

Reform of Securities Trading Law: Volume Two: Market Manipulation Law

Discussion Document

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Summary of Questions for Submissions

1. Should market manipulation be viewed as a private wrong or a wrong against the market?
2. What definition of market manipulation should be adopted for any law that is introduced in New Zealand?
3. Should the concept of market manipulation focus on the purpose or the effect of the conduct? What are the reasons for your view?
4. Do you believe market manipulation exists in New Zealand?
5. Should we regulate market manipulation in New Zealand?
6. What are the reasons for your view?
7. If you are in favour of regulating market manipulation, what do you think the policy justification for our market manipulation legislation should be?
8. Should a market manipulation regime adopted in New Zealand rely on a general prohibition, the prohibition of specific practices or a combination of the two?
9. Should a general prohibition against misleading or deceptive conduct in relation to dealings in securities be adopted in New Zealand?
10. If such a provision is adopted, should the Fair Trading Act 1986 be amended to expressly exclude conduct which relates to securities markets?
11. If such a provision is adopted, should the Commerce Commission or the Securities Commission be the body responsible for its enforcement?
12. Should a specific prohibition against conduct creating an artificial price be adopted in New Zealand?
13. Should the prohibition be effect based or purpose based?
14. Should the prohibition be broad or prescriptive?
15. Should a provision prohibiting fictitious transactions be adopted in New Zealand?
16. Should the provision be broad or prescriptive?
17. Should the law include a prohibition on making false or misleading statements in relation to dealings in securities?
18. Should the provision be effect or purpose based?
19. Does the fact that short selling is dealt with by self regulation impact on investor confidence in the New Zealand sharemarket? Give reasons for your view.

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20. Should short selling be regulated as part of any market manipulation law implemented?
21. If so, what do you think the policy justification for short selling legislation should be?
22. How should any short selling legislation deal with short selling other than on registered stock exchanges?
23. What should the relationship be between the NZSE membership regulations and any legislative provisions?
24. Should the Securities Commission be given a civil enforcement role in any market manipulation regime introduced?

Process

This discussion paper has been prepared by the Ministry of Economic Development following consultation with other government officials and agencies. Written submissions on the issues raised in the discussion paper are invited from all interested parties. The closing date for submissions is **Friday, 30 August 2002**. After receipt of submissions they will be evaluated and further comments sought as required before the Ministry develops recommendations for the government to consider.

Submissions should be sent by e-mail to kirstie.drake@med.govt.nz or by hard copy to:

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Volume Two: Market Manipulation Law
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If sending a hard copy, please also include, if possible, a computer disk with a copy of your submission in Microsoft Word version 2000 or lower.

Official Information and Privacy Act Requirements

Please note that the contents of submissions provided to the Ministry in response to this discussion paper will be subject to the Official Information Act 1982 and the Privacy Act 1993. If the Ministry receives a request for information contained in a submission, it would be required to consider release of the submission, in whole or in part, in terms of the criteria set out in these Acts.

In providing your submission, please advise if you have any objections to the release of any information contained in your submission, and, if you do object, the parts of your submission you would wish withheld, and the grounds for withholding.

Disclaimer

Any statements made or views expressed in this discussion paper are the preliminary views of the Ministry of Economic Development and do not reflect official government policy.

Readers are advised to seek specific advice from a qualified professional before undertaking any action in reliance on the contents of this discussion paper. While every effort has been taken to ensure that the information set out in this paper is accurate, the Crown does not accept any responsibility whether in contract, tort, equity or otherwise for any action taken, or reliance placed on, any part, or all, of the information in this paper or for any error in or omission from this paper.

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Introduction

Context of the Review

1. The government has identified as one of its key objectives promoting confidence in the New Zealand sharemarket. This objective involves increasing the certainty for market participants in relation to the integrity of the market, and the mechanisms for implementing the law. A number of factors can influence the level of confidence both domestic and international investors have in the New Zealand market.

2. The government is in the process of implementing a number of reforms designed to improve confidence in the market. This process includes reforms designed to improve the enforcement, prevention and detection of insider trading in New Zealand. These reforms are contained in the Securities Markets and Institutions Bill that is currently before the Finance and Expenditure Committee and due for report back on 4 June 2002.

3. The Securities Markets and Institutions Bill also includes provisions designed to improve the investigative and enforcement functions of the Securities Commission and Takeovers Panel. The legislation will ensure, among other things, that the bodies have sufficient powers to adequately enforce the law, and will provide a Securities Commission capable of enforcing insider trading, continuous disclosure and potentially market manipulation law.

4. This discussion document, which considers whether more substantive market manipulation law should be implemented in New Zealand, is one of three documents being released for comment at this time; the others being a “first principles” review of insider trading legislation, and a document that considers the implementation of criminal penalties and improvements to civil remedies for securities law. It is envisaged that a further discussion document, which considers possible improvements to the substantial security holder disclosure regime, will also be released later this year.

5. Insider trading and market manipulation issues are closely linked. Both market manipulation and insider trading are considered by some commentators to be forms of market abuse that can damage the efficiency and transparency of markets and affect market integrity and public confidence in securities trading. The procedures for detection and investigation will also be similar for both types of offences.

6. It has been argued that market manipulation harms the integrity of securities and derivatives markets by distorting prices and creating an artificial appearance of market activity. By doing this it undermines public confidence in these markets.

7. At present in New Zealand there is no substantive body of law specifically targeted at addressing market manipulation. Sections of the Crimes Act 1961, Securities Act 1978 and the Fair Trading Act 1986 as well as common law provisions concerning fraud and deceit may address some forms of market manipulation. This review considers whether the current provisions are sufficient or whether further market manipulation law is required.

8. Developments in information and communications technology need to be taken into account in looking at whether further market manipulation law is required. The Internet has increased the opportunities for manipulating securities markets. It has provided an easy and inexpensive method to disseminate information to vast numbers of people instantaneously. It provides an unparalleled opportunity to disseminate information about a particular security with the intention of moving its price.

9. The relationship between the New Zealand regime and those of other countries is also important. Given that other countries have market manipulation regimes, the document considers whether international developments provide an impetus for New Zealand to develop a policy which is consistent with those of other countries. New Zealand must be able to satisfy international investors that our market has integrity and meets international standards. The Ministry will give particular attention to the Australian law, in view of our Memorandum of Understanding on Co-ordination of Business Law with Australia and the obvious advantages of co-ordinating New Zealand and Australian securities law.

10. The increasing prevalence of electronic commerce means that a global approach to business law issues is important. The existence of globalised markets, cross border trading and multiple listings also increase the opportunities for market manipulation, as well as the difficulty in detecting and investigating market manipulation. This impacts on the enforcement of securities law.

11. Taking these factors into account, the document considers the content of a possible market manipulation law regime in New Zealand and invites comment on what provisions, if any, should be adopted.

Inter-Relationship with the Insider Trading and Penalties, Remedies and Application of Securities Trading Law Discussion Documents

12. Market manipulation and insider trading may both affect the efficient operation of securities markets. They both involve a person having some prior knowledge of the likely effect of the information they have acquired and whether using this information may allow them to make money on the transaction.

13. Sometimes there is a fine line between disclosure based market manipulation and insider trading. The difference may depend on whether the information concerned is accurate or misleading and on the use to which the information is put. Insider trading involves a person trading on confidential information which, if publicly known, would affect the price of the relevant securities. Disclosure based market manipulation generally involves a person releasing false or misleading information to the market which materially affects the price of securities.

14. The additional costs of enforcing any market manipulation law that is introduced will be minimised if the systems and procedures developed for the detection and prevention of insider trading activity are able to be utilised. Similar skills would be required to detect and investigate market manipulation and insider trading.

15. Penalties that are significantly high and easy to enforce play an important part in deterring people from engaging in illegal behaviour. Therefore, it is vital that as well as establishing clear and workable laws for market manipulation and insider trading, appropriate and effective penalties are implemented. For this reason the third discussion document considers criminal and civil penalties for continuous disclosure, insider trading, substantial security holders, takeovers and market manipulation.

16. The Takeovers Act 1993 has been enacted for 8 years and Part I of the Securities Amendment Act 1998 has been in force now for 13 years. During this time there have been sophisticated developments in financial products. Further, the way in which these products, issuers of these products and markets are defined and treated by regulators has also developed and changed. For these reasons it is also appropriate to consider which financial products and entities Part I of the Securities Amendment Act 1998 and the Takeovers Act 1993 should apply to.

17. The overall goal in the release of the three discussion documents is to seek the views of the public and market participants on how to minimise market abuse in New Zealand and improve confidence in our market for both New Zealand and international investors.

Executive Summary

Part I: Factors Contributing to the Need for the Review

18. Part I of the document considers the major factors which have driven the need for the review. These include developments in technology and international developments.

Part II: What Is Meant by Market Manipulation and Should it Be Regulated?

19. Part II considers what constitutes market manipulation, the incidence of market manipulation and the arguments for and against regulating to prevent it. It also draws the distinction between disclosure based and trade based market manipulation and outlines the different types of disclosure and trade based manipulation practices that can occur.

Part III: Description of New Zealand Law as it Applies to Market Manipulation

20. Part III of the document outlines the current market manipulation law in New Zealand under legislation such as the Securities Act 1978, the Fair Trading Act 1986 and the Crimes Act 1961.

Part IV: The Content of a Market Manipulation Regime

21. Part IV considers the possible content of a market manipulation regime and seeks comment on various approaches to formulating a regime. It identifies four areas where further market manipulation law could be introduced and seeks comment about whether short selling should be regulated as part of a market manipulation regime. Part IV also discusses whether the Securities Commission should have a civil enforcement role in relation to market manipulation.

Part I: Factors Contributing to the Need for the Review

22. The environment of our securities market is changing. There are a number of factors impacting on the environment in which the New Zealand sharemarket operates. As well as the government's objective of promoting confidence in the market, these factors are significant when considering the reasons for reviewing the current law as it applies to market manipulation.

Developments in Technology¹

23. While the use of information technology is not the cause of offences under market manipulation regimes, developments in technology have increased the opportunities for both information and trading base offences.

24. Since the various laws applicable to market manipulation were passed, there have been vast changes in information technology. The impact of these changes on securities markets must be taken into account in looking at the need to review the law.

25. Markets have always made use of technological advances that increase market efficiencies and enhance information flow. In their time, the telegraph, telephone, and ticker tape all changed the manner and pace of securities trading.

26. The pace of these advances has accelerated in the last few years. Computer hardware and software have become much more sophisticated, resulting in markets that are more efficient and transparent and better able to handle increased trading volumes.

27. The impact of the new technologies has been widespread, throughout all segments of the securities industry, including investors. An individual investor with a computer and a modem now has access to a vast amount of up to date information. Investors who choose to do so are now able to transact business via the Internet.

28. Stock exchanges have established web sites that provide access to information that may be useful to investment advisers and their clients. These web sites may inform advisers and their clients about the investment opportunities in specific countries. Through hyperlinks on a foreign stock exchange's web site, an adviser or client may access the web sites of issuers and financial institutions, including research materials.

