be independent publications may analyse and recommend several stocks, including well-known issuers, emphasise the promoted company, and thereby slip into this category of presentation. Similarly, the manipulator might attempt to disseminate news releases prepared by a public-relations company or press agent retained by the company or the manipulator. It is not uncommon for such media, whether knowingly aiding the scheme or duped, to fail to disclose that the subject company has provided money to the publisher to highlight the issuer.

As stated above, the manipulator may drag broker-dealers into the scheme, whether they are aware of it or not. One tactic the manipulator might use is to pay a registered representative or stock analyst at a stock brokerage firm to prepare a favourable analytical report on the subject company. The report often indicates that the subject company has vast growth potential and recommends that the broker-dealer's customers purchase the stock. The report is published and distributed by the broker-dealer to its offices and its registered representatives, who then send the reports to their customers.

Similarly, the manipulator might disseminate false financial statements, appraisal reports, or audits, or use 'compilations' and/or agreed-upon procedures used in examinations by auditors that are not readily understood by public. In so doing, the manipulator merely seeks to use a reputable firm's letterhead to further the scheme.

In conjunction with the hype, manipulators and their accomplices employ a variety of sales techniques

to persuade unsuspecting customers to purchase the stock. Manipulations at the sales phase are often difficult to identify, for the sales techniques used by illegitimate and legitimate broker-dealers often do not differ. Some such techniques include cold calling; the use of sales scripts approved by the broker-dealer; 'targeting' customers from leads purchased from reputable firms like Dunn & Bradstreet or international services providing lists of 'wealth investors'; encouraging young brokers to make hundreds of calls each day; offering higher payouts for firm sponsored stocks than for listed business; sharing the 'spread' with the registered representative (ie, giving a piece of the firm's profits); and/or offering sales contests, special trips or gifts. Again, these techniques are used by both legitimate and non-legitimate dealers and will probably continue until compensation is based on the *increase in value* of customers' accounts rather than on 'commissions' paid for generating new business.

Finally, some current trends in this type of manipulation are worth noting. First, there has been a tendency to use offshore nominee accounts located in such diverse regions as the Caribbean Islands, the Pacific Islands and even Europe. In addition, manipulators are increasingly seeking out secrecy havens offering favourable regulations or foreign pledges of stock with banks abroad.

The new breed: Manipulation on the Internet/World Wide Web

The rise of the Internet and the World Wide Web has been a major advancement in global development. Corporations large and small, institutional investors and increasing numbers of individuals are finding themselves with unprecedented access to information and the securities markets. Some even liken the 'Internet Revolution' to the industrial revolution of the late 19th and early 20th centuries. But with this great advancement comes the potential for an increase in unscrupulous activity, targeted at increasing numbers of potential 'on-line' victims. While some of the market manipulations in the world of e-commerce will probably resemble those of the old paper economy, the new medium will also bring with it new and evolving schemes that present the same, or even greater, threats to personal and business finance and economic and political stability. And, as we show below, although the Internet is a relatively new tool, manipulators have wasted no time in twisting it to their own ends.

Old 'paper' market schemes still prevail

Any of the old paper market schemes mentioned above, as well as others, can be effected through the Internet as efficiently as in years past. In fact, the Internet has rendered many of those schemes easier to implement and may enable their operation with fewer players involved.

In discussing the *Sheret and Conley* case (see below), the New York Chief of the Federal Bureau of Investigation (FBI) said that the same tactics are used on the Web as in traditional 'pump and dump' stock promotions: 'The defendants combined classic boiler-room tactics with the increased efficiency of the Internet'.[51] In another stock scandal, exposed in August 2000 (see below), a manipulator implemented a scheme over the Internet involving traditional pump and dump methods that resulted in Emulex Corp., losing approximately $2,5bn in market capitalisation — approximately 60 per cent of its market capitalisation — in less than 30 minutes. Other recent pump and dump schemes have been accomplished by touting stocks in Internet 'chat rooms' and through e-mail 'spams'. For instance, in *SEC v Sheret and Conley* and the related case of *United States v Sheret and Conley* civil and criminal charges were brought against persons who used junk e-mail and Internet 'chat rooms' allegedly to manipulate 57 stocks. As part of their scheme, the defendants titled their chat rooms 'AOL Investment Snapshot' and made it appear as though the reader were seeing legitimate talk about particular stocks between two knowledgeable friends. The Internet has also made it easier for manipulators to conduct their activities by using false identities; the defendants in *Sheret* and *Conley* allegedly used 23 different Internet service providers and different aliases in furtherance of their scheme. In addition to facilitating the spread of false information,[52] the rise of 'day trading' has brought about a new wrinkle in the dissemination of false statements and material omissions, through postings on websites and otherwise, leading to government investigations and prosecutions of day-trading 'advisers'.[53]

