Regulating Market Manipulation
An Approach to designing Regulatory Principles

Rebecca Söderström
Abstract
The purpose of this article is to present an approach to regulating market manipulation. Market manipulation is a form of market abuse; e.g. spreading false information on the market, entering both a buy and a sell order for the same security at the same price, or concealing ownership when disclosure is required by law. Market manipulation constitutes together with insider dealing what is regulated as prohibited market behavior. As the financial markets are of central importance to our economic system, finding apt regulation thereof is crucial. Market abuse is one of the greatest threats to the well-being of the financial markets. The question regarding market manipulation regulation is how to find a line between harmful trading and strategic trading. The US and EU market manipulation regimes will be described, compared and analysed from a market efficiency perspective. The article results in proposing three principles for approaching the design of market manipulation regulation, namely; 1) the regulation should secure the market functions and enabling the enhancing of investor confidence and market efficiency, 2) the prohibitions should be action-specific and not comprehensively sorted, and 3) the consumer perspective should not be the leading motive for legislation in this field.

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Regulating Market Manipulation. An Approach to designing Regulatory Principles

Rebecca Söderström
Doktorand i kapitalmarknadsrätt (Doctoral candidate in Capital Market Law)
Faculty of Law
Box 512
SE 751 20 Uppsala
rebecca.soderstrom@jur.uu.se

Available at http://uu.diva-portal.org
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1 Introduction

The recent financial turbulence has lead to a number of legislative proposals, amendments and restructures in the financial field. Regulation of the financial markets has once again hit the headlines. There are many aspects of how stability and growth is best promoted. An inevitable ingredient of financial insecurity is market abuse. Scandals like the Enron and WorldCom cases have had an enormous impact on the global finance and also on the financial regulations all over the world. Market abuse is not only the main cause of such spectacular incidents as large-scale frauds and stock-market crashes, but is a part of everyday trading in contemporary financial markets.

It is a matter of course that investors care about the quality of the market they plan to invest in. To attract investors and obtain a developing and growing financial culture, it is of utmost importance that the market for financial services and capital exhibits market quality and market integrity. Achieving such goals requires a great deal of consideration about how the legislation should be designed. As in all sectors somehow linked to economics or to market interests, there are opinions agitating for flexibility on the market and less interference by legislation and governmental control. This has especially been the case concerning the inside dealing regulations. When it comes to market manipulation, few objections have been raised to the prohibition thereof. Nevertheless there has been and still is much debate on how to define market manipulation and the size of the scope of the prohibition.

2 Outline

Market abuse takes the form of insider dealing and market manipulation. In this article, the object will be to analyse market manipulation from a market efficiency perspective. The insider dealing regulation will only be discussed as a comparative element for reasons of understanding the big picture of market abuse. For the same

1 Engelen, p. 107.
3 Avgouleas, p. 4.
cause is historic legislation only briefly referred to; this is a study of contemporary law with an attempt of a final analysis *de lege ferenda*. In Section 3 the qualities and functions of an effective financial market are described. This section is necessary for the evaluation and discussion of the regulatory alternatives in the final part. The kind of behaviour that typically damages these market qualities is dealt with in Section 4. To continue, Section 5 compares the regulatory and supervisory financial systems of the US and the EU. This chapter forms the background for a detailed study offered in Section 6 of the actual regulations of market manipulation. The article continues to deal with defining market manipulation in Section 7. Thereafter the rationales behind regulating the financial markets in general are addressed in Section 8, together with viewing the profit interests of less regulation opposed to the interests there are of a strict regulation. Finally, in Section 9, the conclusions from previous chapters are summed up and some, hopefully fresh and inspiring, ideas of my own will be presented. The concluding analysis consists of the proposal of three regulatory principles for the regulation of market manipulation. Concluding remarks are offered in Section 10.

3 Background

Financial markets are of central importance to our economic system. Indeed, they constitute the most vital economic institution of modern societies. Largely speaking, the financial markets make trading possible, they are the place of the selling and buying of financial securities, commodities and other fungible items of value. The financial market is a concept comprising different markets depending on categorisation used, e.g., the capital markets, which in turn comprise the securities markets – the specialised market of interest in this study. Significant developments of the modern financial markets are the increasing global integration, the introduction of Internet-based trading, the financial innovations and the competition between traditional and alternative trading systems. Today the financial markets are more sophisticated, diverse, and internationalised than ever before.4

4 Avgouleas, pp. 24-25, 159.
Basically, financial markets facilitate the raising of capital (in the capital markets), the transfer of risk (in the derivatives markets) and the international trade (in the currency markets). A financial system is created for five basic functions: it provides investors and renders the exchange of goods and services possible; it facilitates the trading, hedging, diversifying, and pooling of risk; it allocates resources; it monitors managers and exerts corporate control; and it mobilises savings. Concluding all functions, the main function of the capital market is to supply capital equally to the demand — in other words, without any major shortages or surpluses — and allocate the existing capital efficiently — more precisely, that the marginal productivity of capital be substantially the same in different uses. The quality of these market functions determines the effectiveness of a market.

It is widely admitted that market abuse is one of the greatest threats to the well-being of the financial markets. As a response to this, and to the escalating market changes and technical developments, regulatory activism has been built up during the last five years. New pieces of legislation dealing with market abuse have been adopted, both in the US and in the EU. The provisions in this area have increased in number and details. Today the financial market is heavily regulated. However, there is simultaneously a general trend towards financial liberalization, which is part of a broader trend towards reduced direct intervention of the state in the economy. Thus, detailed financial regulations in some fields clash with deregulating necessity in other fields. This creates a scope for discussing the desirable design of the financial legislative measures and the regulatory principles behind these measures.

Market manipulation distorts the functions and qualities of an effective financial market. This is the main rationale behind prohibiting manipulative behaviour. How the legislation should be designed is a widely discussed matter, but of course all agree that the aim of the market abuse regulation is to make the financial markets work as well as possible. In order to be able to make a qualified

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5 Avgouleas, p. 24.
6 Engelen, p. 28.
7 Houthakker & Williamsson, p. 284.
8 Avgouleas, p. 4.
9 Avgouleas, p. 6.
10 Demirgüç-Kunt & Detragiache, p. 2.
analysis of the market manipulation regulations it is naturally of utmost importance to understand how manipulation damages the market.

4 Behaviour harmful to an effective market

4.1 The context of harmful market behaviour

The importance of well-functioning markets is quite obvious; this is not least evident considering the recent financial turbulence. Of course, in the context of discussing market manipulation regulations and finding a way to deal with such abusive behaviour, it is necessary to identify what kind of actions that can destroy the efficiency of the financial markets. It is crucial to identify the elements, the core and the very essence of market distorting behaviour in order to be able to fully evaluate its impact on the market and how it is best handled in today’s society.

An important initial thing to point out is that the overwhelming majority of transactions are fair. However evident this is, sometimes when becoming absorbed in studying manipulation and abuse on the market, one may lose sight of the normal, average situation. The starting point and basic attitude is that the greatest part of market players want to, and do, act in a legal and non-abusive way. This said, the present study does not omit the problems that lie in this statement. The very problematic essence is that great damage must be avoided somehow, by law or other measures, but not in a way that harms market efficiency. Considering the effects of market abuse, which is the topic of this chapter, it is clear that a few market actors destroy a lot, and to the detriment of the good-intended majority.

This is why market manipulation is such a multifaceted phenomenon, not easily addressed. Indeed, the fact that there are only a marginalised group of market actors involving in abusive schemes, makes it more difficult to find appropriate measures. The main interests to protect belong to those who need a properly functioning financial market. The question is how to define and

11 Avgouleas, p. 4; Siems, p. 15; Svensson & Schedin, p. 31; Samuelsson, p. 282.
regulate against manipulation. Few or many bad-intended market participants do not change the matter of principle – the importance of prohibiting manipulation, but it does matter to the design of the prohibition how many and which group the prohibition is designed for. A sound approach to law-making in this field must therefore always spring from this insight; that the ‘bad’ actors are out-numbered compared to the ‘good’ actors. It does not alter the seriousness or topicality of dealing with manipulation, but it alters the perspective on the target group of the measures taken.

All participants in the financial markets trade to earn profit. A frequently used description is that the capital market is governed by greed and fear.12 This is the primary reason for engaging in market manipulation. The motive is rational utility by profit maximization. The maximization in itself is not harmful, but it is the use of manipulative tools and schemes that harms the market. The result is an artificial situation with an outcome not obtainable without the behaviour causing the profit. It also leads to inequality by distorting the price mechanism on the financial markets.