29. As technologies continue to develop, the regulatory framework must evolve to keep pace with the developments. New technology provides new opportunities for both disclosure based and trade based manipulation. To be able to deal with this, the regulatory framework needs to be broad and flexible. This review will allow the

¹ The following information is largely sourced from the United States Securities and Exchange Commission Report to the Congress: *The Impact of Recent Technological Advances on the Securities Markets*, <http://www.sec.gov/news/studies/techrp97.htm#exec>.

consideration of the appropriateness of the current law and its ability to keep pace with new technology.

International Issues

30. As well as the advances in technology discussed above, there have been economic and regulatory reforms which have changed the environment in which financial markets operate. These changes have led to integration in securities markets and an increase in cross border trading.

31. Developments which have been made possible by these changes include:

- The technological ability to transact quickly and across borders;
- Freeing up regulation relating to financial markets;
- Removal of regulatory impediments to cross border transactions;
- Increasing international financial market regulatory co-ordination, for example, through the OECD and IOSCO; and
- The development of linkages and alliances between financial market institutions, both domestically and internationally, as they seek to increase their global market share.

32. These trends may encourage governments to have regulations similar to other jurisdictions for a number of reasons:

- Investors and sellers operating in a number of international jurisdictions may be deterred from operating in a market where the regulatory requirements are significantly different from those imposed elsewhere, because of the transaction costs involved. These costs may be particularly large in relation to smaller markets, where smaller pools of capital often make the transaction costs of understanding a different regime less attractive to investors as costs are less likely to be recovered. New Zealand is a small and distant market in international terms and a judgement needs to be made as to whether we can afford to be different in terms of the level of protection we provide to market shareholders;
- With the international interest in mergers and alliances of exchanges, and governments entering into agreements and forming trading partnerships with other countries, there is also a pressure to enter into agreements that may involve closer co-ordination or mutual recognition of our laws with other countries; and
- With international developments there comes a trend for countries to move towards, and to agree to, sets of international principles and norms. Compliance with international principles may satisfy investors that a country has a market of integrity that meets international standards, where investors have adequate protections and rights and the laws are enforced. Establishing compliance with these standards not only encourages investment by overseas

investors but also may prevent domestic investors from going elsewhere where they may have greater confidence in the integrity of another market.

33. New Zealand has a high level of overseas investment. For New Zealand to attract foreign investment a credible regulatory regime is needed. New Zealand must be able to reassure international sellers and buyers that New Zealand has a market of integrity with fair rules that are adequately enforced.

34. The convergence of securities regulation internationally also implies the increasing convergence of the nature and role of securities market regulators. Cross-border trading, multiple listings and globalised markets have created difficulties in enforcement of securities laws as national boundaries become blurred making it difficult to determine in which jurisdiction a transaction has taken place, and adding to problems of monitoring and investigation.

35. This has increased the need for international co-operation between regulators in detecting, investigating and prosecuting securities breaches. In particular, New Zealand regulators will need to be able to investigate offences that occur in more than one country (including New Zealand), offences occurring outside of New Zealand but that breach New Zealand law and offences that occur in New Zealand and breach another country's law.

36. These issues will be relevant for any market manipulation law introduced. The question which must be considered is the need for a body to enforce the law, with the ability to co-operate with regulatory bodies overseas.

Co-Ordination with Australia

37. In 2000 the New Zealand government signed a Memorandum of Understanding on Co-ordination of Business Law with Australia. The MoU reflects the desire of the Australian and New Zealand governments to deepen the trans-Tasman relationship within a global market, through increased co-ordination of business law, thereby creating a mutually beneficial trans-Tasman commercial environment.

38. In view of our obligations under the MoU and the obvious advantages of co-ordinating New Zealand and Australian securities law, the Ministry of Economic Development will give particular attention to the Australian law relating to issues raised in this discussion paper.

Part II: What Is Meant by Market Manipulation and Should it Be Regulated?

39. This part of the document looks at what is meant by the term market manipulation and considers arguments for and against regulating market manipulation. It describes specific practices which are likely to come under this heading.

40. There is no generally accepted definition of the term market manipulation. Although manipulation is prohibited under a number of statutes in overseas jurisdictions, it tends not to be defined precisely.

“Manipulation is difficult to define, but manipulative practices and schemes are usually readily identifiable.”²

41. Market manipulation generally involves an attempt to interfere with the operation of the market. Various commentators have described it as “conduct intended to induce people to trade a security or force its price to an artificial level” or “deliberate interference with the free play of supply and demand in the securities markets”. Commentators have also suggested that the inability to define the term market manipulation reflects conceptual confusion. It has been described by the United States Supreme Court as “virtually a term of art”.

42. The traditional approach to regulation of market manipulation has been for the statutory requirements of offences to include proof of the intent of the offender. There has been much debate about whether deception and intent are a specific requirement of manipulative conduct. A possible definition, using an effect rather than an intent or purpose based test, is:

“Conduct likely to mislead or deceive market participants concerning the value and/or trading volume of a security”.

43. Some market manipulation offences in overseas jurisdictions require proof of the intention of the manipulator. This may depend on the level of sanction, with a criminal offence requiring proof of intent, whereas a civil liability will result if there is no proof of intent required. If motive or intent is required for a definition of manipulative conduct, proving the offence becomes much more difficult. The discussion document entitled “Penalties, Remedies and the Application of Securities Trading Law” considers the inter-relationship of criminal and civil penalties at paragraphs 162 to 166.

44. There are two ways of looking at the harm which may be caused by manipulative conduct.

- It may be seen as a wrong against the people who are directly affected, that is those who trade on the basis of the false information concerning the value or

² Vivien Goldwasser, *Stock Market Manipulation and Short Selling*. (Centre for Corporate Law and Securities Regulation, 1999), 154.

trading volume caused by the manipulative conduct. Taking this approach leads to manipulative conduct being seen as a form of fraud; or

- It may be considered a wrong against the market. Those who advocate this approach argue that manipulative conduct undermines public confidence in markets, as investors are unable to rely on the integrity of the market.

45. The view of the harm caused by manipulative conduct will determine the type of legislation that is implemented. If the purpose of the legislation is to prevent damage to confidence in the market, legislative provisions are likely to be different than if it is seen as a problem affecting individuals.

Questions for Submissions

1. Should market manipulation be viewed as a private wrong or a wrong against the market?
2. What definition of market manipulation should be adopted for any law that is introduced in New Zealand?
3. Should the concept of market manipulation focus on the purpose or the effect of the conduct? What are the reasons for your view?

Should We Regulate Market Manipulation?

46. If we believe that market manipulation is occurring in New Zealand, then the issue that needs to be addressed is whether it has a positive or a negative impact on financial markets and whether we need to legislate against it.

47. Market manipulation is regarded by some commentators as essentially a type of fraud. It involves the creation of a false impression of trading activity or price movement or of market information. The existence of such a false or misleading impression leads to a reduction in market efficiency as trading decisions are not made on financial fundamentals. Commentators have argued that market manipulation undermines public confidence in markets as investors are unable to rely on the integrity of the market. This then has detrimental impacts on the level of competition and liquidity of securities markets.

48. It has been argued that investors require higher risk premiums from issuers of securities in a market where manipulative practices are not regulated and where disclosures may not be relied upon. Where the cost to issuers of raising capital is increased, there will be a negative impact on the economy wide level of investment. Hence it may be more difficult for issuers to finance investment projects.

49. Some commentators argue that all investors in a market should be on an equal footing and that fair prices in a market result from all investors having an equal opportunity to obtain and evaluate public information relevant to their trading decisions. Manipulative practices result in investors receiving misleading information. Accordingly, it is argued that prohibitions on manipulative practices promote market

efficiency through allowing investors to have confidence that the information they obtain is based on accurate disclosures and genuine trades.

50. Historically, regulation of market manipulation was formalised in the United States in the 1930s. It was considered by the Congress that there was a link between manipulation of securities prices leading to excessive speculation and the stock market crash of 1929 and the depression of the 1930s. Regulation was considered necessary to ensure investor confidence in the integrity of the securities markets.

51. The rationale for enacting market manipulation law in other countries is similar. In many countries, regulation of market manipulation is seen as part of the wider regulation of financial markets and as contributing to the overall objectives of ensuring an efficient market and promoting confidence in the market. A number of jurisdictions, however, also have as an aim the protection of investors from manipulative practices.

52. Regulation aimed at the prevention of market manipulation focuses on maintaining the integrity of the market price of securities or of derivatives contracts. Regulation attempts to ensure that market prices are not distorted by manipulative activity and to prevent false or misleading information being released into the market. Thus rules imposing disclosure requirements may be seen as a tool for preventing manipulation.

53. The European Council and the United Kingdom regime argue that insider trading and market manipulation are two forms of market abuse, as they both result in some investors being disadvantaged by the conduct of others. There has been debate over the principles promoted in these regimes that confidence in a market requires that all investors are able to have:

- equal access to information;
- confidence in the price setting mechanism; and
- confidence that public information is not false or misleading.

54. The European Council in its proposal for a directive on insider dealing and market manipulation commented that:

“Fair prices result from individual analysis by investors of all public information. Prices resulting from manipulation are set at another level, creating economic advantage solely for the manipulators, but damaging the interests of all other investors”.³

³ *Proposal for a Directive of the European Parliament and of the Council on Insider Dealing and Market Manipulation (Market Abuse)*, http://europa.eu.int/comm/internal_market/en/finances/mobil/com281en.pdf

The Alternative View Regarding Regulation of Market Manipulation

55. There appears to be a widespread acceptance among commentators that manipulation undermines market efficiency through distorting prices and resulting in an inefficient allocation of resources. This differs from the situation with insider trading, where opponents of regulation argue that insider trading makes securities markets more efficient by communicating earlier to the market the existence of inside information. The misleading nature of the information disseminated as a result of manipulative conduct will not provide the correct signals to investors for resources to be allocated to their highest value uses.

56. The arguments of opponents to market manipulation regulation relate mainly to difficulties in defining and detecting manipulative conduct and in enforcing legislation.

57. Some commentators have argued that manipulation in financial markets should not be prohibited.⁴ The reasons for this view may be summarised as follows:

- The lack of an objective definition of manipulation;
- Some manipulative conduct, principally disclosure based manipulation, is a form of fraud and does not need to be considered under the concept of manipulation;
- Trade based manipulation is difficult to identify;
- There is a low probability that trade based manipulation can succeed; and
- Enforcement of prohibitions on manipulation is likely to be costly.

58. Opponents of market manipulation law consider that the various approaches to defining market manipulation are flawed. Manipulative conduct has sometimes been defined as being designed to:

- Interfere with the free play of supply and demand;
- Induce people to trade; or
- Force a security's price to an artificial level.

59. Commentators have said that the concept of "interference" is unhelpful as, like manipulation, it is undefined. The fact that conduct induces people to trade is seen as too broad, as "it includes value-maximising exchanges in which the transaction makes each party better off"⁵. Conduct which has the effect of forcing a security's price to an artificial level might catch trades where the trader genuinely believes that prices will move in one direction, but the trader turns out to be wrong.

⁴ For example, Daniel R. Fischel and David J. Ross, "Should the Law Prohibit 'Manipulation' in Financial Markets," *Harvard Law Review* 105 (1991): 503.

⁵ *Ibid.*, 507

60. On this basis commentators argue that there is no objective definition of market manipulation, with the result that the definition must be subjective, focusing on the intent of the trader. The problems which have arisen from the requirement to prove the intent of the manipulator are discussed in paragraphs 129 to 144 of this paper.