Old 'pump and dump' schemes are part of e-commerce: the tree-trimmer caper

The Internet has given millions of ordinary people — who are neither millionaires nor market 'insiders' — quick and efficient access to the securities markets in ways never before available. It can be said that with

the Internet 'democracy' has come to the securities markets. It can also be said that with the Internet 'democracy' has come to manipulation. This point was made dramatically in April 2000, when the United States Attorney's Office filed criminal charges, and the SEC filed civil suit, against a person formally employed as a tree trimmer for allegedly orchestrating a pump and dump scheme over the Internet.[54]

According to the criminal indictment and civil complaint, the defendant secretly bought and sold shares of a company called eConnect through a company that he owned. He then allegedly issued on the Web a series of fraudulent and fictitious 'analysts' reports', which he wrote himself, through another company that he had formed on the Web, also by himself. Those reports stated that the shares of eConnect were undervalued and could be worth as much as $135 per share. According to the SEC complaint, the bogus reports, along with questionable statements issued by eConnect itself, caused the company's stock price to rise from $1.39 to $21.88 in a little more than a week. During this period, the tree trimmer sold his stock for a profit of approximately $1.4 million.

What the tree-trimmer case illustrates is that in the Internet age, manipulators no longer need an intricate skill and understanding of market activities and functions. No longer does a manipulator need a network of broker-dealers and paid-off account executives, or excessive amounts of money, to finance a scheme. Gone are the days when one needed to have stature, sophistication and public renown like the Rothschilds had when they sold large amounts of securities, thereby inciting the belief that 'Napoleon Defeats Wellington', and then, when rapid selling drove the market down, reversed their positions and bought back those securities at depressed prices. Today, the manipulator might be your local mechanic,[55] the car service driver who takes you home,[56] or the 15-year-old teenager living next door.[57] Hiding behind the anonymity of the Web, all an ordinary person needs to become a manipulator is access to a cheap computer and a modem.

Law enforcement versus individual rights in the electronic age

One other thing that the tree-trimmer case vividly illustrates is that with vigilant monitoring and swift responses by government agencies, even 'anonymous' Internet manipulators can be caught. But law enforcement never comes without a price. To enable prosecutors and regulators to seek out and prevent crime, individuals' rights and freedoms sometimes have to be curtailed, albeit to the least extent possible. This is true of traditional crime: police are empowered to stop and search civilians based on 'probable cause'; search warrants allow entry into homes and private property, the tools (including businesses, homes, cars and other tangible property) used to carry out criminal enterprises are forfeited; and warrants authorise secret wiretaps of telephone lines. While these police powers have long been accepted as necessary evils in the fight against crime, they have not been without debate and controversy. The law pertaining to their exercise is constantly evolving, and the protection of the rights of the innocent requires constant judicial oversight.

With the increasing recognition of the vast potential for crime on the Internet, both in traditional forms and new ones unique to the Web, law enforcement has been challenged to come up with new means, or variations of traditional means, of ferreting out illegal activity and protecting the innocent. To this end, the SEC has established a 'Cyberforce', and the Department of Justice and the FBI have implemented an Internet wiretap system called 'Carnivore'.[58] Not surprisingly, these systems have generated intense debate over the propriety of the government 'snooping' into individuals' and businesses' e-mail and Internet communications.[59] Concerns over the violation of individuals' rights to privacy and to communicate freely have taken on an added, occasionally fervent, dimension, as one might expect from a medium developed with the express goal of fostering free, open and instantaneous communication and sharing of information among academics, scholars, researchers and scientists. These concerns have become even more widespread with the growing infiltration of the Internet into homes and businesses; the proliferation of e-commerce in everything from retail consumer goods to the stock markets to everything in-between; its increasing use as a medium for the mass distribution of popular culture; its ability to provide a forum and audience for the dissemination of minority, unpopular, underground, reactionary and even anti-establishment views; and the rising use of e-mail as an alternative to traditional mail and telephone communication among family, friends, acquaintances and business colleagues.