What then makes a transaction fitting the description of market manipulation? How can a tool or scheme used when trading be considered manipulative? The effect of manipulation is the creation of a misleading impression on the market. What matters to establishing the harmfulness of transactions or any actions else on the market, is the effect of such behaviour on market prices and the damage inflicted on the market’s efficiency.13 It is thus not the construction of the devices, tools or the look of the transactions that are interesting in themselves, but the effect they have on the market. Harmful market behaviour makes the functions of the effective financial market less qualitative. This leads inevitable to diminished confidence for the market – the market integrity is harmed – and in the continuation losses of liquidity in the affected market. The ingredients of behaviour harmful to an effective financial market are, to sum up; an artificial result that could not have been obtained without a manipulative action, the creation of a misleading impression on the market, and most importantly, a distorting effect on the functions of the financial markets.

12 Torssell & Nilsson, p. 249.
13 Avgouleas, p. 73.
4.2 Defining market manipulation

The definition of market manipulation is by nature quite abstract. It has not been defined satisfying in either legal or economic literature.\textsuperscript{14} Many attempts exist nonetheless, both at a regulatory, judicial and scholarly level. Some of these thoughts will be presented here. Together with the legal definitions in the coming sections, I hope to sketch a fairly complete picture of what market manipulation is.

The classic definition of market manipulation is found in \textit{Cargil Inc. v. Hardin}, a quite famous US case from 1971, namely any activity, scheme or artifice that deliberately influences the price of a financial asset, resulting in a price other than the one that would have resulted in the absence of such intervention.\textsuperscript{15} An even older definition, with reference to the reform of the Securities and Exchange Act of 1934, is given in California Law Review in 1940. Manipulation is here said to be ‘broadly defined as the effecting of changes in security prices by means of artificial stimuli, as opposed to the normal changes that occur in the free market subject only to the interplay of supply and demand’\textsuperscript{16}.

Another frequently cited source is the former president for the New York Cotton Exchange, A. Marsh, describing market manipulation as ‘any and every operation or transaction or practice, the purpose of which is not primarily to facilitate the movement of commodity at prices freely responsive to the forces of supply and demand; but on the contrary, is calculated to produce a price distortion of any kind in the market’\textsuperscript{17}. A more recent study simply and bluntly establishes that a situation of manipulation ‘must mean that market participants are somehow being fooled’\textsuperscript{18}. There are various variations, more or less creative, on the definition of market manipulation. A good summary, of which most would agree, is to say market manipulation consists of four elements: 1) a manipulative act or omission; 2) intent; 3) causation; and 4) artificial price.

To sum up; market manipulation constitutes the transfer of wealth from the large number of market players to a very small

\textsuperscript{14} Nelemans, 2007, pp. 1, 43; Nelemans, 2008, p. 1; Avgouleas, p. 104; Fischel & Ross, p. 506.
\textsuperscript{15} \textit{Cargil Inc. v. Hardin}, 452 F 2d 1154, 1163, 1167-70 (1971).
\textsuperscript{16} Porterfield, p. 378.
\textsuperscript{17} Avgouleas, p. 106, see note 16: 1928 \textit{Senate Hearings} 503.
\textsuperscript{18} Abrantes-Metz & Addanki, p. 6.
number of actors, through the use of unfair means by the latter. This is market manipulation in economic terms. The core of manipulation is to distort the price formation on the market, which means that prices of financial instruments become artificial. It is the value, supply or demand of the financial instrument that become manipulated.19

5 The current regulation of market abuse

5.1 General remarks

Over the centuries, numerous incidents of market manipulation and insider dealing have disturbed the financial markets and have at least partly been the cause of the various crashes and other catastrophes through the history of finance. In recent times, cases like the corporate frauds of Enron, Tyco, Adelphia, Qwest and WorldCom – involving both large-scale market manipulation and extensive insider dealing – are well known. The occurrence of such incidents, growing in frequency, has lead to the increase of regulations in the area during the last five years. Both in the EU and in the US this legislative activism is criticised for being an over-reaction. The works of legislation are especially voluminous in the US, and the critique is likewise extensive.20

It is interesting to compare the US and EU systems in the area of financial regulations. It can be noted that a general regulation trend in the financial sector on both sides of the Atlantic, is an increased governmental regulatory interference. This is not however the single trend; interestingly enough many financial areas, e.g. corporate law, face an opposite development with deregulations as a result of political reconstructions. Many steps toward diminished legislative presence are also taken in several other areas in the financial markets. Nevertheless, when observing the recent enactments in the area, it is clear that it is possible to talk of some sort of a law-making escalation. Unheeded the ambiguity of the regulatory role in the financial sector, it is today generally acknowledged

19 Avgouleas, pp. 4-5; Samuelsson, p. 154.
20 Avgouleas, pp. 9, 6.
that the institutional framework is of great importance for the functioning of the financial markets.  

5.2 US market abuse legislation

After the 1929 Wall Street crisis, the US Congress adopted the so-called ‘New Deal’ legislation. The purpose was to reduce fraud by ensuring that the flow of information would be improved, so that investors on the financial markets would not be mislead. The need to legislate was acute. The most important ‘New Deal Statutes’ were the Securities Act of 1933 (SA 1933) and the Securities and Exchange Act of 1934 (SEA 1934). These two acts have not only constituted the basic component parts of the US regulatory system for securities markets, but they have long been the model for securities legislation all over the Western World. The SA 1933 has two major objectives; to require that investors receive financial and other significant information concerning securities being offered for public sale and to prohibit deceit, misrepresentations, and other fraud in the sale of securities. The SEA 1934 likewise identifies and prohibits certain types of conduct in the markets. It also requires periodic reporting of information by companies with publicly traded securities.

The most radical and reforming piece of legislation in the US in this field is however the Sarbanes-Oxley Act of 2002 (SOX). It aims to improve the quality of corporate disclosures, financial reporting and independent audits by increasing civil and criminal penalties for securities law violation. It is a far-reaching regulation, inflicting a higher degree of personal responsibility than previous laws, and is criticised for being too restrictive.

In broad outline, the US securities regulation faces due to internationalisation and technical developments, four clear changes today and in the near future. First, the primary regulator of US securities markets – the Securities and Exchange Commission (SEC) – promulgated new rules to make it easier for foreign private issuers to trade on the US market, by certain exceptions for smaller investors and less strict accounting requirements. Second, it is proposed

21 Petschnigg, p. 4.
22 Avgouleas, pp. 174-175.
24 Avgouleas, pp. 96, 454.
that public comment should be sought regarding whether US issu-
ers should be allowed to file their financial statements in ac-
cordance with International Financial Reporting Standards (IFRS). Third, foreign regulators have been asked to adopt extensible Business Reporting Language (XBRL) as the standard language in which reporting companies around the world would file their fi-
nancial information. Finally, and most significantly, the SEC is in the process of developing a detailed proposal to establish mutual recognition treatment for foreign exchanges and broker-dealers seeking access to the US market.25

5.3 EU market abuse regulation
The EU provisions in the financial area have, just as in the US, re-
cently increased in number and details. However, unlike the US legal development, the force behind the European regulatory ex-
pansion has not been financial crises or competition among agen-
cies and states, but the desire to create a more competitive Euro-
pean financial market place.26 Since the very beginning of the EU-
project, integration and approximation of the inner market has been one of the major purposes. This political ambition together with the substantial technical development during the recent de-
cades, have lead to the European financial markets becoming highly integrated and treated as one single market, by the EU legislator as well as by investors trading across national borders.27 Today the market abuse regulations in the European countries are predomi-
nantly European-based.28

The EU market abuse regime comprises a coherent body of rules, which are adopted to implement the Commission Financial Services Action Plan (FSAP)29. Directives enacted as a consequence of the FSAP are the Market Abuse Directive (MAD)30, the Direc-

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26 Petschnigg, p. 22.
28 Siems, pp. 39-49.
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tive on the Public Disclosure of Inside Information\textsuperscript{31}, the Accepted Practices Directive\textsuperscript{32}, the Public Offers and Admissions Prospectus Directive\textsuperscript{33}, the Directive on Transparency Obligations of Trades Companies\textsuperscript{34} and the Directive on Markets in Financial Instruments (MiFID)\textsuperscript{35}. The purpose of the regulations is to protect investors as well as the integrity of the European financial markets. The provisions concern the prevention of insider dealing, mandatory disclosure, trade transparency and the prohibition of market manipulation. The FSAP has meant a thorough reform in the EU financial regulatory area, not least because of the unusually high level of harmonisation required by the member states in order to implement the legislation.\textsuperscript{36}

6 Defining market manipulation in law and practice

6.1 General remarks

As shown above, market manipulation is a form of economic behaviour, aiming at creating false impressions as regards the value of financial instruments. Yet, market manipulation cannot be defined as every action that puts pressure on the prices of financial instruments, because that would also cover ordinary trading. Moreover, prices are also influenced and distorted by irrational market behaviour due to investors’ biases, overconfidence or fears.


