Manipulation — the unwinnable scam

You might fool the market but you can’t fool the law

Stockmarket traders must be aware of practices which the law deems to be false, misleading or manipulative and the circumstances in which they will bear the onus of proof.

WILLIAM KOECK and TANIA HILLERMAN focus on a court case which highlights the dangers.

Market manipulation practices have a long history. In 1814, when England and her allies were at war with France, an opportunist named De Berenger spread false rumours which caused a dramatic rise in the price of government securities. De Berenger arrived in Winchester from Dover dressed in military colours and burdened with gold. He proclaimed that Napoleon had been killed and that the allies were at Paris. Of course this was not true, but people rushed into the market and the price of government securities soared.

Similar practices still exist, with “runners” circulating rumours or buying up shares to encourage others to buy, before selling out for a quick profit. Other methods of market manipulation have developed and are practised in the stockmarket today. In some cases, traders may be unaware that the practices are illegal; in other cases they believe they will escape punishment because the offence will be too difficult to prove.

In broad terms, market manipulation is any artificial intervention in the natural forces of supply and demand intended either to control the price of securities on a market or to cause an inducement to sell, buy or subscribe for the securities. The intention of the parties is of utmost importance, as rigorous attention is applied by the courts to circumstantial evidence.

Sections 997 to 999 of the Corporations Law forbid stockmarket manipulation, false trading and market-rigging transactions, and making statements or disseminating information which is false or misleading and which is likely to induce other persons to sell or purchase securities.

STOCKMARKET MANIPULATION
Stockmarket manipulation involves entering into a transaction for a purpose other than legitimate trading, with the intention of creating a false impression in the minds of the investing public that there is a genuine demand. Section 997 of the Corporations Law prevents a person from entering into or carrying out two or more transactions which have the effect of increasing, reducing or stabilising the price of securities in circumstances where the person intends to induce other persons to buy or subscribe for or sell the securities.

FALSE TRADING AND MARKET-RIGGING TRANSACTIONS
False trading and market-rigging transactions which are intended to, or are likely to, create a false or misleading appearance of active trading in securities are also prohibited by the law. These activities include “wash sales”, “matched orders” and other fictitious
sales of securities where the beneficial ownership of the securities does not change.

In a wash sale, a person is directly or indirectly both the buyer and the seller of securities in the same transaction. A matched order involves a person, with or without the aid of associates, placing contemporaneous buy and sell orders for substantially the same number of securities at substantially the same price. Wash sales and matched orders both involve a deceptive appearance of genuine transactions or market activity in particular securities at a particular price.

It is also illegal to make a statement or disseminate information which is false in a material particular or is materially misleading and is likely to induce other persons to subscribe for the securities, induce the sale or purchase of securities by other persons, or have the effect of increasing, reducing, maintaining or stabilising the market price of securities.

To commit an offence, when making the statement or disseminating the information, the person must not care whether the statement or information is true or false, or must know or ought reasonably to have known that the statement or information is false in a material particular or materially misleading.

ENDRESZ v WHITEHOUSE

The recent Supreme Court of Victoria Court of Appeal decision Endresz v Whitehouse has served as a reminder of the dangers involved in false trading and stockmarket manipulation. It cautions those who rely on an illusory smokescreen, in the form of the fast and furious pace of the stockmarket, as protection against prosecution for their activities. It also dictates some of the boundaries established by the Corporations Law for manipulative conduct.

Endresz, a director of CTC, instructed a broker to purchase, on behalf of CTC, more than 50% of the shares in another company, Emu Hill, at approximately 22 cents a share in December 1989. Further share parcels in Emu Hill were subsequently bought by CTC between January and April 1990. Meanwhile, Endresz instructed the same broker, again on behalf of CTC, to sell four million shares in Emu Hill. At the same time he instructed another broker to purchase the four million shares at 14 cents a share. Endresz gave the instructions personally and did not inform either broker that the principal was CTC.

Nor did he disclose to each broker his instructions to the other broker to execute the matching transactions. The transaction occurred on or about 13 February 1990, once the market had been “cleared” so as to allow for the sale of the shares at the desired price. On the instructions of Endresz, the brokers later arranged a deferred settlement.

The Australian Stock Exchange, Perth, subsequently sent a letter to Emu Hill noting significant increases in the price of the company’s shares during the period 8-13 February 1990. The letter asked Emu Hill about the existence of information explaining the price variation and the board’s beliefs or suspicions as to any person who bought or sold securities on the basis of that information.

Endresz, who was chairman of Emu Hill, replied to the letter, stating that the directors were not aware of any information which was not available to the market regarding the movement of the share price. He also stated that the board was aware that CTC purchased shares on 13 February 1990 “in the ordinary course of business on a stock market of a stock exchange in accordance with the rules of that stock exchange containing the standard terms and conditions”.

Two main charges were made against Endresz. The first alleged that Endresz, on or about 13 February 1990, created a false or misleading appearance of active trading in Emu Hill by being involved in a transaction which did not involve a change in the beneficial ownership of the securities. Endresz relied on the defence that the purpose of the transaction was not, or did not include, the purpose of creating a false or misleading appearance of active trading in securities on the stockmarket.

Endresz claimed that the purpose of the transaction was merely to obtain a short-term loan. The magistrate found, however, that this purpose could not be supported by the surrounding circumstances.