The debate between individual rights and liberties on the one hand and the acceptable scope and parameters for their justified invasion in furtherance of law enforcement will probably take many years of litigation to resolve. The law pertaining to police stops, asset forfeiture and wiretaps in connection with traditional investigations has, however, evolved to strike a balance between these competing interests, and as the law of the Internet develops, it is unlikely that there will be unfettered governmental intrusion into e-commerce activities and private individual or business Internet and e-mail communications.

WHAT DOES ALL OF THIS MEAN FOR INTERNATIONAL MARKETS?

We have discussed what market manipulations might look like, but have no universal definition of 'manipulation'. We have discussed the implications of the Internet for market manipulations, but have no universally applicable law regarding the proper balance between law enforcement and personal freedoms on the World Wide Web. Given these lingering ambiguities, what, if anything, can we discern to assist in structuring a system of international regulation of securities markets?

For starters, it is apparent that the 24-hour-a-day, global, electronically linked marketplace will become a playing field for sophisticated manipulation. Ultimately, to respond to these threats to individual savings, business investments and national (and international) economic development, we propose that all markets will need to be linked into one system, with common rules and regulations governing the mechanics of purchases, sales, settlement of trades, the flow and mandatory corroboration of information, accounting, record keeping and accountability. And importantly, whether this results in one global system or a series of separate yet similar and interconnected national systems, it must be *transparent*. By that we mean that transactions must be effected and recorded according to common and consistent methods, with common terminology. Transactions, including but not limited to the flow of currency and ownership of securities, must be readily apparent and traceable, regardless of the nation(s) or market(s) where they — or their discrete parts — are placed, effected, consummated, closed, or transferred; regardless of the nationality of the market participants; and regardless of the location or nationality of the law enforcement agency or agencies investigating possible wrongdoing.

What types of international activities are susceptible to manipulation?

Once the system proposed here — or some other system — is up and running, what exactly should prosecutors and regulators be looking for? In other words, what activities are particularly susceptible to manipulation in international markets? While not illegal in and of themselves, the following activities, among others, carry with them the potential to influence prices and/or induce international purchases or sales, and hence to be abused by international market manipulators:

(1) *Short tendering* is the tender of stock into an offer likely to be over tendered and simultaneously selling short into the market, either against the portion of the position that it is believed will not be taken up, or a naked short.

(2) *Margin trading* with the disequilibrium among international margin rules, allows for greater speculative activity and abuse.

(3) *Short selling* is effected by the ability to sell short and not cover for lengthy periods of time in foreign (ie, non-US) countries, versus T+3 (time of order plus three days for settlement of order) settlement required in US transactions.

(4) *American depository receipts* (ADRs) usually track the price of the underlying security; manipulation of the underlying security could therefore affect the price of the ADR on US markets.

(5) *Stock or convertible securities accumulation* often involves the accumulation of stock, or a security readily convertible into the stock, with the purpose of drying up the available float, followed by short selling the stock to drive the price down and covering the position. Conversely, this could involve the use of accumulated positions to drive up the stock price by bidding for a thinly traded or small float stock, and then selling the accumulated position into the manipulated market. The tie-in between the available converted securities and the purchase or sale of options is done in separate markets.

(6) *Intermarket front running* is engaging in transactions made on the basis of undisclosed, non-public, information about a block of the underlying security about to be traded. It occurs

where the manipulator learns of a block transaction, or of a material development not yet disclosed by the issuer or affecting the issuer's business, or of a large influx of orders, options or futures transactions. With this information the manipulator buys or sells options on the security or stock index futures, or places orders in another market elsewhere in the world, in order to profit from the impact the transaction will have on the market.