\textsuperscript{32} Directive 2004/72/EC of the Commission of 29 April 2004 implementing Directive 2003/6/EC on accepted market practices, the definition of inside information in relation to derivatives and commodities, the drawing up of lists of insiders, the notification of managers’ transactions and the notification of suspicious transactions.

\textsuperscript{33} Directive 2003/71 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.

\textsuperscript{34} Directive 2004/109/EC of 15 December 2004 on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.


\textsuperscript{36} Avgouleas, pp. 239-241.
The prohibition of market manipulation has been one of the most substantial goals of the SA 1933 and SEA 1934. However, a definition of market manipulation is nowhere to be found in the US securities regulation. The SEA 1934 has instead a number of provisions that target specific forms of manipulation, which will be presented below. The absence of a legal definition of market manipulation has lead to the manifold attempts mentioned above to define the concept in other fora; which has created further confusion as to the actual meaning of market manipulation. The Market Abuse Directive (MAD) has contributed a great deal to clarify the concept of market manipulation. In contrast to the US legislation, the MAD actually proscribes market manipulation by name and describes the various manifestations thereof. Article 5 of the Directive states that ‘Member States shall prohibit any person from engaging in market manipulation’. Besides the MAD, two implementing directives and the guidelines by the Committee of European Securities Regulators (CESR), have to be considered to find a full legal definition. CESR has listed 13 possible ‘signals’ of market manipulation for the purpose to facilitate the local authorities’ assessments of suspected manipulative actions.

However detailed the European securities legislation may be, market manipulation is a very elusive concept and is criticised for being too bureaucratically and confusingly drawn up. The combination of the detailed legal framework and a yet hard-defined offence will lead to increased costs of compliance and enforcement, which of course means raised costs for business actors on the European financial markets. In the next, the main forms of market manipulation will be analysed, with the SEA and MAD respective definitions introducing each form.

37 Mahoney, p. 343.
38 Avgouleas, p. 104; Fischel & Ross, p. 507.
40 CESR/04-505b Guidance, p. 17.
6.2 Legal definitions of market manipulation

False or misleading transactions

‘Transactions or orders to trade, which give or are likely to give, false or misleading signals as to the supply of, demand for or price of financial instruments.’

MAD article 2 a. para. 1\(^\text{41}\)

‘For the purpose of creating a false or misleading appearance of active trading /…/, to effect any transaction /…/ which involves no change in the beneficial ownership thereof, or to enter an order /…/ with the knowledge that an order of substantially the same size, time and price, for the sale /or the purchase/ of any such security, has been or will be entered by or for the same or different parties.’

SEA section 9(a)(1)\(^\text{42}\)

By transactions designed to push securities’ prices up or down, manipulators can unload their position or buy in lower prices at profit. Trade-based manipulation usually needs to be large, structured and timed to influence the supply, demand, or price levels of traded investments. Since all large, informed transactions could have a price effect, it becomes essential to find the false or misleading element in the transaction. In the implementing EU directives and the CESR publications there are guidelines, detailed indicators, examples and signals to facilitate the discovery of a manipulative transaction. Most important seems the extent of the suspected transaction, which in comparison to the total trade of that share may indicate manipulation.

One example is wash trades, which means that a manipulator enters both a buy and a sell order for the same security at the same price, thus a transaction is recorded and the market is mislead by the impression that there is interest to buy the security concerned. The transaction is fictitious since there is no change in the beneficial ownership. A slightly different conduct is where both buy and

\(^{41}\) Dir. 2003/124/EC, 2004/72/EC.
CESR/04-505b Guidance, para. 4.11.

sell orders are entered at or nearly at the same time, with the same price and quantity by different but colluding parties. Improper matched orders are creating a misleading appearance of market activity. Proving a substantial match between orders can be a difficult thing; manipulators with such intent will do their best to make the orders look normal and the match only accidental.

Further, a market actor may by a large, sudden purchase, move the price of a financial instrument. This is called ‘window dressing’ or ‘painting the tape’ and may have several benefits such as improving the value of the possession before a reporting opportunity.43 Another practice is to place orders with no intention of executing them. These cases are very hard to judge, but it is clear that placing trade orders without a real intent matching the price of the order is misleading the market and constitutes market manipulation.44

**Price positioning**

‘Transactions or orders to trade which secure, by a person or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level.’

*MAD article 2 a. para. 2*

‘/.../ to induce the purchase or sale of any security /…/ to the effect that the price of any such security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.’

*SEA section 9(a)(3), (5)*

Price positioning is the most difficult form of manipulation to define, because of the need to use futures, options and other derivative instruments to get a dominant position over the price of securities. If for instance a party has significant influence over the supply, demand or delivery mechanisms of a financial instrument,

43 Svensson & Schedin, pp. 40-41.
44 Ibid, p. 47.
45 CESR/04-505b Guidance, para. 4.12.
46 Author’s redactions.
he can use his dominant position in order to move the price very close to an anticipated conclusion of a derivative contract. This behaviour of ‘abusive squeeze’ makes the manipulator profit, not from the trades as such but from the conclusion of an advantageous agreement based on a manipulated price.

The internationally accepted definition of an artificial price is ‘the divergence of price from the legitimate forces of supply and demand’\(^{47}\). Nevertheless, even proper interaction of supply and demand often lead to pressed price situations on the market; this does not in itself constitute, as little as having a dominant position, market manipulation. Here the transaction must lead, or more accurately, mislead another party to enter a contract. The misleading component is distinct also for this type of market manipulation.

In the MAD the example of ‘buying or selling of financial instruments at the close of the market with the effect of misleading investors acting on the basis of closing prices’, is given as a typical case of price positioning.\(^{48}\) This so called ‘end of the day trading’ or as the CESR puts it ‘marking the close’, serves the purpose of influencing the closing price of a share by a potential manipulator making the last trade order suit his position. However, it would be too rash to conclude that any trade order that is made just before closing the stock exchange constitutes a manipulative transaction. The trader is perhaps only careful, following a strict policy to watch prices before trading or being pressed by urgent trading needs. Other forms of price positioning is colluding in the aftermarket of an initial public offer, creation of a floor in the price pattern, excessive bid-ask spreads and trading on one market to improperly position the price of a financial instrument on a related market.\(^{49}\)

**Artificial transactions**

‘Transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance.’

**MAD article 2 b**\(^{50}\)

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\(^{47}\) Avgouleas, p.109.

\(^{48}\) MAD art 2, section 2, ind 2.

\(^{49}\) CESR/04-505b Guidance, para. 4.12.

\(^{50}\) CESR/04-505b Guidance, para. 4.13.
This variant of manipulation can be hard to distinguish from the first alternative, as they both cover transactions by which the actor, in one way or another, wishes to deceive the market. A typically infamous action in this category is 'pump and dump'. A small group of informed investors take a long position in a security before they recommend it to other market participants by misleading positive information about the security. The result is a quick spike in the price followed by an equally quick downfall. The manipulator who has bought the stock early sells out at the inflated price.

Opposite of pump and dump is 'trash and cash'. The market is deceived by the manipulator taking a short position in a security and spreading misleading negative information to make the price fall and then closing the position after the price has fallen. Other deceptive transactions could be to conceal ownership when disclosure is required by law or to open a position and closing it immediately after its public disclosure. Common for this section is that the transactions involve deception; they are misleading other actors on the market.

**False or misleading information**

‘Dissemination of information through the media /…/ which give, or are likely to give, false or misleading signals as to financial instruments, including the dissemination of rumours and false or misleading news /…/’

**MAD article 2 c**

‘/…/ for the purpose of inducing the purchase or sale of such security, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect

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51 Author’s redactions.
52 CESR/04-505b Guidance, para. 4.14.
to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.’

**SEA section 9(a)(4)**

Information-based manipulation is least complex; the situations covered by this variant are straightforward, e.g., securities fraud. Mainly, this form deals with misrepresentations by issuers and investment advisers, talking up a security to unsuspecting investors. Another practice under this section is dissemination of false rumours, which has become more common with the Internet. This form of manipulation does not require any accompanying transaction.