61. Fictitious transactions such as wash sales or matched orders are designed to mislead market participants that trading is taking place when in fact no transactions are taking place. Hence it is argued that this is a form of fraud. A similar argument can be made as regards false or misleading statements.

62. The argument of the opponents regarding actual trades where the trader has a manipulative intent is that in most cases individual trades will not affect price. Taking into account transaction costs, they argue that manipulative trades are not likely to be profitable. It has been argued that "there is no compelling reason to be concerned about such trading because it is likely to be self deterring."⁶

63. Some commentators argue that the lack of an objective definition of manipulation increases enforcement costs. Another concern is that, if the law is drafted too broadly, it may prohibit conduct which might otherwise be considered efficient. If market manipulation law were to have the effect of deterring trading unnecessarily, market efficiency would be reduced.

"Because manipulative intent is hard to identify, a rule prohibiting manipulative trades is expensive to administer and deters some appropriate and beneficial trading."⁷

Market Manipulation Practices

64. The practices which are generally considered to come within the ambit of market manipulation are of two main types:

- **Disclosure based manipulation.** This occurs where a person disseminates false or misleading information which has the effect of misleading other participants about the value or trading volume of a security.
- **Trade based manipulation.** This is the buying or selling of a security by a person which misleads or deceives other participants about the value or trading volume of that security.

Disclosure Based Market Manipulation

65. Disclosure based market manipulation generally involves a person releasing information that misleads the market and in this way materially affects the price of shares.

66. An example is where a person disseminates unrealistic, unsubstantiated or incorrect data, projections or evaluations. The manipulator then uses the demand

⁶ Ibid., 553

⁷ Goldwasser, *Stock Market Manipulation and Short Selling*, 48.

generated by the false information to sell their own shares. This is sometimes known as “hype and dump” or “pump and dump”.

67. Another example would be a person such as an investment advisor purchasing a security before recommending it to others, with the intention of selling it at a profit after the recommendation has resulted in an increase in price.

68. As discussed in Part I, developments in technology have impacted on the potential for these types of practice as they have changed the ways in which information can be disseminated. For example, the use of the Internet creates opportunities for information, whether accurate or inaccurate, to be widely disseminated almost instantaneously. New technologies have provided many investors with a multitude of information about their investments, often at no charge. In recent years, many investors have begun to search the Internet for information about their investment options.

Trading Based Market Manipulation

69. Some of the specific trading practices which may be considered as market manipulation are described below.⁸ These fall into the general categories of artificial transactions and price manipulation. There are many variations on the practices and the terminology used to describe them.

70. The objective of these forms of manipulative conduct will normally be to make money. Ways in which this objective may be achieved include:

- Influencing the price or value of a security so that the manipulator can buy at a lower price, sell at a higher price, influence takeover bids or combat competitive transactions;
- Influencing the price of a derivative contract or the underlying asset;
- Influencing the price of a security underlying an index;
- Influencing the price of a security in connection with takeover offers; and
- Influencing someone to subscribe for, purchase, or sell assets.

Matched Orders

71. A matched order occurs when a person buys a security with a low turnover and subsequently places contemporaneous buy and sell orders for that security. These orders will be for substantially the same number of securities at substantially the same time and at substantially the same price. The aim of this is to convey an appearance of renewed interest in the security to attempt to induce others to buy the security. The intention is that enough new investors are attracted by the apparent

⁸ This information is largely taken from Technical Committee of the International Organization of Securities Commissions, *Investigating and Prosecuting Market Manipulation* (May 2000).

increase in activity so that the price of the security rises. The manipulator is then able to sell the security and make a financial gain.

Pools

72. A pool is essentially the same type of practice as a matched order, but involves more than one person colluding to generate artificial market activity.

Wash Sales

73. A wash sale involves a person, either directly or indirectly, being both the buyer and seller of securities in the same transaction, that is there is no actual change in ownership of the securities. The manipulator will undertake frequent trades hoping to attract other investors who note the increased turnover in the security. The manipulator aims to gain financially through creating a small price differential between the buy and sell rates of the security in question.

Runs

74. A run involves a person creating activity in a security by successively buying (or selling) that security. The intention is that the increased activity would, in the case where the person is buying, attract others to buy and push up the price. At that point, those organising the run would then attempt to sell out at a financial gain. This is sometimes known as "pumping and dumping."

Corners

75. A corner is where a person buys up a substantial volume of a security knowing that other market participants will be forced to buy from him at a higher price. An example of this would be where the other market participants hold short positions in the security which must be settled. A similar practice is the "abusive squeeze" where a person takes advantage of a shortage in an asset by controlling the demand side and creating artificial prices.

Market Stabilisation

76. This involves trading in a security at the time of a new issue in order to prevent a decline in the price of the security. This would normally involve issuers, underwriters or those participating in an offering of securities trading to avoid the failure of the offering.

Marking the Close

77. Marking the close is making a purchase or sale of a security near the close of the day's trading in an effort to alter the closing price of the security. This might be done to avoid margin calls (when the trader's position is not self-financed), to support a flagging price or to affect the valuation of a portfolio (called "window dressing"). A common indicator is trading in small parcels of the security just before the market closes.

Parking and Warehousing

78. These involve a person holding shares which are actually controlled by another person whose identity is not disclosed, sometimes through nominee or fictitious accounts. While the failure to disclose a change in shareholding may be dealt with under Part II of the Securities Amendment Act 1988, these trading practices may be used to conceal matched orders or wash sales.

Computerised Program Trading

79. A market practice which has been linked to market manipulation is computerised program trading. This is a strategy mainly used by large institutional investors. It uses computer programs which determine the timing of transactions, for example if there is a discrepancy between the price of a futures index and the shares included in the index. It is likely to influence the price of securities, but may not be caught by market manipulation laws as it is not likely that an element of intent to induce trading or to mislead others could be proven. Trading programs themselves are not manipulative.

Short Selling

80. Another trading practice which is sometimes considered manipulative is short selling. Short selling is defined as the sale of securities where, at the time of sale, the seller does not own the securities.

81. Short selling is used when a person considers that the price of a security will fall. A person will make a profit if he sells at the current price and purchases later at a lower price. Arguments for and against regulating short selling are discussed at paragraphs 170 to 175. Short sellers generally need to deposit with the broker the amount of cash needed to purchase the shares they are shorting in order to short sell.

Incidence of Market Manipulation

82. There is very little data available on the incidence of market manipulation in New Zealand. Commentary referring to market manipulation has tended to be in the context of discussions on public confidence in the sharemarket.

83. The New Zealand sharemarket underwent particular scrutiny for its poor performance in the years following the 1987 sharemarket crash.

“A 1992 public opinion survey indicated that the New Zealand public held the share market in very low esteem. A total of forty-four per cent of respondents believed that the share market was manipulated compared to sixteen per cent who did not, and forty percent said they had no opinion. When asked ‘do you think all investors are treated fairly or do you think big investors can manipulate the market?’, a total of seventy

seven per cent said that big investors can manipulate the market and only three per cent stated all shareholders were treated fairly.”⁹

84. More recently, media attention was drawn to market manipulation following an investigation by the Securities Commission into trading in the shares of Fletcher Challenge Limited¹⁰ which found conduct involving a person releasing information “to cause a movement in the price of FCL shares by which he could profit”. The Commission commented “The question arises whether actions of this sort are better recognised by the law as deliberate attempts to manipulate a market”.

85. The 1974 Report of the Senate Select Committee on Securities and Exchange, known as the Rae Report, is the major detailed study in Australia on the conduct of stock market manipulation.

86. The Rae Report noted that:

“the deliberate manipulation of the market for listed shares on the organised exchange has at times been widely practised in Australia. Although this manipulation has been known to prominent market traders, the practices have seldom been exposed publicly. They have not been effectively regulated.”¹¹

87. The United States is the jurisdiction where market manipulation has received the most attention. Legislation to deal with market manipulation was introduced in the 1930s, following massive sharemarket losses suffered by the public during the Depression. After the 1987 sharemarket crash, there were a number of high profile cases involving insider trading and market manipulation.

“The widely publicized criminal prosecutions of Michael Milken, Drexel Burnham Lambert, Ivan Boesky, Dennis Levine, Boyd Jefferies, the GAF Corporation and James Sherwin, Salim “Sandy” Lewis, Paul Bilzerian, and others all involved allegations of manipulation of securities markets.”¹²

88. The most recent focus of the United States Securities and Exchange Commission is on Internet investment fraud, including pump and dump schemes.

“In its fourth nationwide Internet fraud sweep, the Securities and Exchange Commission today announced 15 enforcement actions against 33 companies and

⁹ Brian Gaynor, "Securities Regulation in New Zealand: Crisis and Reform" *Securities Regulation in Australia and New Zealand*, ed. Gordon Walker and Brent Fisse (1994), 11, referring to "A Poll Conducted by Insight Research between 10th & 12th October 1992," *National Business Review* (6 November 1992), 4.

¹⁰ Securities Commission, *Insider Trading Law and Practice, Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited in May 1999* (20 November 2000).

¹¹ Senate Select Committee on Securities and Exchange, *Australian Securities Markets and their Regulation*. (AGPS, 1974).

¹² Fischel and Ross, "Should the Law Prohibit 'Manipulation' in Financial Markets," 505.

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individuals who used the Internet to defraud investors by engaging in pump-and-dump stock manipulations.”¹³

89. The International Organisation of Securities Commissions (IOSCO) has published a report entitled “Investigating and Prosecuting Market Manipulation.”¹⁴ This report includes an annex containing 13 examples of manipulation cases in various jurisdictions. These cases were investigated in the United States, France, Australia, Hong Kong, Portugal and Greece

Questions for Submissions

4. Do you believe market manipulation exists in New Zealand?
5. Should we regulate market manipulation in New Zealand?
6. What are the reasons for your view?
7. If you are in favour of regulating market manipulation, what do you think the policy justification for our market manipulation legislation should be?

¹³ *SEC Charges 33 Companies and Individuals With Fraud for Manipulating Microcap Stocks*, news release 6 September 2000, <http://www.sec.gov/news/headlines/intmm.htm>

¹⁴ See note 8.

Part III: Description of New Zealand Law as it Applies to Market Manipulation

90. This part of the discussion document describes the current position in New Zealand with regard to the laws which may apply to market manipulation.

91. These laws and regulations include provisions of the Crimes Act 1961, section 9 of the Fair Trading Act 1986, parts of the Securities Act 1978 and the Securities Regulations 1983. The common law tort of deceit may also be able to be used against some forms of market manipulation.

92. There are also self regulatory arrangements which regulate aspects of market manipulation. These are found in the New Zealand Stock Exchange's Code of Business Practice and the New Zealand Futures and Options Exchange's Business Conduct Rules.

93. The issue of trading based market manipulation is not addressed directly by New Zealand legislation. There are some provisions regulating the offering of securities and providing for civil and criminal liability for false or misleading statements in prospectuses and advertisements, providing some regulation of disclosure based manipulation. Apart from these, certain provisions of criminal and consumer protection legislation have some application to market manipulation. There are no provisions specifically dealing with manipulative practices in the secondary market for securities trading.