Intermarket frontrunning is not very difficult and provides an interesting example with which to demonstrate the potential for international market manipulation. Assume that a portfolio manager for a large mutual fund in domestic country X tells a domestic trader in country X to buy or sell a large position in a particular security traded on the New York Stock Exchange over a period of time. The trader-manipulator contacts a confederate at a foreign broker-dealer in country Y who buys an option or a future on the underlying security in a market in country Z, in advance of the mutual fund's order or before its order is completed. In other words, domestic country X manipulator tips off country Y confederate who illegally purchases in country Z at the lower (or higher) price. The mutual fund's order is completed, prices rise (or fall), and money is made when the country Y confederate exercises his option or future.

But now the foreign broker-dealer confederate in country Y has to pay off the domestic manager-manipulator in country X for giving him the inside information. That is accomplished in a later separate transaction. The foreign (country Y) confederate sells a different, third security to a broker-dealer at which the country X trader-manipulator or a relative maintains an account, at a limited sell order for the block. Simultaneously, or in advance of the block sell limit order, the country X trader-manipulator places an order to buy a position in the same stock also at a limit order, and his order is filled. The appearance of active trading causes market prices to rise, the domestic trader-manipulator or a relative makes a profit by selling at the higher price, and the payoff is completed. If skilfully done, without excessive greed, it is highly unlikely that, under the conditions currently prevailing in international markets, any regulator would piece this scam together unless someone talked and revealed the mechanism used.

Technology will require changes to securities regulation and to government in general

Obviously, technological advancements, the Internet and the increasing globalisation of securities markets will require changes to existing laws and regulations. Without the benefit of a crystal ball, it is hard to predict the directions in which the new technology will take us, and it is difficult to advocate proactively particular laws and regulations to address crimes that have not yet been envisioned, let alone committed. Undaunted, and admirably, some market participants and commentators have nevertheless taken up the challenge.

For example, a February 2000 *Wall Street Journal* article[60] reported on a proposal by several major broker-dealers to adopt a new market system that includes a self-regulatory group and a central display of all stock quotes. The article notes that broker-dealers acting as market makers, particularly in NASDAQ stocks, may be 'free riding', because investors who post the best price on an electronic trading system may see that price used by the market maker as a reference price. But when the market-maker increases its price in this manner, are we witnessing a 'better educated public', as referenced in *US v Hall*,[61] or a 'manipulator' merely raising its prices without any individualised reasoning?

One Silicon Valley guru, William Davidow, has prophesied that special interest groups, multinational corporations — which make up 50 of the world's 100 largest 'economies', the others being nations — 'are usurping government's traditional role'.[62] Mr Davidow has forecast that the government's traditional approach of responding 'to challenges by passing new laws to preserve existing systems won't work today because information technology is empowering new institutions and techniques that circumvent the system'.[63] Mr Davidow chillingly concludes:

'Many institutions will simply not survive the information revolution. Frankly, governments will be among the group least effective in coping with change. They will try to preserve the status quo by passing laws to buttress it. The winners in a civilization remade around computers and the Internet will not be those who attempt to contain the technology. The winners will be those who invent new structures of government, business and society in which technology is embedded.'[64]

US PROSECUTION OF FOREIGNERS ENGAGED IN OFF-SHORE MANIPULATIONS AFFECTING US MARKETS OR ISSUERS

Once it has determined what sorts of conduct will be prohibited, a nation must take steps to ensure that its laws can be and are in practice applied to all market participants equally, be they foreign or domestic. Necessarily, enforcement will depend on each nation's laws governing its procedures in criminal and regulatory matters. Care must still be taken to ensure that the securities laws themselves set forth a statutory basis for investigations and prosecutions, both to enable foreign investors to understand clearly the applicability of particular laws to their conduct and hence to conform their behaviour accordingly, and also to provide comfort that those laws will be applied fairly, impartially and uniformly to protect them and their investments.