The problematic thing here is to prove that the person knew that the information was false or misleading and that he or she was disseminating the information in order to create a false or misleading impression. The CESR guidelines also mention that this variant includes spreading misleading information through means other than the media. Yet again, the element of what constitutes a false and misleading behaviour becomes the cardinal prerequisite for the assessment of market manipulation.

7 Finding the line

Even if we are clear about what *could be* market manipulation, according to the detailed legal definitions as presented above, it is crucial to know where the outer borders are drawn, i.e., *what is not* market manipulation. A first important distinction to make is between unfair manipulation and actions aimed at stabilising financial instruments. Stabilising actions are when a financial institution is trading exclusively for supporting the market price of a security for a predominated period of time, due to selling pressure in the securities. The EU regulation on Share buy-backs and Stabilisation prescribes how stabilisation is to be performed in terms of disclosure, reporting, time, and price. According to SEC, stabilisation is

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53 Author’s redactions.
54 Siems, p. 16.
55 Regulation (EC) 2273/2003, art. 2.
to buy securities for the limited purpose of preventing or retarding a decline in its open market price in order to facilitate its distribution to the public.\textsuperscript{57} SEA 11a-1 provides exemptions for transactions of registered specialists, constituting stabilizing activities under the Exchange Act and transactions approved for the purpose of maintaining a fair and orderly market, and transactions made to offset errors.\textsuperscript{58} Such trading is legal, but since its purpose is to influence the price just as a manipulative action, it can be difficult to tell the difference, and one must look closer at the transaction at hand.\textsuperscript{59}

Another kind of exception is accepted market practices (AMP), which are found in both the US and the European legal financial systems. AMPs are practices that are reasonably expected in one or more financial markets. In the EU system, an otherwise manipulative action on the market must, to be an AMP, be accepted by the competent authority in accordance with the Directive 2004/72 and the CESR guidelines.\textsuperscript{60} AMPs can be decisive as a demarcation between manipulative and non-manipulative behaviour. Even though they contribute to offer ‘negative criteria’ for the definition of market manipulation,\textsuperscript{61} they are not uniform but depend on the particular market. Moreover, the AMPs too need evaluation. The question of what is a manipulative conduct in the first place remains even if it in a specific case is found accepted by the market.

The legal provisions together with the various exceptions form a departure point in defining market manipulation. To go from there, trying to find the actual line between manipulative and non-manipulative activity is nonetheless a hard thing. This is indeed a weakness in the current regulation on both sides of the Atlantic. However long and detailed the list of possible examples of such abuse is, the outer boarders of the prohibited area are not made clear.\textsuperscript{62} The legal situation is like a sea with a very blurred coastline. It is simply hopeless trying to identify where the water – filled with nasty fish – meets the safety of dry land.

\textsuperscript{57} Commission’s Securities Exchange Act Release No. 2446 (March 18, 1940) at 3; Parlin & Everett, p. 607.
\textsuperscript{58} SEC Report, 1994, Appendix V, p. 4.
\textsuperscript{59} Samuelsson, p. 129.
\textsuperscript{60} MAD, art. 1(5).
\textsuperscript{61} Siems, p. 16.
\textsuperscript{62} Other exceptions like e.g buyback programmes (MAD art. 8), will not be examined in this paper.
A capital reason for the regulation of financial transactions is obviously the fact that trade on the financial markets is growing more and more international and finds new means which, naturally, the illegal trading likewise does. It is crucial to secure the confidence of the market to achieve market efficiency. This is the aim of the MAD: ‘to guarantee the integrity of European financial markets and increase investor confidence’63 as well as for the SEA, which was created to ensure ‘open markets for securities, where supply and demand may freely meet’64. The need for, and justification of, regulation is widely accepted when it comes to market manipulation. Naturally, critique has been directed at the extensiveness of the EU and US regulations and that the continuing growth of legislation may be difficult to comply with and enforce.65 As showed above, the formulation of a legal definition of market manipulation has been a great challenge in this area. This is the main reason for the vast number of provisions in the SEA, the MAD and connected legislation.

The common feature for all forms of market manipulation is that the action concerned is misleading or false in some way. The behaviour is fraudulent, however it might be of value to clarify that market manipulation cannot comprehensively be classified as fraud. This is because fraud is by definition consisting of a bad act, e.g. a false statement, plus an intent to defraud. If there is no objectively bad act (if the statement is true), there is no harm or loss, and the question of intent is uninteresting and insufficient to establish fraud. Conclusively, trade-based manipulations cannot be defined as fraud. Only if there would be a general duty not to mislead the market through trading, it would be possible to make a classification of manipulation as fraud.66

Despite various examples, descriptions and forms laid down in the securities regulations, the definition of manipulation still halts at the indefinable misleading element. The phenomenon of manipulating the market is built on the idea to distort the mechanisms of normal financial transactions. Transactions that in themselves are not harming market integrity or liquidity are carried out with the intent to mislead. This is the core of market manipulation. To

64 Fischel & Ross, p. 504. Referring to: Ellenberger & Maher.
65 Avgouleas, pp. 210-211; Siems, pp. 16, 26-27.
66 Fischel & Ross, pp. 510-511; Avgouleas, pp. 113-116.
act manipulatively constitutes a tool to make profits that would otherwise be unattainable, unless the action was performed detrimental to other market actors. The behaviour leads to less confidence for the market and has thereby a destructive effect on the capital market in large.

The reason, I believe, for the lack of an objective definition of market manipulation is that the most indispensable criterion for establishing manipulation is a subjective one. Both the US and EU regulatory definitions of market manipulation are objectively based, claiming by describing certain behaviour as manipulative, that the law can draw a line between manipulative and non-manipulative actions. In the CESR guiding list, the recurring characteristic in the description of all forms of manipulation, which signals that a transaction could be manipulative, is *appear* or *apparent*. Typical examples are ‘transactions which *appear* to have the purpose…’, ‘transactions which *appear* to be seeking…’, ‘transactions with no other *apparent* justification…’ I find this interesting, because it spotlights the very essence of why market manipulation seems so hard to define. It is the appearance of a manipulative purpose, and not the detectable result of the transaction, that makes the behaviour distinguishable from a when a fair transaction is made. This is why finding the line between illegal market manipulation and legal market speculation becomes a matter of highlighting specific situations, trying to find the line not in the law but in each specific case.

8 Rationales and interests behind regulation

8.1 General remarks

Effective allocation of resources and balance of supply and demand of capital are important for a good financial performance and for the economy in large. The financial market is the scene where these objectives are attained. How and by what means these objectives and the well-functioning of the financial markets are best achieved, is a classic discussion. In the financial markets, the debate about these questions has reached enormous proportions not least

67 CESR/04-505b Guidance, p. 17.
in connection with the recent corporate scandals and the effects of the SOX legislation in the US. Since the trend today is enhanced regulatory activism, together with an increased number of areas facing deregulation and self-regulation, the rationales and interests behind financial market regulation become even more topical.

As in many legal fields, control over wrongs and mistakes is set against flexibility and room for the maximization of profit or some other interest. The issue of how to regulate market manipulation is a cardinal matter in this balance of interests. In order to enabling the designing of market manipulation regulatory principles, a larger perspective of the arguments for and against public regulation is needed. The section at hand will deal with the standpoints for and against strong regulations on the financial markets, including as much of shades and different approaches as necessary, to get a good picture of the principles underlying the financial regulations.

8.2 The justification of regulation in general

The main justification to regulate the activity on the financial markets is to help the financial markets perform more efficiently. Regulation is in this context the umbrella term for public regulation, which is the governmental interference in an area of interaction between private subjects, imposing prohibitions rules and sanctions, and private regulation, which is when private entities regulate the market themselves through codes of conduct and other branch specific agreements. The departure point is that no market is perfect, abuse has and will always exist, thus some kind of regulation (governmental measures or self-regulation) is needed. I also count in the fact that most financial markets actually are, more or less, governed by a body of public rules. To get rid of governmental measures altogether on financial markets, and in the field of market abuse, is therefore not a realistic possibility and not an alternative elaborated with in this article. The matter at hand is the design and extent of public measures.

The regulation of financial markets, on whichever level, has two main purposes: maintaining competition and protecting investors against fraud and other kinds of abusive behavior. In order to fulfill these purposes the financial regulation needs to safeguard the systematic stability, protect the integrity of the market and foster market efficiency. If these aims are attained, the overarching objective of the
financial market regulation will be served: the preservation of the investor confidence in financial markets.68

The complex question and matter widely debated is how the regulation should be designed to maximize the functions and qualities of the financial markets. What is best for the different actors on the financial markets, seen to their interests and roles? To what extent is public regulation desirable? I hope to answer these questions in the following.