94. The laws and arrangements mentioned above demonstrate a piecemeal approach which may deal with some forms of market manipulation. It can be seen that there is no comprehensive body of law designed exclusively to deal with market manipulation. There is also a lack of consistency with the regulation of insider trading. Some of the laws that appear to apply do so only incidentally, as part of general laws such as those for consumer protection or those intended to apply to fraudulent activity.

95. The application of these laws and regulations to market manipulation is discussed below.

Securities Act 1978

96. Part II of the Securities Act 1978 prohibits offers of securities for subscription to the public without an authorised investment statement or registered prospectus.

97. Section 55 of the Securities Act deems that a statement is untrue if it is misleading in the form and context in which it is included or is misleading by reason of the omission of a particular which is material to the statement in the form and context in which it is included.

98. Section 56 imposes civil liability for misstatements in a prospectus or advertisement. The section provides that certain persons are "liable to pay compensation to all persons who subscribe for any securities on the faith of an

advertisement or registered prospectus which contains any untrue statement for the loss or damage they may have sustained by reason of such untrue statement”.

99. Regulation 8 of the Securities Regulations 1983 provides further prohibitions for advertisements. The section states that “no advertisement shall contain any information, sound, image, or other matter that is likely to deceive, mislead, or confuse with regard to any particular that is material to the offer of securities contained or referred to in the advertisement”.

100. Regulation 5(1) of the Securities Regulations requires the disclosure of additional information in a prospectus, if without such information, a statement would be misleading.

Crimes Act 1961

101. Section 257 of the Crimes Act deals with conspiracy to defraud and provides:

“Every one is liable to imprisonment for a term not exceeding 5 years who conspires with any other person by deceit or falsehood or other fraudulent means to defraud the public, or any person ascertained or unascertained, or to affect the public market price of stocks, funds, shares, merchandise, or any thing else publicly sold, whether the deceit or falsehood or other fraudulent means would or would not amount to a false pretence as hereinbefore defined.”

102. In the case *R v Adams & Ors* T No 240/91 the Crown alleged that Mr Hawkins and Mr Darvell conspired by deceit, falsehood and other fraudulent means to affect the public market price of shares in Equiticorp Holdings Limited in that they agreed to dishonestly support the company’s share price. Although the Crown was able to establish that both defendants had misled the press and the New Zealand Stock Exchange, the Crown failed to establish that this conduct resulted from any concerted action between the two accused that amounted to a conspiracy for the purposes of section 257. This section is targeted at preventing conspiracy, but does not cover fraudulent conduct carried out by an individual.

103. This provision as it relates to market manipulation is discussed in paragraph 128 below. Other fraud provisions of the Crimes Act may also apply, for example section 250 under which it is an offence for any promoter, director or officer of a company to make a false statement with intent to induce any person to buy shares in the company. There is, however, a lack of case law on this.

Fair Trading Act 1986

104. Section 9 of the Fair Trading Act 1986 contains a general prohibition against misleading conduct in trade. This section states:

“No person shall, in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive”.

105. This prohibition may apply to market manipulation which involves misleading or deceptive conduct. This issue is discussed in paragraphs 118 to 125 below.

New Zealand Stock Exchange Code of Conduct

106. The relevant section of the New Zealand Stock Exchange's Code of Conduct is:

Avoiding misleading or deceptive acts or representations

Member Firms and their representatives shall refrain from any action which would hinder or disrupt the fair, efficient and orderly functioning of the market.

Member Firms shall not communicate groundless or false information or rumours and may not undertake any activities, including advertising, which are misleading or deceptive or would mislead or deceive others about the true state of the market.

Member Firms and their representatives shall not engage in any manipulative practices such as trades which involve no change in beneficial ownership, or which falsely indicate activity.

The NZSE will not discourage new trading strategies provided they are not prohibited by law (such as insider trading) and they do not diminish the fairness, openness or efficiency of the market.

107. Breaches of the Code are treated by the Board of NZSE as breaches of the requirement to observe good stockbroking practice and the disciplinary provisions of the Rules apply. These provisions give the disciplinary committee, if it finds a member guilty of a breach, the power to:

- Expel the member from membership;
- Suspend the member for a stated period;
- Order the member to pay a penalty not exceeding \$100,000 for an individual member or \$1,000,000 for a member firm, plus GST or any other applicable tax; or
- Censure the member

New Zealand Futures and Options Exchange Business Conduct Rules

108. The New Zealand Futures and Options Exchange includes in its Business Conduct Rules a prohibition against misleading conduct and describes manipulative activity as an "undesirable situation" which may be investigated by the business conduct committee. The committee may terminate or suspend a dealer's membership for breaches of the rules.

Part IV: The Content of a Market Manipulation Regime

109. This part of the document is based on the assumption that market manipulation is, to some greater or lesser degree, undesirable and that regulation can serve to reduce the associated detriment.

110. There are three main approaches which can be followed when formulating a regime to regulate market manipulation:

- A general prohibition on manipulative conduct;
- Prohibitions on specific practices; or
- A hybrid of the two, with prohibitions on specific practices and a general catch-all to deal with novel variations which do not fit within the specific prohibitions.

111. The main areas regulated by market manipulation law in overseas jurisdictions are each discussed below, comparing the current New Zealand provisions where applicable. Comment is sought on whether provisions dealing with these areas should be adopted in a New Zealand regime.

Questions for Submissions

8. Should a market manipulation regime adopted in New Zealand rely on a general prohibition, the prohibition of specific practices or a combination of the two?

Misleading or Deceptive Conduct

112. Some jurisdictions include a general prohibition on misleading or deceptive conduct in relation to dealings in securities.

113. In Australia, the Corporations Act 2001¹⁵ includes a broad provision prohibiting conduct that is misleading or deceptive or is likely to mislead or deceive in relation to a financial product or financial service.¹⁶ Unlike the other Australian market manipulation provisions this results in a civil liability only.¹⁷ A copy of the sections of the Corporations Act 2001 relating to market manipulation is attached as Appendix I.

¹⁵ The Australian law relating to market manipulation is part of the Corporations Act 2001. The Financial Services Reform Act 2001 repealed Chapters 7 and 8 of the Corporations Act 2001 and enacted the new provisions as discussed.

¹⁶ Section 1041H Corporations Act 2001

¹⁷ The linkages between the market manipulation provisions and fault elements as they apply in civil and criminal liability are discussed in the discussion document entitled "Penalties, Remedies and the Application of Securities Trading Law" at paragraphs 186 to 193.

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114. Under United States law, Section 10(b) of the Securities Exchange Act of 1934, regulates the use of manipulative and deceptive devices or contrivances. This is a broad catch-all provision and it empowers the SEC to make rules and regulations prohibiting the use of manipulative and deceptive devices or contrivances in the trade of securities. The SEC has used this statutory authority to promulgate a number of rules proscribing manipulative conduct. This has been the most widely used provision in the SEC's enforcement of market manipulation regulation.¹⁸

115. In the United Kingdom, the Financial Services and Markets Act 2000 introduced a new regime to tackle market abuse, replacing the Financial Services Act 1986. The provisions in the Act are generally expressed in broad terms. However, section 119 of the Act requires the Financial Services Authority (FSA) to issue a Code of Market Conduct to give guidance to those determining whether or not behaviour amounts to market abuse.

116. The Code specifies that the prohibition on behaviour likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for, or as to the price or value of, investments includes within the description of behaviour engaging in a course of conduct which will give or is likely to give a false impression.

117. The Code is a lengthy document which has been the subject of much consultation by the FSA. It aims to give guidance but not to be exhaustive as the FSA has said that it "must retain some flexibility to deal with the emergence of novel forms of abuse, which may not be explicitly addressed in the Code."¹⁹

118. At present under New Zealand law, such conduct would likely be dealt with under the Fair Trading Act 1986. The aim of the Fair Trading Act is to protect the consumer. It is designed to ensure that consumers receive accurate information in order to make rational choices in the marketplace.

119. The Fair Trading Act applies to goods and services. Whether section 9 of the Act applies to conduct relating to securities depends on whether securities come within the definitions of goods or services in the Act, and on whether the conduct takes place in trade.

120. The word "trade" is defined in section 2(1) as:

"any trade, business, industry, profession, occupation, activity of commerce, or undertaking relating to the supply or acquisition of goods or services or to the disposition or acquisition of any interest in land."

121. There is uncertainty in relation to both of these issues for the following reasons:

- It might be argued that sending mass e-mail messages, as occurs in hype and dump schemes is not conduct taking place in trade;

¹⁸ Goldwasser, *Stock Market Manipulation and Short Selling*, 80.

¹⁹ Financial Services Authority, *Policy Statement, Code of Market Conduct, Feedback on CP59 and CP76*, 3.

- While there have been cases under the Fair Trading Act which have involved shares, and views have been expressed that shares can be regarded as goods, this question has not been finally determined. Goods are generally considered to be tangible property; and
- A breach of Section 9 of the Fair Trading Act results in a civil liability. An individual who considered that he had suffered loss from a manipulative practice would have to bring civil proceedings. Taking into account the complex nature of manipulative practices and the costs involved in taking civil action, the provision is not likely to be a deterrent to market manipulation.

122. The appropriateness of the Fair Trading Act applying to securities is an important issue. The legislation in Australia equivalent to the Fair Trading Act is Part V of the Trade Practices Act 1974. In 1996-1997, there was a major review of the Australian financial system.²⁰ Under the new regime, which came into effect from 1 July 1998, policy making for financial services moved to the Commonwealth Department of Treasury, APRA became the new prudential supervisory body and assumed responsibility for policy implementation while ASIC (formerly the Australian Securities Commission) assumed new consumer protection responsibilities for financial services.

123. The Trade Practices Act was consequently amended to exclude conduct in relation to financial services. While the provisions for financial products and services mirror the provisions for other goods and services found in the Trade Practices Act, they are enforced by ASIC rather than by the ACCC, the body otherwise responsible for consumer protection issues. Hence conduct in relation to takeovers and issuing and dealing in securities is governed by the Corporations Act and not by general consumer protection legislation.

124. As discussed above, the Securities Act 1978 contains provisions dealing with misleading conduct in relation to offers of securities to the public for subscription. It has been suggested that the fact that such misleading conduct may fall under the provisions of the Securities Act and also the Fair Trading Act leads to confusion and a lack of clarity as to the appropriate body to deal with a breach of this nature. The Commerce Commission is the body charged with enforcement of the Fair Trading Act, but the Securities Commission is the body with expert knowledge of securities markets.

125. Misleading conduct relating to securities has the effect of undermining market integrity. One of the principal functions of the Securities Commission is to promote market integrity. Accordingly it may be argued that the appropriate body to enforce a breach would be the Securities Commission.

²⁰ Australian Financial System Inquiry, *Final Report (Wallis Report)* (Canberra: AGPS, March 1997) refers. Australia's current regulatory framework generally implements the recommendations of the Wallis Inquiry resulting in a division of responsibilities between the Australian Prudential Regulation Authority (APRA), the Australian Securities & Investments Commission (ASIC) and the Australian Competition and Consumer Commission (ACCC).

Questions for Submissions

9. Should a general prohibition against misleading or deceptive conduct in relation to dealings in securities be adopted in New Zealand?
10. If such a provision is adopted, should the Fair Trading Act 1986 be amended to expressly exclude conduct which relates to securities markets?
11. If such a provision is adopted, should the Commerce Commission or the Securities Commission be the body responsible for its enforcement?