While mindful of our position that the USA's securities laws and regulations are less than clear as to the definition of 'manipulation', by way of illustration, we briefly note that those laws are made expressly applicable to foreign investors. Section 9(a) of the 1934 Act applies to 'any person', including a foreign national, who engages in manipulative activity through the 'use of any means or instrumentality of interstate commerce', which includes e-mails, faxes and telephone communications. Thus, foreign investors may be prosecuted for violating the prohibitions contained in s. 9, including those pertaining to puts, calls, straddles, or options set forth in subsection 9(b). Likewise, s. 10(a) prohibits 'any person' from engaging in proscribed 'short sales' activity involving the use of the mails, the facility of a national securities exchange, or the use of any means or instruments of interstate commerce. US courts have interpreted the securities laws to apply to foreign nationals. In *Leasco Data Processing Equipment Corp. v Maxwell*[65] the Second Circuit Court of Appeals held generally that in light of the principal purpose of US securities laws to protect American investors exposed to fraudulent or manipulative activities that implicate the use of the jurisdictional means — ie, interstate commerce — even foreign activities by a foreign national producing such a result in the USA or affecting US investors will subject the foreign national to US jurisdiction. Such a finding of jurisdiction will displace foreign law and will, as a matter of conflict of laws, allow American courts to apply US law to the foreign national.[66]

CONCLUSION

In conclusion, it seems that one thing is certain: we still have no universally applicable definition of what constitutes 'market manipulation'. Perhaps that is because 'manipulation' is timeless and plasmatic. It runs from Dutch tulip bulb mania to Internet technology companies, and from the Rothschilds' use of carrier pigeons to bring the (secret) news of Wellington's defeat of Napoleon to a tree trimmer's use of the Web to chat up investors and hype a security, to the use of the Web to disseminate false, negative views about an issuer to drive down the market price for its securities. To encourage foreign investment, individual nations will have to instil confidence in their ability to prosecute 'manipulations'. Successful prosecutions, in turn, will require global cooperation and coordination; transparency of markets; uniformity of rules regarding the mechanics, recording and accounting of transactions and the dissemination of information; and, where possible, uniformity of at least terminology, if not rules, pertaining to particular types of transactions such as trading on margin, short selling and the like. Perhaps most importantly, encouraging foreign investment and instilling confidence in respective nations' ability to protect foreign investors will also require fidelity to the notion that 'democracy' and 'democratic' institutions and fairness are not a function of what any one particular nation's constitution, laws, or regulations say, but of the *fairness of the procedures* used by nations to implement their constitutions, laws and regulations. That will be a greater and more difficult task requiring more governmental self-discipline (or judicially imposed strictures) than merely finding the 'manipulations' themselves.

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(3) 15 U.S.C. § 78 *et seq.*

(4) Securities Industry Association (1999), 'Capital Markets Handbook', p. 101.

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(17) Ref. 14 above.

(18) 937 F.2d 823 (2d Cir. 1991).

(19) *Ibid.* at 829.

(20) 938 F.2d 364, 368 (2d Cir. 1991).

(21) 74 F.3d 1383 (2d Cir. 1996).

(22) *Ibid.* at 1394 (emphasis added). *Accord*, *United States v Hall*, 48 F. Supp.2d 386, 387 (S.D.N.Y. 1999).

(23) See *Chiarella*, ref. 16 above.

(24) 47 F.3d 857 (7th Cir.), *cert. denied sub nom*, *Harkins v Scattered Corp.*, 516 U.S. 818 (1995).

(25) Ref. 14 above, at p. 12.

(26) *United States v Hall*, ref. 22 above, at 387 (emphasis added).

(27) *Cowen & Co. v Merriam*, 745 F. Supp. 925, 929–31 (S.D.N.Y. 1990) (NASD/NASDAQ is not a national securities exchange).

(28) 15 U.S.C. § 77 *et seq.*

(29) *SEC v Torr*, 22 F. Supp. 602, 607 (S.D.N.Y. 1938).

(30) *Chemtron Corp. v Business Funds Inc.*, 682 F.2d 1149, 1164 (5th Cir. 1982), *vacated on other grounds*, 460 U.S. 1007 (1983).

(31) *Kidder Peabody & Co.*, 1945 WL 824 (S.E.C.) at *7–9, 18 S.E.C. 559, 568–570 (1945).

(32) *Adams & Co.*, 1952 WL 1057 (S.E.C.), 33 S.E.C. 444 (1952).