8.3   Theories and arguments emphasizing regulation

The public regulations today are mainly concerned with the establishment, prudent operation and continuous supervision of the financial markets.69 The justification for a strong public regulatory system for these functions is built on the presumption that regulation supplied by the government is necessary to correct market failures. Public interference is thus the remedy for market practices that make the market inefficient, e.g. fraud, monopoly, manipulation and information asymmetries. Usually these views are named the ‘public interest theory’.70 According to this theory, abuse and other wrongs in the financial markets are looked upon as failures of the market’s self-regulatory mechanisms. Therefore public regulation is a suitable measure to handle the erring market features.

The main characteristic of the public interest theory is that it attributes a desire to pursue collective goals to the government and other public functionaries. What a public interest really means is differently viewed, but an interesting development of the public interest theory is the approving of what is called ‘paternalistic regulation’. This is when regulation is based on the belief that the market is unable to regulate itself, for instance in the financial field, and is in need of excessively intervening public initiatives. Especially in connection with the discussion on behavioral economics, the benefits of paternalistic policies has become relevant. By pointing out some of the ways that human behavior falls short of perfect rationality, public regulation can be adopted in order to constrain individual choice.71

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68 Avgouleas, p. 167; Houthakker & Williamsson, p. 285; Blume, p. 3; Zingales, p. 28.
69 Avgouleas, p. 167.
70 Avgouleas, pp. 160-162.
Another argument put forward, often called the ‘public choice theory’, is that utility maximization is the force behind all human behavior. This applies also when legislators and politicians act. Rules and regulations are therefore provided with their drafters’ self-interest as the underlying goal. Groups representing certain interests can, by lobbying and other political activities, put pressure on those in charge of rule-making and make sure the group’s interests become in line with the rule-makers’ advancing of their own cause. Public regulation is on this ground seen as attractive, since it is the public choice that sets the frames for when and how regulations are designed.72

Regulation of the financial markets through governmental and public structures has existed for over a century and the discussion on the adequacy thereof has been held since.73 As emphasized by the theories, the main reason for public regulation is to correct market failures. All kinds of rules, on all levels and of all degrees, aim to somehow control the market, remedy wrongs and improve the structure. But what interests are there to keep the market intact by public-regulatory means? I can think of three major interests behind the will to regulate mainly by governmental measures.

Firstly, there is the interest to make the state part of, and an important actor on, the financial market. In itself this means stability to some extent. Since the financial markets are the most important economic institution of today’s societies74, their functioning affects the well-being of all areas of human life – which the state as institution is ultimately responsible for. The state represents the general public and the interests of society in large. To exercise controlling powers is a way to obtain the generally desirable results. To prohibit and deter some actors on the market becomes legitimate for the sake of the greater good. A way to justify a strong legislator in the financial sector can be to value state interference as the only equally measurable backlash to activity damaging market efficiency. Public regulation becomes the solution to market abusive behavior, such as market manipulation, which is looked upon as a serious threat to and a demoralizer of the market as well as the cause of financial crises.75

72 Avgouleas, pp. 163-164.
73 Nelemans, 2008, p. 3.
74 Avgouleas, p. 159.
75 Fischel & Ross, pp. 503-504.
Secondly, there is an interest to protect certain actors on the market. This is a common object of public legislation, to strengthen individuals or other entities that are in a weak position or are otherwise exposed. The need of consumer protection in the financial sector has emerged in pace with the growing participation of small investors on the market. This is especially evident within the EU regulatory system, where protective rules for consumer rights are one of the goals and commonly a ground for measures aiming at the harmonization of the inner market. To maximize consumer welfare is both an independent objective for the EC competition policy and a way to, together with optimal allocation of resources, enhance efficiency in the European financial markets. Often, consumer protection is intimately connected with stability of the financial markets. When market players are not very versed in the financial system the demands are higher on companies to handle financial risks in the business with diligence. Perhaps there is a need to increase information spreading. Naturally, the financial stability has to do with the confidence in the markets. Companies are by public regulations forced to comply with certain requirements adjusted to protect small investors from losing confidence and being harmed.

Thirdly, there is the interest for society to uphold justness and moral standards in the financial market. Fraud, including financial market abuse, has never been an accepted behavior but rather seen as the opposite; repulsive, abnormal and punishable. As shown above, the core of market manipulation is to use unfair methods in order to obtain profits to the detriment of the quality of the market functions. Publicly regulatory prohibitions signal the common dissociation and depreciation of such abusive behavior. The status and respect of the law in a society is usually in itself helpful to reinforce the view that one act or another is wrong. In a whole other sense than self-regulative measures, the prohibitions of the state sanction the importance of detecting and deterring market actors involved in manipulative schemes. Even if there was no other rea-

77 EC Treaty, art 3 (t); Craig & de Burca, pp. 936-937.
78 FI Dnr 08-2222, pp. 1-2.
79 Avgouleas, p. 499.
son, the reason of ethics could be seen as enough cause to prohibit market manipulation in law. If someone does something fraudulent, even if the outcome might not be totally warped market functions, failing to call such actions wrong would not be accordable with a democratic and just society.

8.4 Theories and arguments emphasizing free competitive markets

Not everyone takes the same standpoint in the regulatory discussion as displayed above. A famous theory is the Chicago theory of regulation, or ‘the theory of capture’, which holds that regulations, irrespective of the motives of the regulations, are always products allocated in accordance with the laws of supply and demand. The rules governing the market are captive to the concerns, interests and influences of the industry they aim to regulate. The regulation can thus be of use for the groups that benefit from the regulation. However, since this will almost always include that some other group loses due to the regulation, the theory of capture supports in practice the view that regulation on most occasions is more likely to create a market failure or aggravate an existing one than to provide the desired remedy. The arguments at hand condition the making of public regulation with the concrete benefit for those who value and extract utility from the regulation. There must be a demand for, and supply of, regulation and the cost and benefit of regulation need then to be calculated. If the profitability of a regulation is diminished because of damage caused to certain individuals or groups, the cost is too high and the regulation is not worthwhile. Regulation is only desirable in as large extent as the total benefit for the market. Considering the fact that not many regulations are totally clean of negative effects, the Chicago theory can be said to support a larger scope of non-interference by governmental regulations.

Support for free markets instead of formal regulation is also given by ‘the behavioral theory’, which abstractly ascribes the behavioral biases (overconfidence, framing, loss aversion) to be bigger in the political field than in economic life. Individuals have

80 Stigler, p. 18; Avgouleas, p. 163.
81 Stigler, pp. 7, 10.
fewer incentives to dedicate resources to make sure the choices are well-founded and enlightened when it comes to politics, compared to investing decisions or other activity in the economical sphere. False believes and biases are more likely to govern and persist in the political arena. This inevitably leads to less quality of political decisions and diminished confidence for public regulations.82

A first notation to make is that regulation as a ‘device’ to obtain market control is not designed by economists but is the result of political pressures exerted by different lobby groups.83 This does not mean that regulation is bad for the market. Even if welfare enhancing legislation can have severe distorting effects on the efficiency of financial markets, the discussion on flexibility and deregulation must notwithstanding circle around the presence of governmental interference. Or as I like to put it; it is about finding regulatory principles. This search includes weighing the arguments for self-regulation against those described above that are in favor of a strong public regulatory system. This is the aim of the remains of this study.

The departure point of the theoretical arguments against formal regulations of the markets is that such regulation in one way or another has been found insufficient or inefficient. Arguments supporting market flexibility are based on the negative effects of statutory regulations. Compared to the pro regulation standpoints, it is much easier to find a cost-benefit evaluation of regulatory measures in the theory of capture or the behavioral theory. The advantages of deregulating an area, to the benefit of self-regulation by market actors, is weighed against what disadvantages the lack of public rules bring about.