Price Manipulation

126. Price manipulation is a general term for trading activities which have the effect of increasing or reducing the price of securities. The types of conduct which come under this heading include marking the close, pumping and dumping, cornering. Overseas jurisdictions often have prohibitions against specific practices of price manipulation.

127. There is no legislation in New Zealand which deals specifically with this conduct.

128. To be caught by section 257 of the Crimes Act 1961, which was discussed earlier, the conduct must involve a conspiracy between at least two people and involve deceit, falsehood or other fraudulent means. This means that any fraudulent conduct carried out by an individual is not an offence under this section. Hence the types of conduct mentioned above, which are generally unilateral activities, would not be an offence under this section.

129. The Australian Corporations Act 2001 prohibits the carrying out of transactions which have, or are likely to have, the effect of creating an artificial price for trading in financial products or maintaining a price at an artificial level.²¹ This may be compared with the former provision of the Corporations Act²² (repealed by the Financial Services Reform Act 2001) which prohibited the carrying out of transactions with the effect of increasing, reducing, or stabilising the price of those securities on a stock market, with the intention of inducing other people to buy or sell those or related securities. The provision was designed to prohibit people from causing an artificial price, with the intention of inducing trading. The causing of the artificial price was not sufficient, an intention to induce the relevant conduct was also required. The key concept now is whether a price is artificial.

130. The previous Australian market manipulation law provisions were criticised for being too complex and creating problems of proof.²³ Commentators described

²¹ Section 1041A Corporations Act 2001

²² Former Section 997 Corporations Act 2001

²³ Goldwasser, *Stock Market Manipulation and Short Selling*, 75-76

section 997 of the Corporations Act in particular as a difficult section to prove. One reason for this was that section 997 required proof of intention to induce other persons to sell, buy or subscribe for securities. "It is usually impossible to ascertain with certainty what motivates a particular trade."²⁴ This section applied only where there were two or more transactions, hence it did not cover individual manipulative transactions. The equivalent new provision in the Corporations Act 2001 applies to individual transactions and focuses on the effect of the conduct rather than the intent of the trader.

131. Although some significant changes appear to have been made by the Financial Services Reform Act, the explanatory memorandum states that no substantial change in approach to the regulation of market manipulation was intended.

132. Commentators have been critical of the fact that the financial services reforms being implemented by the Australian government are not based on a fundamental review of the market manipulation provisions. Instead they are a blend of the former provisions relating to securities and to futures.

133. Section 118 of the Financial Services and Markets Act 2000 in the United Kingdom defines three broad types of behaviour which may amount to market abuse:

- the misuse of information that is not generally available to users of the market;
- the dissemination of false or misleading information; and
- market distortion.

Of these types of behaviour, market distortion includes conduct involving price manipulation.

134. Section 118 defines market distortion as behaviour which:

"...a regular user of the market would, or would be likely to, regard the behaviour as behaviour which would, or would be likely to, distort the market in investments of the kind in question; and

which is likely to be regarded by a regular user of that market who is aware of the behaviour as a failure on the part of the person or persons concerned to observe the standard of behaviour reasonably expected of a person in his or their position in relation to the market."

135. A regular user is defined in Section 118(10) of the Act as "in relation to a particular market, a reasonable person who regularly deals on that market in investments of the kind in question."

136. Behaviour will amount to market abuse if the behaviour engaged in interferes with the proper operation of market forces with the purpose of positioning prices at a distorted level. This need not be the sole purpose of entering into the transaction,

²⁴ Ibid., 58

but must be an actuating purpose. An actuating purpose is defined as a purpose which motivates or incites a person to act.

137. The United Kingdom Code gives examples of behaviour amounting to market abuse:

“The following is an example of *price* positioning at a distorted level: A trader simultaneously *buys* and *sells* the same *investment* (that is, trades with himself) to give the appearance of a legitimate transfer of title or risk (or both) at a *price* outside the normal trading range for the *investment*. The *price* of the *investment* is relevant to the calculation of the settlement value of an *option*. He does this while holding a position in the *option*. His purpose is to position the *price* of the *investment* at a distorted level, making him a profit or avoiding a loss;” and

“The following is an example of an abusive squeeze. A trader with a long position in bond *futures* *buys* or borrows a large amount of the cheapest to deliver bonds and either refuses to re-lend these bonds or will only lend them to parties he believes will not re-lend to the market. His purpose is to position the *price* at which those with short positions have to deliver to satisfy their obligations at a materially higher level, making him a profit.”

Hence the United Kingdom prohibition requires proof of the purpose of the person in entering into the transaction.

138. Under the Criminal Code of Canada “every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretense within the meaning of this Act, with intent to defraud, affects the public market price of stocks, shares, merchandise or anything that is offered for sale to the public is guilty of an indictable offense...”²⁵

139. In Hong Kong, there is a prohibition on the creation of a false market on the Hong Kong Stock Exchange in which the market price of a particular security is raised or depressed or pegged or stabilised by means of:

- Sales and purchases transacted by persons acting in collaboration with each other for the purpose of securing a market price for a particular security that is not justified by the fundamentals of the company;
- Any act which has the effect of preventing or inhibiting the free negotiation of market prices for the purchase or sale of the security.

140. The main provisions in the United States are:

- Section 17(a) of the Securities Act of 1933, which prohibits manipulative conduct in the offer and sale of securities.
- Section 9(a) of the Securities Exchange Act of 1934, which contains prohibitions against manipulation of securities prices.

²⁵ Section 380(2) of the Criminal Code of Canada.

141. For the purposes of these provisions, manipulation is intentional interference with the free forces of supply and demand for a security, often designed to deceive or defraud investors through controlling or artificially affecting the price of securities or market activity.

142. Section 9(a)(2) of the Securities Exchange Act states that it is unlawful for any person to effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange ...raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others. This section is the equivalent of former section 997 in the Australian Corporations Act 2001.

143. The issue of proving the purpose of inducing other investors into purchasing or selling securities has been a major issue in most of the litigation under this section. In fact the difficulty in proving “the intention to produce the forbidden result” has been a recurring theme in all the literature on the subject of market manipulation.²⁶ The requirement to prove purpose or intention remains in the United States and United Kingdom, but is not found in the new Australian provision nor in the European Council’s proposed directive. The explanatory memorandum to the proposed directive states that the “definition of ‘Market Manipulation’ relies on the behaviour of its authors, and not on their intention or aim”.

144. The ways of dealing with price manipulation illustrate an important trade-off. The use of an effect based test may deter desirable conduct whereas the use of a purpose based test may not provide a sufficient deterrent to undesirable conduct. Some jurisdictions have attempted to take account of this through penalty regimes, by providing for both civil and criminal penalties. This issue is discussed in Part II of the document entitled *Reform of Securities Trading Law: Volume Three: Penalties, Remedies and the Application of Securities Trading Law*.

Questions for Submissions

12. Should a specific prohibition against conduct creating an artificial price be adopted in New Zealand?
13. Should the prohibition be effect based or purpose based?
14. Should the prohibition be broad or prescriptive?

Fictitious Transactions

145. Although the details vary, a common feature of market manipulation law in most jurisdictions is a prohibition on fictitious transactions. These fictitious transactions may be distinguished from the actual trading practices which come under the heading of price manipulation. They would include practices such as wash sales and matched orders.

²⁶ Goldwasser, *Stock Market Manipulation and Short Selling*, 111.

146. The relevant prohibitions in the Australian Corporations Act 2001 are:

- creation of a false or misleading appearance of active trading in financial products;²⁷
- carrying out fictitious transactions which have the effect of maintaining, inflating or depressing the price of financial products.²⁸

147. Without limiting the general prohibition, false or misleading appearance is deemed to have been created in circumstances where there is no change in beneficial ownership or where there are matched sales.²⁹

148. The corresponding United Kingdom provision prohibits behaviour where the behaviour is likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for, or as to the price or value of, investments of the kind in question.

149. The United Kingdom Code of Market Conduct provides:

“A transaction which creates a false or misleading impression will not normally be considered to have a legitimate commercial rationale where the purpose behind the transaction was to induce others to trade in, or to position or move the price of, a qualifying investment or relevant product. This need not be the sole purpose for entering into the transaction or transactions, but must be an actuating purpose. Equally, transactions will not automatically be considered to have a legitimate commercial rationale simply because the purpose behind the transaction was to make a profit or avoid a loss (whether directly or indirectly).”

150. The Code includes the following examples of *behaviour* which might give rise to a false or misleading impression:

“(1) arrangements for the sale or purchase of a *qualifying investment or relevant product* (other than on *repo* or on *stock lending* or borrowing terms) whereby there is no change in beneficial interests or market risk, or the transfer of beneficial interest or market risk is only between *persons* who are acting in concert or collusion;

(2) a transaction or series of transactions that are designed to conceal the ownership of a *qualifying investment or relevant product*, so that disclosure requirements are circumvented by the holding of the *qualifying investment* in the name of a colluding party, such that disclosures are misleading in respect of the true underlying holding of the *security*. These transactions are often structured so that market risk remains with the seller. This does not include nominee holdings;

(3) a fictitious transaction.”

²⁷ Section 1041B Corporations 2001.

²⁸ Section 1041C Corporations Act 2001.

²⁹ Section 1041D Corporations Act 2001.

151. In Hong Kong, the law prohibits the creation of a false market on the Hong Kong Stock Exchange in which the market price of a particular security is raised or depressed or pegged or stabilised by means of the employment of any fictitious transaction or devices or any other form of deception or contrivance. It also includes a specific prohibition on any purchase or sale of a particular security which involves no change in the beneficial ownership of that security and which is conducted with the intention of depressing, raising or causing fluctuations in the market prices of that security.

152. Section 382 of the Criminal Code of Canada expressly prohibits wash trading and match trading, when done with the intent to create a false or misleading appearance with respect to public trading or market price.

153. In the United States, section 9(a)(1) of the Securities and Exchange Act 1934 is the relevant provision. This provision states that it is unlawful for any person:

“For the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security,

A. to effect any transaction in such security which involves no change in the beneficial ownership thereof, or

B. to enter an order or orders for the purchase of such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or

C. to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties.”

154. The European proposal for a directive on market abuse prohibits transactions or orders to trade which give or are likely to give false or misleading signals as to the supply, demand, or price of financial instruments or which employ fictitious devices or any other form of deception or contrivance.

155. There generally appears to be a prohibition on specific practices, as well as the general prohibition on fictitious transactions. Alternatively some jurisdictions give examples or guidance as to types of conduct prohibited.

Questions for Submissions

15. Should a provision prohibiting fictitious transactions be adopted in New Zealand?
16. Should the provision be broad or prescriptive?

False or Misleading Statements

156. Most jurisdictions specifically prohibit the making of false or misleading statements in relation to securities, that is disclosure based manipulation.

157. In New Zealand, this is covered by the provisions in the Securities Act 1978, described in Part II, which apply to offers of securities to the public for subscription. They are intended to prohibit disclosure based manipulations at the time of offer. However, there are no comparable provisions applying to subsequent transactions between parties for the sale or purchase of securities.