(33) *Kidder Peabody*, ref. 31 above, at 570.

(34) *Michael J. Meehan*, 1937 WL 1551 (S.E.C.), 2 S.E.C. 588, 616 (1937).

(35) *SEC v Resch-Cassin & Co., Inc.*, 362 F. Supp. 964, 976 (S.D.N.Y. 1973); *United States v Stein*, 456 F.2d 844, 850 (2d Cir.), *cert. denied*, 408 U.S. 922 (1972).

(36) *Resch-Cassin & Co.*, ref. 35 above, at 976 (defendant's aggressive buying campaign created actual activity).

(37) *Ibid.*

(38) H.R. Rep. No. 3383, 73d Cong., 2d Sess. 20 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 17 (1934).

(39) *Chriscraft Indus. Inc. v Piper Aircraft Corp.*, 480 F.2d 341, 383 (2d Cir.), *cert. denied*, 414 U.S. 910 (1973) (law does not proscribe all activity which tends to raise or lower the price of a security); *Trane Co.*, ref. 7 above, at 304–06 (purchase of 15 per cent of outstanding stock over nine-month period, producing steadily rising prices and increased volume, held not to be manipulation. Defendants' motive was to obtain personal profit, through an arbitrage, and had purchased to trigger interest in a takeover of Trane); see also *Alan Bennett Harp*, Sec. Exch. Act. Rel. No. 22511 (Oct. 7, 1985) (SEC reversed Administrative Law Judge's finding of manipulation because, while the circumstances of the trading raised 'suspicions' of manipulation, the presence of an arguably legitimate basis for Harp to be buying at limit orders to keep the price pegged above the trigger price in a contract that would have required Harp to deliver additional shares to a third party was a legitimate personal profit interest).

(40) Other parts of s. 9(a) contain prohibitions of activities more recently adopted by the Penny Stock Rule.

(41) Section 9(a)(1)(A); *In re J.A. Latimer & Co., Inc.*, 1958 WL 2293 (S.E.C.) at *2, 38 S.E.C. 790, 792 (1958) (a 'wash sale' is a transaction involving no change in beneficial ownership).

(42) Section 9(a)(1)(B),(C); *In re Thornton & Co.*, 1948 WL 833 (S.E.C.), 28 S.E.C. 208, 209–210 (1948).

(43) *Santa Fe Indus. Inc. v Green*, 430 U.S. 462, 476 (1977) ('Manipulations' held to refer generally to wash sales, matched orders, pegging and rigged prices that are intended to mislead investors by *artificially* affecting market activity); *Ernst & Ernst*, ref. 2 above, at 199.

(44) *United States v Carr*, 543 F.2d 1042 (2d Cir. 1976).

(45) This is the same language as the broader scope found in the fraud language of s. 10(b) and Rule 10b-5.

(46) Emphasis added.

(47) The SEC has defined 'floating supply' as 'that part of the issue which is outstanding and which is held by dealers and the public with a view to resale for a trading profit, as distinguished from that part of the stock held for investment'. *In re Barrett & Co.*, 1941 WL 1481 (S.E.C.) at *7 n.8, 9 S.E.C. 319, 327 n.8 (1941).

(48) It should be noted that units can have a legitimate purpose, and the warrant element adds value, because when exercised (or called) the issuer will get a second helping of cash at a predetermined level.

(49) The types of activities that follow in the text are engaged in for both IPOs and secondary trading in the securities of the 'public shell'.

(50) See, eg, *SEC v Hoke*, Litigation Release No. 16266, 1999 SEC LEXIS 1735 (C.D. Cal. August 30, 1999) (PairGain Technologies); Emulex Corp., below, main text at ref. 52.

(51) *New York Post*, 25th February, 2000, at 33.