The selling broker’s employee stated that he paid Endresz immediately because he failed to realise that it was a deferred settlement. Therefore, it was fortuitous that Endresz obtained the money from the selling broker at such an early date. In further support of the magistrate’s finding was evidence that Endresz did not pay interest on the advance effectively obtained. He concluded that the purpose of the transaction was unclear except that it was found to be “very much a part of that overall plan that the price of the shares on the market should have been rigged”.

The appeal judge reduced the issue to a single question: “Whether the inference can be properly drawn that Endresz did something calculated to create a false and misleading appearance of active trading on the market.” He noted that the object of the Corporations Law is to protect the market against manipulation and to ensure that it reflects the forces of genuine supply and demand. Further, the law aims to prohibit not only fictitious transactions but also transactions which appear to be real and genuine and which operate according to their terms but which are nevertheless capable of creating a false or misleading impression as to the market or the price. Justice Ormiston concluded that this transaction was “real and genuine.” It did operate according to its terms, but its terms were established so as to create a false or misleading impression of the market.

The court rejected Endresz’s alleged purpose and found that the only inference available to it was that the price of the four million shares was raised so as to create a false and misleading appearance of active trading at a substantially higher price in the
Emu Hill shares. Market manipulation was inferred from the activities of Endresz and was found to be a significant purpose. Although market manipulation may not have been the sole purpose of the transaction, the court found that there was a breach of the Corporations Law. Endresz's defence was unsuccessful as he failed to prove that market manipulation could be excluded as one of the purposes of the transaction.

Three pertinent points can be distilled from Justice Ormiston's judgment. Transactions which are real and genuine, and operate according to their terms, may still infringe the Corporations Law. The intention of the "market rigger" can be inferred by the court from the circumstances where there is no proof of subjective intention. Market manipulation need not be the sole purpose of the transaction, provided it is a significant purpose.

The second charge against Endresz alleged that he made a statement that was false or misleading in a material particular, and was likely to have the effect of maintaining or stabilising the market price of securities, when Endresz ought to have known that the statement was false or misleading in a material particular. Endresz contended that his answers to the letter were given in his capacity as chairman of the board of directors of Emu Hill and not in his capacity as a director of CTC. He claimed that the duty of confidentiality which he owed to CTC precluded him from including in his answer knowledge gained by him purely as an officer of CTC.

Justice Ormiston chose to resolve the issue in terms of whether or not Endresz was entitled to exclude from his reply to the ASX any matter which he knew solely because he was a director of CTC. Instead of not responding at all, or having the secretary respond for him, Endresz had chosen to give an answer which was misleading. The information which he gave was a selective disclosure of the information known by him, not as a director of Emu Hill but as a director of CTC. The shares purchased by CTC were not purchased "in the ordinary course of business" but were purchased in order to "clear the market" for the four-million-shares transaction. By choosing only to give some of the facts to the ASX while knowing all the facts, Endresz did not act candidly and gave only a half-true answer.

Justice Ormiston concluded his judgment with the comment: "Whatever may have been the limits of that knowledge... the opinion expressed in the letter went far beyond what that limited knowledge could otherwise have sustained or justified. By opening up those matters of opinion, he [Endresz] was obliged to give complete and accurate answers."

This case illustrates the potential conflict of interest which can arise when a person making a statement is a director of two companies and has knowledge from one company which may relate to the other. If this situation arises it is important to consider carefully any statement that is made. If the statement includes any information which arises from the director's position in the other company, then full and complete knowledge must be revealed.

In addition, statements to the ASX must include full and frank disclosure. The magistrate in the case stated that, as a matter of policy, he would not allow a director to rest behind any duty of confidentiality so far as his or her obligation to respond to letters from the stock exchange was concerned.

The penalty for a person contravening Section 997, 998 or 999 of the Corporations Law is a fine of up to $20,000, imprisonment for up to five years, or both. The penalty for a body corporate is a maximum fine of $100,000.

A civil remedy is also available if a person suffers loss or damage through the conduct of another person who contravenes any of the above sections. The victim may recover that amount of the loss or damage by action against any person involved in the contravention, regardless of whether that person has been convicted of an offence in respect of the contravention.

PRACTICAL ADVICE FOR TRADERS

- When entering into a transaction on the stockmarket, make sure the purpose of the transaction is not to create a false or misleading appearance of active trading in the market or in the price of the securities. Ensure that circumstantial evidence does not point to this purpose.

- When making a transaction, be sure no inference can be drawn which points to a false or misleading appearance of active trading in the market or in the price of the securities.

- Make sure that market manipulation is not a significant purpose for entering into the transaction, despite there being a separate, dominant purpose.

- Be confident that, if requested, you could prove the purpose for which you entered into the transaction.

- Be confident that, if requested, you could prove that the purpose for which you entered into the transaction is not and does not include the purpose of creating a false or misleading appearance of active trading in securities on the stockmarket.

- If, in making a statement or disseminating information which may induce persons to subscribe for, sell or buy securities, or affect the price of the securities (including maintaining or stabilising the price), you open up matters of opinion (even if you are deemed to have limited knowledge of those matters) you must give true and complete statements in relation to those matters.

REFERENCES

Endresz vs Whitehouse 24 ACSR 208, 6-7 May, 27 June 1997, Melbourne.