A larger scope of flexibility on the financial markets constitutes a catch-all point of view, comprising different compositions and grades of less public regulation, self-regulation by voluntary rules of an industry association, and non-regulation where pure financial mechanisms gear the market functions. The main interests behind a market free of heavy state interfering activism is without doubt profit maximizing interest by economically motivated market players. Being able to decide their own set of rules, market participants act from a common interest in acting to maintain their collective

82 Avgouleas, p. 164; Zingales, pp. 30-31.
83 Zingales, pp. 3-4.
reputation. Business practice brings forth standards directly formed out of the existing needs and desirable results. The rules are agreed upon by those who in fact are the subjects on the market.84

Proponents of self-regulation assert the preference of self-regulation over formal law basically on quite practical grounds. Firstly, a self-regulatory market has greater technical knowledge, a higher level of expertise and is better at taking advantage of innovation possibilities. Secondly, the costs for making, interpreting and enforcing the rules and standards are lower because the actors on the market have common interests. The costs are moreover borne by the actors themselves instead of tax-payers, which means minimal administrative system costs and an incentive to formulate business standards as efficiently as possible. Thirdly, self-regulation is argued to be both faster and more flexible than governmental regulation, since processes and rules are less formalized.85

8.5 How regulation affects the market

The previous section has dealt with theories and arguments put forward either supporting strong public regulatory control or flexible self-regulation. Both views must be evaluated from a market efficiency perspective. What serves best the effectiveness of financial markets? Before this question is answered, in the form of a proposal below consisting of principles for regulating market manipulation, this general regulatory analysis must be carried on a little further. Understanding how to apply these more or less very theoretical assumptions on the market manipulation matter requires a comparison between the arguments at hand.

The principal difference between the standpoints is that those advocating the importance of free competitive markets see the existence of e.g. a public prohibition in the context of the effects on the market and on the market players. On the other hand, the pro-regulation arguments seem to balance the weight of a strong governmental regulator against the size of damages on the market due to, for instance, market abuse. The appalling effects of manipulative activism can in their view only be remedied through state interference. The non-public regulation view does however value gov-

84 Avgouleas, p. 227.
85 Avgouleas, p. 228.
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governmental rule-making in relation to the groups on the market that are affected by the rules. Here the market effect of the legislative activism, not the abusive activism, is the opposite pole of the governmental role. While a damage-remedy perspective prevails in the pro-public standpoint, those opposed of public regulations keep a cost-benefit perspective.

The result of this comparison is that a tool to measure the market confidence can be constructed. Market confidence is, as repeatedly stressed, the aim of all kinds of regulations in this area and necessary for efficient resource allocation and price formation on the market. Without taking standing for or against public regulation in the financial sector, which is quite hard to do only on theoretical grounds, it is obvious that the self-regulatory view has a clearer market efficiency perspective. Here the effect of state interference on the actual trade on the market is of direct interest. The market players’ trading is the centre of discussion and the important thing is to keep the trading friction free. The financial markets are valued as good as the actors who trade on it. What restricts the actors restricts the market. Public regulation is limiting the trading since it sets up boundaries the market players cannot dispose for themselves. The self-regulatory proponents thus have a great confidence in the financial markets and the ability of the market actors to govern the market independently. Remember again, I do not assume that this view advocates a market totally unregulated by the public. It is about rejecting strong interference by the legislator, e.g. the SOX rules.

In the case of arguing for a powerful governmental regulation for the benefit of well-functioning financial markets, the confidence for the market to mind its own businesses is not very strong. The existence of large-scale abusive schemes and manipulating actors demands for a clear governmental presence in order to keep things functioning on the market. Relying on the forces of supply and demand, and the good will of most investors, is simply not enough when the great damages of some abusive market activity are considered.

The grades of confidence shown by the two views are different because there is a difference in the opinions of what interests should be protected on the market. Consumer protection, moral upholding and the interest to make the state an active part of the market to gain stability, are all risk diminishing interests, whereas the
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interest of flexibility, scope for rule-participation by the market actors and cost efficiency, are profit enhancing interests. As I see it, it is the latter view that will in work in the long run. The perspective must be that the market is basically able to achieve its own goals. Confidence in the market should be a fundamental approach in financial law-making. A profit enhancing departure point and the self-regulatory arguments show highest confidence and are closest anchored to the market actors themselves.

As repeatedly mentioned, there will always be a need for some public regulation on the financial markets. My conclusions above concern the approach to regulatory activity when it comes to the financial field. How the legislation should be handled in the specific case of market manipulation, is still dependent on further analysis. This will be dealt with in the coming, where three regulatory principles will be presented.

9 Regulatory principles

What principles should underlie and support a regulation of market manipulation that is beneficial for the market? How is market efficiency best achieved? In the previous, many regulatory and systematic aspects of financial behavior have been discussed. I have analysed what behavior is harming the efficiency of the financial markets. Further, I have described the US and the European regulations. Also, the difficulty with finding the line between unlawful manipulative and mere speculative actions has been raised. My conclusion in this part is that such a line cannot be drawn in the law as it is today. One must look at each case and value the circumstances at hand. Yet, I am not satisfied with that conclusion. The fact that the term market manipulation is blurred and all-inclusive is a matter worth focusing on. It is especially interesting when identifying regulatory principles. The big question here is if the comprehensive handling of market manipulation really is desirable. How should the legislation be designed if the definition (or lack of definition, rather the continuous endeavors to define) was rejected?

Finally, above, I analysed the rationales behind the financial regulations, both the public regulation and the self-regulation standpoints. From this section emerged the interests behind the will to either regulate the market strongly or deregulate in favor of self-regulation. These interests have a direct connection to the
coming discussion on the topic of finding regulatory principles. As simple as this, the question is what interests should prevail in order to make the market work as efficiently as possible. I will argue with departure point in these interests, weighing them against each other, to find a workable balance that can form the ground for the principles laid out. My aim is to make a summarizing analysis and present regulatory principles for the prohibition of market manipulative behavior.

9.1 Secure the market functions!
As has been iteratively mentioned and stressed as basic in the thesis, the fundamental reason of regulating the financial markets is to secure the market functions. The main purposes are to maintain competition and protect investors against market abuse. In order to fulfill these purposes the financial regulation needs to safeguard the systematic stability, protect the integrity of the market and foster market efficiency. If these aims are attained, the overarching objective of the financial market regulation will be served: the preservation of the investor confidence in financial markets. Yet, as I see it, investor confidence has no value in itself. The market functions, not the confidence, must be what the regulation aims at preserving. The way the legislator sees this is decisive for how the regulation of market manipulation is designed.

Also, the discussion on market functions, the confidence and the efficiency thereof, is connected to behavioral finance. It is a fact that market functions may be distorted by investors acting irrationally. The regulation of the market must take this in consideration. Regulatory principle number one is: cultivate the motives for the financial regulations! I find it of outmost importance that the goal of the market manipulation legislation is to secure the market functions.

The investor confidence is extensively talked of in financial contexts as the crucial thing to obtain. Losses of confidence in a market are equal to less investing in the market, which leads to a lower economic result. Confidence might however turn into a magic word for the description of what is to be achieved. Preserving the confidence in a market becomes the remedy to any and every reduction of market functions. If the confidence seems to be maintained, the market is assumed to be governed by well-adjusted
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rules. However, the existence of confidence is no evidence for the market regulation being sound. This is especially evident in the case of market manipulation regulations. If thinking logical, it is quite clear that even an extremely strictly regulated market can deflect a high confidence in the market. Suppose that the regulator could obtain a market where abuse never occurs. Surely investors would admit that they would feel secure in trading on the market, in the sense that the risk of being fooled is very small. Still, a heavily regulated market is not attractive for investors. It would include too cost- and time consuming public interference, such as excessive control mechanisms, far reaching inquiry and reporting policies and meticulous law enforcement procedures. There is conclusively no successive connection between regulation, confidence and efficiency. Confidence is no market function, and the important thing for the law is to preserve the market functions.

Moreover, I have had the impression, just as I said earlier, that fear is underlying the market abuse legislation of today. There is a fear of losing control. There is also the fear of financial instability leading to crises. Yet, most of all there is a fear of not being able to keep the same developing and activity speed as the actors on the financial markets. If pace is not held, the market might run away into all sorts of destructing anomalies and the confidence would be ruined. This fear has a direct link to making confidence the primary focus of the market abuse regulation. To construct regulation systems on a fear for wrongful behaviour would never be needed if confidence was not such a big deal. If the qualities of the financial market were the highest values to secure, the rationales for regulating would be to enhance integrity and liquidity in the market. The confidence would then be expected to follow, because the law secures the market qualities. I claim that there is a successive connection between regulation, secured market functions and confidence. Confidence leads to efficiency, but only if the confidence depends on the well-functioning in the financial market. Fear of losing control or position over a market should therefore not be underlying the prohibition of certain behavior on the market, such as market manipulative behavior.