158. Based on the current experience in the United States, the predominant type of disclosure based manipulation is likely to be in secondary markets through dissemination of inaccurate information via the Internet: using websites, bulletin boards, chat rooms and e-mail. It is possible that these practices could be dealt with under the Fair Trading Act 1986 or the Crimes Act 1961.

159. In the Australian Corporations 2001 there is a prohibition on making a statement or disseminating information that is false or misleading in a material particular, and which is likely to induce other persons to deal in financial products or to affect the price of financial products.³⁰

160. The United Kingdom provisions on market abuse prohibit behaviour where the behaviour is likely to give a regular user of the market a false or misleading impression as to the supply of, or demand for, or as to the price or value of, investments.

161. The United Kingdom prohibition on behaviour giving rise to a false or misleading impression includes artificial transactions (as discussed above) and disseminating false or misleading information, as well as the dissemination of information through an accepted channel. An actuating purpose of disseminating the information must be to create a false or misleading impression.

162. The prohibition applies when the person knows, or could reasonably be expected to know, that the information disseminated is false or misleading.

163. The United Kingdom Code of Market Conduct includes as an example of behaviour which would be prohibited:

“The following is an example of disseminating false or misleading information. A person posts information on an Internet bulletin board or chat room which contains false or misleading statements about the takeover of a company whose shares are qualifying investments. The person knows that the information is false or misleading and he has posted the information in order to create a false or misleading impression.”

164. The provision relating to the dissemination of information through an accepted channel imposes an obligation on providers of information to take reasonable care to ensure that information is not inaccurate or misleading.

³⁰ Section 1041E Corporations Act 2001.

165. The Code also focuses on the channels for dissemination of information.

“The FSA recognises the importance of information disseminated through accepted channels for the dissemination of information. Users of such information should be able to rely on the accuracy and integrity of information carried through these channels. It is, therefore, appropriate that those who disseminate information through them, for example, the company itself, its financial advisers or its public relations advisers, take reasonable care to ensure the information is not inaccurate or misleading. Where they do not, and the information is likely to give rise to a false or misleading impression, they will be regarded as engaging in *behaviour* which amounts to market abuse.”³¹

166. Under the Hong Kong regime, the Securities Ordinance prohibits the dissemination of any statement with respect to securities which the disseminator knows or has reasonable grounds to believe to be false or misleading. The statement must be made for the purposes of inducing the sale of the securities.

167. In the United States, section 9(a)(4) of the Securities Exchange Act 1934 provides:

“If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to make, regarding any security registered on a national securities exchange, 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 to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.”

168. Section 10b of the Act empowers the SEC to make rules and regulations prohibiting the employment of certain types of manipulative or deceptive devices in the trade of securities.

“Rule 10b 5, promulgated by the SEC under the general authority delegated to it by section 10b, has become a highly significant enforcement weapon against securities fraud both in SEC proceedings and in private litigation.”³²

169. A common feature of these prohibitions on false or misleading statements is that they include statements where the maker ought to have known or had reasonable grounds to believe that the statement was false or misleading. They may include a purpose based element, that is the statement was made for the purpose of inducing the purchase or sale of a security, or the statement was made to create a false or misleading impression.

Questions for Submissions

17. Should the law include a prohibition on making false or misleading statements in relation to dealings in securities?
18. Should the provision be effect or purpose based?

³¹ Code of Market Conduct 1.5.20.

³² Goldwasser, *Stock Market Manipulation and Short Selling*, 80.

Short Selling

Arguments for and against Regulating Short Selling

170. The practice of short selling has been the target of much criticism as a perceived cause of market instability. It has been linked to market manipulation. The issue of whether short selling has a positive or a negative impact on financial markets and whether we need to legislate against it are discussed below.

171. Some commentators have argued that short selling is a normal part of market operation.

“Short selling is, in a wide variety of circumstances, a legitimate and useful practice, and it is this element which distinguishes it from those market practices generally regarded as ‘misleading’ or ‘deceptive.’”³³

172. Short selling is said by its supporters to level out fluctuations in market prices and to increase liquidity in the market.

173. The Securities and Exchange Commission in the United States made the following comments on short selling in *SEC Concept Release: Short Sales*³⁴ in which it sought public comment on the regulation of short sales of securities.

“Short selling provides the market with two important benefits: market liquidity and pricing efficiency. Substantial market liquidity is provided through short selling by market professionals, such as market makers, block positioners, and specialists, who facilitate the operation of the markets by offsetting temporary imbalances in the supply and demand for securities. To the extent that short sales are effected in the market by securities professionals, such short sale activities, in effect, add to the trading supply of stock available to purchasers and reduce the risk that the price paid by investors is artificially high because of a temporary contraction of supply.

Short selling also can contribute to the pricing efficiency of the equities markets. Efficient markets require that prices fully reflect all buy and sell interest. When a short seller speculates on a downward movement in a security, his transaction is a mirror image of the person who purchases the security based upon speculation that the security's price will rise. Both the purchaser and the short seller hope to profit by buying the security at one price and selling at a higher price. The strategies primarily differ in the sequence of transactions. Market participants who believe a stock is overvalued may engage in short sales in an attempt to profit from a perceived divergence of prices from true economic values. Such short sellers add to stock pricing efficiency because their transactions inform the market of their evaluation of future stock price performance. This evaluation is reflected in the resulting market price of the security. Arbitrageurs also contribute to pricing efficiency by utilizing short sales to profit from price disparities between a stock and a derivative security, such as a convertible security or an option on that stock. For example, an arbitrageur may purchase a convertible security and sell the underlying stock short to profit from a current price differential between two economically similar positions.”

³³ Ibid., 19.

³⁴ <http://www.sec.gov/rules/concept/34-42037.htm>

174. However the SEC also commented that:

“Although short selling serves useful market purposes, it also may be used as a tool for manipulation. One example is the "bear raid" where an equity security is sold short in an effort to drive down the price of the security by creating an imbalance of sell-side interest. Many people blamed "bear raids" for the 1929 stock market crash and the market's prolonged inability to recover from the crash.”

175. Commentators have argued that the regulation of short selling eliminates short sales which would otherwise occur whenever those who did not currently hold a particular security received adverse information about the security. It is argued that the result is to decrease the speed at which information is reflected in market prices and thus to reduce the efficiency of markets.³⁵

176. Short selling is prohibited under the Corporations Act 2001³⁶ in Australia (refer to Appendix I for a copy of the relevant provisions), but the prohibition includes a number of exceptions. This means that short selling is possible under certain restrictive conditions.

177. These conditions are:

- Where the sale is made for the purpose of buying or selling an odd lot of securities;
- Where the sale is part of an arbitrage transaction;
- Where the seller has entered into a contract to buy the securities which is conditional only on payment, an instrument of transfer or documentation;
- Where arrangements have been made for the delivery of the securities to the buyer within three business days. If the sale is made on a stock exchange, the price must not be lower than the last reported sale and the stock exchange must be informed that it is a short sale; or
- Where the securities being sold are the subject of a declaration by a stock exchange that they are approved for short selling.

178. While the description above refers to securities, these provisions apply also to certain other financial products as well as securities.³⁷

179. Short selling in the United States is principally regulated by the SEC. The SEC has promulgated three rules that operate together to regulate short selling:

- Rule 3b-3, which defines the term "short sale";

³⁵ Fischel and Ross, "Should the Law Prohibit 'Manipulation' in Financial Markets," 522.

³⁶ Section 1020B Corporations Act 2001.

³⁷ Section 1020B(1) Corporations Act 2001.

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- Rule 10a-1 which is the prohibition on short selling in a falling market; and
- Rule 10a-2 which prohibits broker-dealers from engaging in certain activities that could facilitate an illegal short sale.

180. Rule 10a-1 of the Securities Exchange Act, known as the uptick rule, seeks to limit short selling in a declining market. The rule prohibits investors from selling an exchange-listed stock short unless the stock's last trade was at the same price or higher than the previous trade.

181. In addition, Rule 10a-2 of the Securities Exchange Act requires brokerage firms that sell a stock short or allow their customers to sell short to first make sure that the shares can be borrowed or that delivery of the securities can be made to the purchaser by the settlement date.

182. The SEC has recently sought comment on the regulation of short selling and whether Rule 10a-1 should be eliminated.

183. Some commentators in Australia have also suggested that the prohibition against short selling should be removed. One of the conditions under which short selling is allowed in terms of the Corporations Act 2001 is where it is the subject of a declaration by a market operator (such as a stock exchange) as approved for short selling. Hence the Australian legislation recognises that short selling may take place in accordance with the rules of the Australian Stock Exchange.

184. There is no legislation dealing with short selling in New Zealand. However, the New Zealand Stock Exchange, in its self regulatory role, has provisions in the regulations governing its members which deal with short selling.

185. As defined in the NZSE membership regulations, a "short sale" means a sale of any approved security where, at the time of the sale, the seller does not have a presently exercisable and unconditional right to vest the security in the buyer.

186. The relevant section of the regulations is summarised in Appendix II.

Questions for Submissions

19. Does the fact that short selling is dealt with by self regulation impact on investor confidence in the New Zealand sharemarket? Give reasons for your view.
20. Should short selling be regulated as part of any market manipulation law implemented?
21. If so, what do you think the policy justification for short selling legislation should be?
22. How should any short selling legislation deal with short selling other than on registered stock exchanges?
23. What should the relationship be between the NZSE membership regulations and any legislative provisions?

Enforcement of Market Manipulation Law

187. As well as considering overseas market manipulation laws, it is also useful to consider the powers available to the regulatory bodies in those jurisdictions. In this era of global markets, regulators of securities markets need to be aware of what conduct is prohibited in overseas markets and may need to cooperate in the detection and investigation of market manipulation.

188. There are reforms currently underway to give the Securities Commission powers as a public enforcement agency for insider trading. These powers have the potential to be used for the enforcement of a market manipulation regime.

The Role of the Securities Commission

189. In order for a market manipulation regime to be effective it must be able to be effectively enforced. The Government has recently announced its intention to make the Securities Commission a civil enforcement body for insider trading and continuous disclosure. This role is likely to involve the Commission being empowered to issue restraining orders and to take civil proceedings for breaches of insider trading and continuous disclosure law.

190. It may also be appropriate to give the Commission a civil enforcement role in market manipulation for the following reasons:

- **Deterrence:** Providing an enforcement body dedicated to the detection and enforcement of market manipulation law could act as a deterrent to potential market manipulators;
- **Evidential problems with private enforcement:** An individual may not have the ability to require the necessary information from a market manipulator to prove a case. A state agency, such as the Commission, can have a significant

advantage over private enforcement in obtaining information through exercising statutory investigative powers. Equally the Commission can have an advantage in obtaining information in foreign jurisdictions through networks and legislation (bilateral and multilateral agreements);

- **Lack of incentives for private enforcement:** The losses associated with instances of market manipulation are usually dispersed among a number of people, none of which individually may have a sufficient economic motivation to take an action. The Commission would not be deterred by the costs or time involved in taking an action and would be able to undertake an action where there was clear market manipulation and it was desirable for the public benefit;
- **Expertise:** The Commission can establish a high level of expertise and experience in securities law matters. This gives the Commission an advantage over an individual in being able to efficiently and effectively analyse any information obtained and identify non-compliance with the law;
- The Commission will have the resources to monitor and investigate potential market manipulation activity, which may increase the likelihood of catching manipulators;

The issue of whether criminal penalties should apply and the appropriate body to take criminal actions is discussed in the document entitled *Reform of Securities Trading Law: Volume Three: Penalties, Remedies and the Application of Securities Trading Law*.