(52) See, eg, 'Internet Business's International, Inc. Initiates Legal Action Against Potential Stock Manipulators', *Buisness Wire*, 6th June, 2000, as reproduced on Yahoo!Finance at http://biz.yahoo.com/bw/000606/nv_interne.html

(53) See Pelofsky, Jeremy (2000) 'U.S. Cracks Down on Claims by Day-Trading Advisors', *Reuters Ltd.*, 1st May as reproduced on Yahoo!News at http://dailynews.yahoo.com/h/nm/20000501/wr/financial_daytrading_1.html

(54) Miller, Michael (2000) 'Man Accused in "Pump-And-Dump" eConnect Stock Scam', *Reuters Ltd.*, 25th April as reproduced on Yahoo!News at http://dailynews.yahoo.com/h/nm/2000425/wr/crime_internet_2.html

(55) See Ramjug, Peter (2000) 'Regulators Target Internet "Pump and Dump" Scams', *Reuters Ltd.*, 6th September as reproduced on Yahoo!News at http://dailynews.yahoo.com/h/nm/20000906/bs/fraud_dc_1.html (on 6 September 2000, SEC filed 15 enforcement actions, including ones against a mechanic and a car service driver).

(56) *Ibid.*

(57) See 'SEC Settles Teen Internet Stock Fraud Case', *Reuters Ltd.*, 20th September, 2000 as reproduced on Yahoo!News at http://dailynews.yahoo.com/h/nm/20000920/wr/crime_teen_dc_1.html

(58) See 'Reno Describes FBI Internet-Wiretap System Review', *Reuters Ltd.*, 27th July, 2000, as reproduced on Yahoo!News at http://dailynews.yahoo.com/h/nm/20000727/wr/carnivore_dc_1.html

(59) See generally Meares, Richard (2000) 'Digital Surveillance? You'll Get Used to It', *Reuters Ltd.*, 21st July as reproduced on Yahoo!News at http://dailynews.yahoo.com/h/nm/20000721/wr/usa_lawyers_dc_1.html
(60) (2000) 'Sweeping Change in Market Structure Sought', *Wall Street Journal*, 29th February, at C1.
(61) See ref. 26 above, and accompanying text.
(62) Davidow, William (2000) 'Altered States', *Forbes ASAP*, 29th May, at p. 73.
(63) *Ibid.*
(64) *Ibid.*, at p. 74.
(65) 468 F.2d 1326 (2d Cir. 1972).
(66) See also *SEC v Kasser*, 391 F. Supp. 1167 (D.N.J. 1975), *rev'd on other grounds*, 548 F.2d 109 (3d Cir.) (ruling in part that US federal court had jurisdiction even though only victim of alleged fraud was Canadian corporation), *cert. denied sub nom, Churchill Forest Indus. Ltd v SEC*, 431 U.S. 938 (1977).

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Revised advice issued over Antigua and Barbuda

The treasury issued revised advice in July to financial institutions in their dealings with persons and businesses domiciled in Antigua and Barbuda following the introduction of improved regulation. This replaces the advice issued to UK financial institutions in April 1999 following legislative changes to the anti-money laundering laws in Antigua and Barbuda that weakened the capacity of the jurisdiction to deal effectively with money laundering and put the offshore sector at risk from criminal activity. The revised guidance is being sent out through the Joint Money Laundering Steering Group.

Many of the more detrimental legislative changes made by Antigua and Barbuda have been undone, with further improvements planned. It has also taken steps to ensure the independence of the offshore financial services sector regulatory authorities, and has strengthened the capacity of the financial intelligence unit to handle suspected money laundering cases.

Ruth Kelly, Economic Secretary to the treasury, said that in recognition of regulatory improvements it is no longer considered necessary for UK financial institutions to pay special attention to their dealings with persons or businesses domiciled in Antigua or Barbuda. Such institutions should apply normal due diligence procedures appropriate to transactions from jurisdictions that are not members of the Financial Action Task Force.

Journal of Financial Crime is published quarterly.

Editorial: The editors and Main Editorial Board welcome the submission of briefing and analysis articles for publication. All contributions not specifically commissioned will be refereed. Analysis articles should not exceed 6,000 words, and all contributions should be submitted in typescript, on A4 or US letter-sized paper. Details of the author's affiliation should be given. The correct citation for this issue is (2001) 9 JFC 2.

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Subscriptions: the subscription for the current volume, Volume 9, comprising 4 issues, is £245 in Europe; $370 in USA and Canada; and £260 in the rest of the world. Price includes postage and packing. Discounts for multiple subscriptions are available.

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