Market functions may be distorted by other things than evil-minded manipulators. Regulations aiming at reducing the employment of manipulative schemes, it thus faced with a challenge to separate such behavior from actions with the same result but with
different motive. According to the findings of behavioral finance, the actions of investors show to often be based on biases. Investors are acting irrationally to a larger extent than one may think, I believe. This article is not the place for examining how commonly biases are decisive on the market, however interesting it would be. Yet, the regulation of the market must take in consideration that biased behavior often resembles market distorting activity. The reasons for financial decisions are greatly affected by psychology. As mentioned earlier, greed and fear are often said to be the two major influences on a person’s trading on the market. Such influenced activity on the market is not something the law can prohibit. If a prohibition is adapted to making sure no market quality is harmed in the slightest, the prohibition will be too wide-stretched. A maladjusted market manipulation regulation will thus not succeed in securing the market functions.

I propose for a principle of regulating market manipulation that focuses on the unfair and malicious-intended activity, even if biased behavior does harm the market. Perhaps irrationality is just as market distorting as market manipulation in a certain market. Nevertheless the regulation should be lenient enough to let irrationality pass. The difficulty here is that biased or irrational behavior can resemble manipulative behavior. The only difference is then the intent to manipulate in the latter case. The legislation must for these instances make sure the intent of the investor is a prerequisite for a conviction of market manipulation. For the great majority of cases, it is the use of manipulating devices, spreading misleading rumors and making artificial transactions that constitute the manipulative action. These clear and harmful manipulative schemes should of course be prohibited.

In the case of behavior that easily could be motivated out of both biases just as well as a will to manipulate, I propose a deregulation policy. In my opinion not all market distorting manipulative behavior needs be prohibited. It is better to keep the flexibility in the market by not having to check on each and every transaction with a destructing result. The principle should be to target the actions usually following a manipulative intent, and let unclear cases be unregulated. This will have special actuality for trade-based manipulation. When the transaction is the one and only evidence for the effect on the price, the cardinal rule should be that the intent
must be obviously manipulative in order to progress with the prosecution.

9.2 Drop the concept!

As previously discussed, one of the major problems with regulating market manipulation is the difficulty to provide a definition of the phenomenon. Market manipulation is a concept covering a large area of economic offences. In the US legislation market manipulation is not expressively named, which is the case in the MAD. However, as accounted for, the confusing state is evident in both jurisdictions as to how manipulation should be defined. Where is the line drawn? What behavior is not manipulation, but perhaps only speculative trading? Could speculation in the financial market not also be seen as a form of manipulation? In my view, an apt choice of concept is not the solution to finding the line between harmful manipulation and fair speculation. Instead, the legislator should prohibit market manipulative actions by identifying what really is harmful.

When the outer borders are clear, the next step is to deal with those actions that are within the borders. Not every manipulative activity is equally harmful to the financial markets. Diverse behavior requires a diverse set of rules. It is therefore important to adapt the regulation of market manipulation not to a uniform concept but to each specific detrimental action. Regulatory principle number two is: get rid of the comprehensive legal handling of market manipulation. In other words, drop the concept! My arguments for this conclusion are three folded, as follows.

Firstly, the term ‘manipulation’ has not self-evidently a solely negative purport. In one sense it is a neutral word, describing some kind of influencing or causing activity. Often there is an undue purpose behind an action which in everyday language is called manipulation, but not always. Even less so needs an action be illegal in order to fit the description as manipulation. Public commercials are one example, which often can be described as manipulative in the sense of being persuasive. To advertise new products is however most of the time neither illegal nor an unduly motivated activity. Another example is when speaking of a company’s economic methods or tactics as manipulative; the aim is to affect the outcome of something, cause a change somehow or make people act in a
certain way. In this context the actions are usually not considered equal to fraudulent behavior, but they are nonetheless ‘manipulative’. Notable is again the discrepancy between fraud and manipulation. Fraud is unambiguously defined as a reprehensible behavior, which fully corresponds to the legal prohibition thereof.

My point with this disquisition is: naming something manipulation means using a term that in itself, literally and contextually, comprises both totally normal and accepted activity as well as unaccepted and even illegal behavior. This is in my opinion one of the grounds for criticizing the existing collective-minded legal classification of market manipulative behavior. The term manipulation is not precise enough in my opinion. Finding a definition of manipulation should, if not be abandoned wholly, at least not be seen as worth striving for in law nor in legal and economic writing. Market manipulative behavior needs to be clarified and the question answered what actions that are part of the concept. Here is already a definition-problematic situation, considering the extent of the actual prohibitions. There is no value in keeping an indistinct name for the concept when the main problem with this regulation is how to define what the concept comprises. Or rather, there is no value in striving to make market manipulation a logic over-all term of the various actions that could be manipulative. The term market manipulation is in my opinion maladjusted and should not be the leading star for the design of market manipulation regulations.

Secondly, to manipulate is not always harmful to the market. As it is today, market manipulation comprises many types of behavior that somehow is manipulative. Of course, detrimental effect on the market is a prerequisite for an action to fit the description as manipulative, at least in legal theory. Looking at the actual pieces of legislation, however, the harmful elements are not as clear. All there is to base the examination of the concerned activity upon, are descriptions like: ‘false or misleading signals’, ‘abnormal or artificial price level’, ‘any manipulative or deceptive device’ and writings alike. Nowhere is the result of damaged market functions a prerequisite for defining the activity as unlawful. One exception is the prohibition of price positioning, where a distorted price formation (abnormal or artificial price level) evidently is a clear description of something harmful to the financial markets. In the other cases the legislation halts at the causing elements; the signals or use of deceptive devices, and not whether this leads to detriment to the market.
I believe that the outer borders of the prohibitions of market manipulation must be drawn according to what behavior is harmful. As previously discussed, the current regulations of market manipulation do not make it possible to draw a line between harmful manipulation of the capital market and mere strategically speculative actions. By making market damage a prerequisite in the legal definitions of different manipulative offences, the outer borders of the market manipulation prohibitions will be narrowed and clarified. Any sound legislation should not make prohibitions wider than necessary. An offence must be clearly outlined, for the sake of the efficiency of the financial markets as well as legal security. Signals and devices are not enough. Market damage must be established. The law should ban what is actually harmful.

Thirdly, I believe that different behavior also needs different prohibitions and classifications. Market manipulation takes various shapes; artificial transactions, price positioning, false or misleading transactions or information. All these different expressions have been squeezed into a uniform legal grasp, where they are conformably targeted as harmful to the functions of the financial market. This has lead to a confusion of concept and a maladjusted regulation. The standardized managing of market manipulative behavior exists both in the US and in the European Union. Even if there is no explicit definition of market manipulation in the SEA, the law deals with the different forms by exactly the same methods. The US prohibition is, just as in the MAD, unitarily drafted, covering all types of manipulative activism.

The current types of actions that could fit the description as market manipulation are too diverse considering their actual carrying out and their effects on the market, to be handled as a homogenous group. The different kinds of behavior classified as manipulation are different in their very essence. There are directly fraudulent procedures, like artificial transactions. Trading is carried out in the market, but only for the sake of appearances. There is also the case of spreading information that influences the market negatively, but where it is unclear what the purpose behind the dissemination is. Such spreading of information needs not be directly fraudulent even if it is misleading. Moreover, all manipulation is not equally harmful to the market, nor is the damage always uniformly measurable. I advocate that the legal prohibition of market manipulation should be distinguished between the different forms...
of manipulation that are found harmful to the financial markets. If the uniform concept is rejected in favor of fragmentized prohibitions of the specific market damaging activity, the enforcement will with all certainty be more effective. I thus see no particular value in striving for deregulation the area of market manipulation. Splitting the uniform prohibition into action-specific rules, does however have the effect of enlarging the self-regulatory scope. If there is no overarching prohibition, it is in inevitable that unregulated area occurs ‘between’ the specialized new provisions. This is in my view a welcomed effect that is in line with finding well-adapted regulatory principles for market manipulation. Enhanced self-regulatory and competitive freedom on the market are not on their own fruitful principles to gear the legal handling of market manipulation. But the matter is different when deregulation comes as a corollary of finding an adjusted legislation.

The strive for a uniform concept slows down the development of a well-adjusted, easily enforced and updated regulation. The mission must be to create legislation that prohibits the forms of behavior there are that undoubtedly manipulates the market in a harmful way. An action-specific regulation, where the harmful elements are isolated and dealt with separately, will help prohibiting market destructive behavior adequately. What I advertise for is a division of the different types of behavior included in the current offence ‘market manipulation’.