Question for Submissions

24. Should the Securities Commission be given a civil enforcement role in any market manipulation regime introduced?

Application of the Law

191. When considering the issue of the regulation of market manipulation, two questions arise on the application of such law. These questions are:

- what entities should the law apply to; and
- what financial products should be covered by the law.

192. These issues are considered in paragraphs 145 to 155 of the discussion document entitled *Reform of Securities Trading Law: Volume Three: Penalties, Remedies and the Application of Securities Trading Law*.

Appendix I: Australian Market Manipulation Provisions

Australian Corporations Act 2001

Part 7.10--Market Misconduct and Other Prohibited Conduct Relating to Financial Products and Financial Services

Division 1--Preliminary

1040A Content of Part

This Part deals in Division 2 with various kinds of prohibited conduct, other than insider trading. The insider trading prohibitions are contained in Division 3.

Division 2--The Prohibited Conduct (Other than Insider Trading Prohibitions)

1041A Market Manipulation

A person must not take part in, or carry out (whether directly or indirectly and whether in this jurisdiction or elsewhere):

- (a) a transaction that has or is likely to have; or
- (b) 2 or more transactions that have or are likely to have; the effect of:
- (c) creating an artificial price for trading in financial products on a financial market operated in this jurisdiction; or
- (d) maintaining at a level that is artificial (whether or not it was previously artificial) a price for trading in financial products on a financial market operated in this jurisdiction.

Note 1: Failure to comply with this section is an offence (see subsection 1311(1)).

Note 2: This section is also a civil penalty provision (see section 1317E). For relief from liability to a civil penalty relating to this section, see section 1317S.

1041B False Trading and Market Rigging--Creating a False or Misleading Appearance of Active Trading Etc.

(1) A person must not do, or omit to do, an act (whether in this jurisdiction or elsewhere) if that act or omission has or is likely to have the effect of creating, or causing the creation of, a false or misleading appearance:

- (a) of active trading in financial products on a financial market operated in this jurisdiction; or
- (b) with respect to the market for, or the price for trading in, financial products on a financial market operated in this jurisdiction.

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Note 1: Failure to comply with this subsection is an offence (see subsection 1311(1)). For defences to a prosecution based on this subsection, see Division 4.

Note 2: This subsection is also a civil penalty provision (see section 1317E). For relief from liability to a civil penalty relating to this subsection, see Division 4 and section 1317S.

(2) For the purposes of subsection (1), a person is taken to have created a false or misleading appearance of active trading in particular financial products on a financial market if the person:

(a) enters into, or carries out, either directly or indirectly, any transaction of acquisition or disposal of any of those financial products that does not involve any change in the beneficial ownership of the products; or

(b) makes an offer (the *regulated offer*) to acquire or to dispose of any of those financial products in the following circumstances:

(i) the offer is to acquire or to dispose of at a specified price; and

(ii) the person has made or proposes to make, or knows that an associate of the person has made or proposes to make:

(A) if the regulated offer is an offer to acquire--an offer to dispose of;
or

(B) if the regulated offer is an offer to dispose of--an offer to acquire;

the same number, or substantially the same number, of those financial products at a price that is substantially the same as the price referred to in subparagraph (i).

Note: The circumstances in which a person creates a false or misleading appearance of active trading in particular financial products on a financial market are not limited to the circumstances set out in this subsection.

(3) For the purposes of paragraph (2)(a), an acquisition or disposal of financial products does not involve a change in the beneficial ownership if:

(a) a person who had an interest in the financial products before the acquisition or disposal; or

(b) an associate of such a person;

has an interest in the financial products after the acquisition or disposal.

(4) The reference in paragraph (2)(a) to a transaction of acquisition or disposal of financial products includes:

(a) a reference to the making of an offer to acquire or dispose of financial products; and

(b) a reference to the making of an invitation, however expressed, that expressly or impliedly invites a person to offer to acquire or dispose of financial products.

1041C False Trading and Market Rigging--Artificially Maintaining Etc. Trading Price

(1) A person must not (whether in this jurisdiction or elsewhere) enter into, or engage in, a fictitious or artificial transaction or device if that transaction or device results in:

(a) the price for trading in financial products on a financial market operated in this jurisdiction being maintained, inflated or depressed; or

(b) fluctuations in the price for trading in financial products on a financial market operated in this jurisdiction.

Note 1: Failure to comply with this subsection is an offence (see subsection 1311(1)). For defences to a prosecution based on this subsection, see Division 4.

Note 2: This subsection is also a civil penalty provision (see section 1317E). For relief from liability to a civil penalty relating to this subsection, see Division 4 and section 1317S.

(2) In determining whether a transaction is fictitious or artificial for the purposes of subsection (1), the fact that the transaction is, or was at any time, intended by the parties who entered into it to have effect according to its terms is not conclusive.

1041D Dissemination of Information about Illegal Transactions

A person must not (whether in this jurisdiction or elsewhere) circulate or disseminate, or be involved in the circulation or dissemination of, any statement or information to the effect that the price for trading in financial products on a financial market operated in this jurisdiction will, or is likely to, rise or fall, or be maintained, because of a transaction, or other act or thing done, in relation to those financial products, if:

(a) the transaction, or thing done, constitutes or would constitute a contravention of section 1041A, 1041B, 1041C, 1041E or 1041F; and

(b) the person, or an associate of the person:

(i) has entered into such a transaction or done such an act or thing; or

(ii) has received, or may receive, directly or indirectly, a consideration or benefit for circulating or disseminating, or authorising the circulation or dissemination of, the statement or information.

Note 1: Failure to comply with this section is an offence (see subsection 1311(1)). For defences to a prosecution based on this section, see Division 4.

Note 2: This section is also a civil penalty provision (see section 1317E). For relief from liability to a civil penalty relating to this section, see Division 4 and section 1317S.

1041E False or Misleading Statements

(1) A person must not (whether in this jurisdiction or elsewhere) make a statement, or disseminate information, if:

(a) the statement or information is false in a material particular or is materially misleading; and

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(b) the statement or information is likely:

- (i) to induce persons in this jurisdiction to apply for financial products; or
- (ii) to induce persons in this jurisdiction to dispose of or acquire financial products; or
- (iii) to have the effect of increasing, reducing, maintaining or stabilising the price for trading in financial products on a financial market operated in this jurisdiction; and

(c) when the person makes the statement, or disseminates the information:

- (i) the person does not care whether the statement or information is true or false; or
- (ii) the person knows, or ought reasonably to have known, that the statement or information is false in a material particular or is materially misleading.

Note 1: Failure to comply with this section is an offence (see subsection 1311(1)). For defences to a prosecution based on this subsection, see Division 4.

Note 2: Failure to comply with this section may also lead to civil liability under section 1041I. For relief from liability under that section, see Division 4.

(2) For the purposes of the application of the *Criminal Code* in relation to an offence based on subsection (1), paragraph (1)(a) is a physical element, the fault element for which is as specified in paragraph (1)(c).

(3) For the purposes of an offence based on subsection (1), strict liability applies to subparagraphs (1)(b)(i), (ii) and (iii).

Note: For *strict liability*, see section 6.1 of the *Criminal Code*.

1041F Inducing Persons to Deal

(1) A person must not, in this jurisdiction, induce another person to deal in financial products:

- (a) by making or publishing a statement, promise or forecast if the person knows, or is reckless as to whether, the statement is misleading, false or deceptive; or
- (b) by a dishonest concealment of material facts; or
- (c) by recording or storing information that the person knows to be false or misleading in a material particular or materially misleading if:
 - (i) the information is recorded or stored in, or by means of, a mechanical, electronic or other device; and

(ii) when the information was so recorded or stored, the person had reasonable grounds for expecting that it would be available to the other person, or a class of persons that includes the other person.

Note 1: Failure to comply with this subsection is an offence (see subsection 1311(1)). For defences to a prosecution based on this subsection, see Division 4.

Note 2: Failure to comply with this subsection may also lead to civil liability under section 1041I. For relief from liability under that section, see Division 4.

(2) In this section:

dishonest means:

- (a) dishonest according to the standards of ordinary people; and
- (b) known by the person to be dishonest according to the standards of ordinary people.

(3) This section applies in relation to the following conduct as if that conduct were dealing in financial products:

- (a) applying to become a standard employer-sponsor (within the meaning of the Superannuation Industry (Supervision) Act 1993) of a superannuation entity (within the meaning of that Act);
- (b) permitting a person to become a standard employer-sponsor (within the meaning of the Superannuation Industry (Supervision) Act 1993) of a superannuation entity (within the meaning of that Act);
- (c) applying, on behalf of an employee (within the meaning of the Retirement Savings Accounts Act 1997), for the employee to become the holder of an RSA product.

1041G Dishonest Conduct

(1) A person must not, in the course of carrying on a financial services business in this jurisdiction, engage in dishonest conduct in relation to a financial product or financial service.

Note 1: Failure to comply with this subsection is an offence (see subsection 1311(1)).

Note 2: Failure to comply with this subsection may also lead to civil liability under section 1041I.

(2) In this section:

dishonest means:

- (a) dishonest according to the standards of ordinary people; and
- (b) known by the person to be dishonest according to the standards of ordinary people.

1041H Misleading or Deceptive Conduct (Civil Liability Only)

(1) A person must not, in this jurisdiction, engage in conduct, in relation to a financial product or a financial service, that is misleading or deceptive or is likely to mislead or deceive.

Note 1: Failure to comply with this subsection is not an offence.

Note 2: Failure to comply with this subsection may lead to civil liability under section 1041I. For relief from liability under that section, see Division 4.

(2) The reference in subsection (1) to engaging in conduct in relation to a financial product includes (but is not limited to) any of the following:

- (a) dealing in a financial product;
- (b) without limiting paragraph (a):
 - (i) issuing a financial product;
 - (ii) publishing a notice in relation to a financial product;
 - (iii) making, or making an evaluation of, an offer under a takeover bid or a recommendation relating to such an offer;
 - (iv) applying to become a standard employer-sponsor (within the meaning of the *Superannuation Industry (Supervision) Act 1993*) of a superannuation entity (within the meaning of that Act);
 - (v) permitting a person to become a standard employer-sponsor (within the meaning of the *Superannuation Industry (Supervision) Act 1993*) of a superannuation entity (within the meaning of that Act);
 - (vi) a trustee of a superannuation entity (within the meaning of the *Superannuation Industry (Supervision) Act 1993*) dealing with a beneficiary of that entity as such a beneficiary;
 - (vii) a trustee of a superannuation entity (within the meaning of the *Superannuation Industry (Supervision) Act 1993*) dealing with an employer-sponsor (within the meaning of that Act), or an associate (within the meaning of that Act) of an employer-sponsor, of that entity as such an employer-sponsor or associate;
 - (viii) applying, on behalf of an employee (within the meaning of the *Retirement Savings Accounts Act 1997*), for the employee to become the holder of an RSA product;
 - (ix) an RSA provider (within the meaning of the *Retirement Savings Accounts Act 1997*) dealing with an employer (within the meaning of that Act), or an associate (within the meaning of that Act) of an employer, who makes an application, on behalf of an employee (within the meaning of that Act) of the employer, for the employee to become the holder of an RSA product, as such an employer;

(x) carrying on negotiations, or making arrangements, or doing any other act, preparatory to, or in any way related to, an activity covered by any of subparagraphs (i) to (ix).

(3) Conduct:

(a) that contravenes:

(i) section 670A (misleading or deceptive takeover document); or

(ii) section 728 (misleading or deceptive fundraising document); or

(b) in relation to a disclosure document or statement within the meaning of section 953A; or

(c) in relation to a disclosure document or statement within the meaning of section 1022A;

does not contravene subsection (1). For this purpose, conduct contravenes the provision even if the conduct does not constitute an offence, or does not lead to any liability, because of the availability of a defence.

1041I Civil Action for Loss or Damage for Contravention of Sections 1041E to 1041H

(1) A person who suffers loss or damage by conduct of another person that was engaged in in contravention of section 1041E, 1041F, 1041G or 1041H may recover the amount of the loss or damage by action against that other person or against any person involved in the contravention, whether or not that other person or any person involved in the contravention has been convicted of an offence in respect of the contravention.

(2) An action under subsection (1) may be begun at any time within 6 years after the day on which the cause of action arose.

(3) This section does not affect any liability that a person has under any other law.

(4) Section 1317S (which provides for relief from liability) applies in relation to liability under subsection (1) as if:

(a) the sections referred to in subsection (1) were civil penalty provisions; and

(b) proceedings under subsection (1) were eligible proceedings.

Note: Relief from liability under this section may also be available (depending on the circumstances) under Division 4.

1041J Sections of This Division Have Effect Independently to Each Other

Subject to any express provision to the contrary, the various sections in this Division have effect independently of each other, and nothing in any of the sections limits the scope or application of any of the other sections.

1041K Division Applies to Certain Conduct to the Exclusion of State Fair Trading Acts Provisions

(1) This section applies to conduct:

(a) that contravenes:

(i) section 670A (misleading or deceptive takeover document); or

(ii) section 728 (misleading or deceptive fundraising document); or

(b) that relates to a disclosure document or statement within the meaning of section 953A; or

(c) that relates to a disclosure document or statement within the meaning of section 1022A.

For this purpose, conduct contravenes the provision even if the conduct does not constitute an offence, or does not lead to any liability, because of the availability of a defence.

(2) This Division operates in relation to conduct to which this section applies to the exclusion of the provisions of the State Fair Trading Act of any State or Territory.

Australian Short Selling Provisions

Part 7.9--Financial Product Disclosure and Other Provisions Relating to Issue and Sale of Financial Products

Division 6—Miscellaneous

1020B Short Selling of Securities, Managed Investment Products and Certain Other Financial Products

(1) In this section and section 1020C:

section 1020B products means:

(a) securities; or

(b) managed investment products; or

(c) financial products referred to in paragraph 764A(1)(j); or

(d) financial products of any other kind prescribed by regulations made for the purposes of this definition.

(2) Subject to this section and the regulations, a person must only, in this jurisdiction, sell section 1020B products to a buyer if, at the time of the sale:

(a) the person has or, if the person is selling on behalf of another person, that other person has; or

(b) the person believes on reasonable grounds that the person has, or if the person is selling on behalf of another person, that other person has;

(c) a presently exercisable and unconditional right to vest the products in the buyer.

Note: Failure to comply with this subsection is an offence (see subsection 1311(1)).

(3) For the purposes of subsection (2):

(a) a person who, at a particular time, has a presently exercisable and unconditional right to have section 1020B products vested in the person, or in accordance with the directions of the person, has at that time a presently exercisable and unconditional right to vest the products in another person; and

(b) a right of a person to vest section 1020B products in another person is not conditional merely because the products are charged or pledged in favour of another person to secure the repayment of money.

(4) Subsection (2) does not apply in relation to:

(a) a sale of section 1020B products by a financial services licensee who is a participant in a licensed market and specialises in transactions relating to odd lots of section 1020B products, being a sale made by the licensee on their own behalf solely for the purpose of:

(i) accepting an offer to buy an odd lot of section 1020B products; or

(ii) disposing of a parcel of section 1020B products that is less than one marketable parcel of section 1020B products by means of a sale of one marketable parcel of those products; or

(b) a sale of section 1020B products as part of an arbitrage transaction; or

(c) a sale of section 1020B products by a person who, before the time of sale, has entered into a contract to buy those products and who has a right to have those products vested in the person that is conditional only upon all or any of the following:

(i) payment of the consideration in respect of the purchase;

(ii) the receipt by the person of a proper instrument of transfer in respect of the products;

(iii) the receipt by the person of the documents that are, or are documents of title to, the products; or

(d) a sale of section 1020B products in the following circumstances:

(i) the person who sold the products is not an associate of the body corporate that issued the products; and

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(ii) arrangements are made before the time of the sale that will enable delivery of products of the class sold to be made to the buyer within 3 business days after the date of the transaction effecting the sale; and

(iii) if the sale is made on a licensed market:

(A) the price per unit in respect of the sale is not below the price at which the immediately preceding ordinary sale was effected; and

(B) the price per unit is above the price at which the immediately preceding ordinary sale was made, unless the price at which the immediately preceding ordinary sale was made was higher than the next preceding different price at which an ordinary sale had been made;

and the operator of the market is informed as soon as practicable that the sale has been made short in accordance with this subparagraph; or

(e) a sale of section 1020B products in the following circumstances:

(i) the products are included in a class of products in relation to which there is in force a declaration, made by the operator of a licensed market as provided by the operating rules of the market, to the effect that the class is a class of products to which this paragraph applies; and

(ii) the sale is made as provided by the operating rules of the market; and

(iii) at the time of the sale, neither the person who sold the products, nor any person on behalf of whom the first-mentioned person sold the products, was an associate, in relation to the sale, of the body corporate that issued the products.

Note: A defendant bears an evidential burden in relation to the matters in this subsection. See subsection 13.3(3) of the *Criminal Code*.

(5) A person who requests a financial services licensee to make a sale of section 1020B products that would contravene subsection (2) but for paragraph (4)(b), (d) or (e) must, when making the request, inform the licensee that the sale is a short sale.

Note: Failure to comply with this subsection is an offence (see subsection 1311(1)).

(6) If:

(a) a person who, through a licensed market, makes a sale of section 1020B products (whether or not on the person's own behalf); and

(b) the sale would contravene subsection (2) but for paragraph (4)(d); the person must endorse a statement that the sale was a short sale on any document evidencing the sale that is given to the person who buys the products (whether or not on that person's own behalf).

Note: Failure to comply with this subsection is an offence (see subsection 1311(1)).

(7) For the purposes of this section, a person who:

- (a) purports to sell section 1020B products; or
- (b) offers to sell section 1020B products; or
- (c) holds himself, herself or itself out as entitled to sell section 1020B products; or is taken to sell the products.

1020C ASIC's Power to Prohibit Short Selling in Certain Cases

(1) If ASIC forms the opinion that it is necessary to prohibit section 1020B products (as defined in subsection 1020B(1)), or a particular class of section 1020B products, from being sold on a licensed market in a manner that, but for paragraph 1020B(4)(e), would contravene subsection 1020B(2), in order to:

- (a) protect persons who might suffer financial loss if they were to buy or sell those products in that manner; or
- (b) protect the public interest;

ASIC may give written notice (the *preliminary notice*) to the operator of the market stating that it has formed that opinion and setting out the reasons for that opinion.

(2) If, after receiving the preliminary notice:

- (a) the operator does not take action to prevent the selling on the market of the products, or class of products, specified in the preliminary notice in the manner referred to in subsection (1); and
- (b) ASIC is still of the opinion that it is necessary to prohibit the selling on that market of the products, or class of products, in that manner;

ASIC may, by a further written notice (the *prohibition notice*) given to the operator, prohibit the selling on the market of the products, or class of products, in that manner during a period of not more than 21 days.

(3) As soon as practicable after giving the prohibition notice to the operator, ASIC must give to the Minister a written report setting out the reasons for the giving of the prohibition notice and send a copy of the report to the operator.

(4) On receiving the report, the Minister may direct ASIC to revoke the prohibition notice and, if such a direction is given, ASIC must immediately revoke the prohibition notice.

(5) While the prohibition notice is in force, the operator must not permit the selling of section 1020B products on the market in a way that contravenes the prohibition notice.

Note: Failure to comply with this subsection is an offence (see subsection 1311(1)).

Appendix II: New Zealand Stock Exchange Members Regulations

It is a condition of membership that members and proposing members agree in writing to comply with, and be bound by, the Rules, the Regulations and the Code.

The regulations on short selling are summarised as follows:

- Members may short sell “approved securities” only in accordance with the regulations. Approved securities are securities designated by the Board of the exchange as having sufficient liquidity in the market.
- Short selling is not permitted if the result of the sale would be that more than 10% of the total number of issued securities of that issuer would be the subject of short sale contracts.
- No member will accept from a client a selling instruction which would be a short sale where the member has reasonable cause to believe that it would involve a short sale resulting in more than 10% of the total number of issued securities of that issuer being the subject of short sale contracts.
- All net short positions of \$50,000 or greater in value in each Approved Security must be reported to the Exchange by the selling broker before 9.00 a.m. each business day. Where the broker is selling on behalf of a client any short sale must be designated as such on the contract note given to the selling client.
- No member may make a short sale on behalf of a client without having first obtained from that client an initial margin of cover (provided either in cash or in listed securities or in a combination of both) of at least 20% of the contract price of the short sale.
- In the event that the issuer of any listed security proposed or provided as cover is suspended, delisted, placed in receivership or liquidation or has its operations in any way restricted, either by the Exchange or by legal process, the member will require the client to provide further margin of cover to the extent that the original margin of cover has been reduced by the deduction of the suspended security.
- Where there is a rise of more than 10% in the market price of a security which has been short sold and is not yet delivered, the selling member will require the selling client to provide additional margin of cover equal to at least 20% of the amount of the increase.
- Where there is a fall in the market price of any security provided as margin cover, the selling member must require the selling client to provide additional margin of cover to make up the shortfall.
- Notwithstanding any other provision in the regulations, a member may at any time require a short selling client to pay or provide security for 100% of the current cost of closing out a short sale.

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- If a short selling client fails to provide any margin of cover, by the beginning of the next trading session after the demand is made, the member acting for that client may proceed to close out the short sale at the client's risk and expense. If a profit results, the member shall account to the client accordingly.
- No short sale may be made during a trading session or before 5.00pm on any trading day at a price lower than the last reported sale of the security in question. Short sales made after 5.00pm on any trading day may be at a price mutually agreeable between buyer and seller.
- No short sale of an approved security may be made where a Notice of Restricted Transfer has been received by the Exchange unless the transfer of securities that are the subject of the Restricted Transfer has been completed, or the Notice of Restricted Transfer has been withdrawn.
- The Board has complete discretion either to designate a particular security as an Approved Security or to withdraw that designation either temporarily or permanently.
- Existing short sale contracts in any security which loses its designation as an approved security will be allowed to stand but once the Exchange has announced the withdrawal of such designation no member may make any further short sales in that security until the designation is restored.
- The Board has an absolute discretion to prohibit or otherwise limit short selling in all or any of the approved securities.