9.3 Protect those worth protecting!

Market manipulation regulations aim of course at protecting the market against the negative effects of abusive activity. Simply put, harmful behavior should be prohibited, so that the market is protected from being harmed. The need to protect actors on the financial market is the other side of the coin of securing market functions. Both protection of investors and secured functions are necessary to enhance financial efficiency. However, the aim of market protective measures is not just a matter of reaching a state of protected investors. One must ask whom should be protected, and to what extent. The first question in this section is what weight is assigned to the protective motive behind market manipulation regulations. How important are protective measures? How much
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protection needs to be obtained in order to make investors rely on a market?

The second question is which group of actors that should be protected. One interest I pointed out above behind a strong regulatory interference, is the interest to protect certain actors on the market. It is a common object of public legislation to strengthen individuals that are not considered equally strong as the majority in a certain context or else are in a weak position. The example closest at hand is of course consumer protection regulations. Consumer protection has become more and more a motive for regulating the financial markets. I argue that in the case of market manipulation regulations, small investors should not be the target group of the prohibitions laid out. Protecting measures should aim at the influencing investors. Regulatory principle number three is: keep up competition by designing market manipulation regulations according to the real need of protection. The best way to achieve this is to protect those worth protecting. I will clarify this principle in the coming sections.

When it comes to the question of to what extent actors on the markets need protection, two things can be said. Firstly, the actual reason of protection must be worked out. Designing a regulation with a protection motive means that the regulation becomes restricting in some way. It is impossible to protect someone without restraining someone else. To restrict the financial market by prohibiting market manipulation must always be in proportion to the protection needed. The goal of the financial regulation should be to maximize competition because competition is welfare enhancing. Therefore, regulation should facilitate competition and only impose regulations that restrict competition when the social benefits of such restrictions are proven. It becomes important to value the restricting protective motives in the matter of manipulation. Harmful manipulation is in no way good for the market and the need to protect the market from it is evident. However, a principle in this discussion must be to weigh the effects of the restrictive legislative measure against the effects of the manipulative activity the measure aims at banning. Only when the latter out-weighs the former, a protective regulation is justified.

Secondly, different investors have different needs of protection. Not all investors require or desire the same level of protection. As earlier mentioned, it is a matter of course that the investors care
about the quality of the financial market in which they trade. Moreover, it must be a departure point that protective measures can never be thought of as the solution to market actors’ irrationality or mistakes. It is impossible to protect people completely from all consequences of their own errors. This is true in the debate of financial regulatory principles as well as all other areas of life. However self-evident it might seem, it is a necessary approach in order to maintain a sound competition and being able to even begin discussing the design of protective legislation.

Lately, the participation of small investors on the financial markets has grown. Accessibility to trading facilities through the Internet, increased wealth fare and economic resources of private persons together with improved information channels are reasons for this development. It is especially evident within the EU regulatory system that protective rules for consumer rights are becoming more and more the focus at the regulation of the financial markets. Companies are by public regulations forced to comply with certain requirements adjusted to protect small investors from losing confidence and being harmed. Is this a desirable development? Should the rules on the financial market be adapted to small investors? I see a clear danger in a regulatory principle of putting consumer protection as a focus point in the financial field. My reasons for this are quite logic. When market players are not very versed in the financial system the demands in the legislation are set higher. There is a greater need to increase and make information easier to understand. There also follow stronger requirements for disclosure and facilitation of the whole process of trading. An increased regulative activism becomes the obvious corollary of consumer, or small investor, protection measures. I am convinced that a too extensive regulation leads to undesirable effects for the financial market in large.

Firstly, inexperienced investors may falsely believe that all is well on the market. Instead of feeling an urge to examine the market themselves, not so versed investors rely on the regulatory and supervisory system. Sooner or later such a belief will prove wrong and erroneous trading will follow, causing distortion in the market as well as detriment to the small investor in question. Secondly, an extensive regulation inevitably leads to a legislative escalation. If the regulation claims to protect small investors from all kinds of abusive activity, and this thus includes strict demands for companies,
the regulator will feel complied to correct any new incongruity on the market. A continuous increasing strictness of the regulation will be the result hereof, which hardly constitutes a suitable regulatory principle for a well-adjusted financial regulation.

Investors without specialized knowledge cannot be the target group of the market manipulation prohibitions. It is not appropriate to design financial regulations with the goal to make trading risk-free and effort-less. The rules should not be adjusted to the investors least fit to enter the financial markets, but rather those investors who actually contribute to the growth thereof. The financial regulations, and the prohibitions on market manipulation, should aim at promoting the total profit growth, which of course is made by larger investors. Large, influencing investors should be the target group of financial regulation. Consumers will gain from this, since they also part-take of the total economic growth. What is good for larger investors is also good for smaller investors. Also, the fact that the larger investors are those that potentially could distort the market intentionally, is an argument for adapting the regulations to this group.

10 Concluding remarks

In this article, the phenomenon of market manipulation has been the object of study. The financial regulations to prohibit market manipulation are detailed and comprise many types of activities on the market. The question is how to find a line between harmful trading and strategic trading. I have elaborated three regulatory principles which would help to find a desirable legal approach in the case of market manipulation.

Firstly, the regulations should aim at securing the market functions and not primarily to obtain strong investor confidence. The liquidity and integrity of a market should, in order for the market to function well, be secured by the legislation. I believe that investor confidence in a market has no value in itself. Market qualities are the ultimate factors that must be preserved. In my opinion, confidence is only a tool to measure the qualities of an effective financial market. The confidence of a market cannot independently be guiding as to the design of the financial regulation. The regulation should instead be outlined with the intention to secure the market functions. In order to secure the market functions, a clear focus on
the maliciously manipulating activity should be applied. Some cases of trade-based manipulation could be left outside the scope of the prohibitions of market manipulation. The risk that biases or irrationality have lead to the market damaging effect on the market function is big when it comes to activity described as trade-based manipulation. Flexibility is advocated in these instances. Target should be on the transactions that most often are maliciously intended and what clearly damages the market should be prohibited. In other words, the law should not shoot a mosquito with cannon. I believe market efficiency is best enhanced with well-targeted and damage focused prohibitions on market manipulation. The regulation should rest upon the mission to secure the market functions and thus enabling the enhancing of investor confidence and market efficiency.

Secondly, the prohibitions should be action-specific and the comprehensive concept of market manipulation should be rejected. There is a comprehensive handling of market manipulative behavior in the current legislation. This is combined with the lack of a proper distinction of where the borders around the prohibitions are drawn, i.e. the line constituting the boundary of the punishable area for market manipulation as an offence. The use of an unclear term adds to the uncertainty of where to draw the line between legal and illegal manipulation of the financial markets. If comprehensive handling together with blurred outer lines are arched with titling the whole phenomenon with the neutrally wishy-washy term manipulation, the result becomes appallingly confusing! I believe the existence of a damaging result on the market functions may serve as a demarcation between legal speculation and illegal manipulation. I believe likewise it is important to go the whole hog in leaving the uniform concept of market manipulation. Specialized prohibitions need to be adopted for each specific type of manipulative behavior that is harmful to the financial markets. To sum up the arguments; I do not argue a change of concept. I argue that the concept should be rejected altogether as a catch-all. Firstly, because it is too widely applicable, too abstract and too neutral. Secondly, because not all manipulation is harmful to the financial market; the line between harmful and not harmful behavior must show in the law. Thirdly, because all harmful actions are not equally or uniformly harmful and should thus not be dealt identically.
Thirdly, it is important to protect those worth protecting and that the consumer perspective is not the leading motive for legislation in this field. In order for the financial market regulations to achieve the goal of enhancing market efficiency, the motives of protection must be attended. The regulatory principle should be to protect those worth protecting. All investors cannot be protected, since stupidity, irrationality and mistakes are part of trading at all levels. The legislation cannot protect investors from each and every consequence of their trading. Further, all investors need not protection from market abuse in the same way. The proportion of the effects of a regulation must always be weighed against the effects of the behaviour it aims at diminishing. Some risks, some errors and some abuse simply must be borne by the market actors. The question is then what group of actors that should bear the costs of an incomplete protection. I argue in this part that it is not suitable to base the financial regulation on the need of the small investors on the market. To adopt a regulatory principle adapted to the market players least versed in financial matters will lead to a regulatory escalation. The regulation should instead focus on the influencing investors who contribute to the profit growth and the financial development. If these investors get on well in a market, their presence will be maintained and the small investors will gain from the financial results achieved. The actors that are worth protection are not those who are in a consumer position, but those whose protection is proportionate to the effects obtained by protecting their interests.
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