

**M. Nelemans, *The Prohibition on Market Manipulation* (dissertation, 512 pages, in Dutch), Deventer: Kluwer (October 2007)**

## **Summary – Het verbod van marktmanipulatie**

### *Introduction*

The principal purpose of this study is to explain the Dutch prohibition on market manipulation, which consists of a prohibition on information-based manipulation in section 5:58 sub 1(d) Financial Supervision Act (*Wet financieel toezicht* (“Wft”)) and a prohibition on trade-based manipulation in section 5:58 sub 1(a)(b) Wft. Both prohibitions are fairly broad and presuppose that practitioners have a good understanding of the mechanics of the financial markets and the distinction between manipulative and non-manipulative behavior. This study not only provides an interpretation of both prohibitions but also introduces new ideas about effective regulation. As a result, market participants have better tools to decide if certain behavior qualifies as manipulation and regulators have a better understanding of when certain behavior should be penalized, or not. The study is based on the following central question: how should the Dutch prohibition on market manipulation be interpreted and enforced? Because of the breadth of the central question this study is divided into six subquestions. The six parts of this book reflect these six subquestions.

### *Part I*

The structure of the European prohibition on market manipulation is rather complex and contains a number of very important and less important elements. For the purposes of this study the descriptive core of the prohibition has been isolated, temporarily setting aside any less important elements. The first subquestion is: how should the descriptive core of the European prohibition on market manipulation be interpreted? Throughout this study I use the term ‘disseminating information’ to refer to the descriptive core of the prohibition on information-based manipulation, and the term ‘executing transactions that result in a certain price level’ to refer to the descriptive core of the prohibition on trade-based manipulation.

Chapter 1 examines firstly how one should interpret ‘disseminating information’ and secondly how new information influences the price of financial instruments. ‘Disseminating’ can best be defined as ‘placing, sending, or scattering in all directions over a surface or through space’ and ‘information’ can best be defined as ‘all interpreted and uninterpreted data’. Having defined the descriptive core of the prohibition on information-based manipulation, we examine how new information may influence the price of financial instruments. Based on some economic insights, such as the net present value rule and the capital asset pricing model, it is clear that new information may result in a re-valuation of the net present value and/or the risk of a financial instrument. When traders use new information to re-valuate the fundamental value of a financial instrument, they may decide to buy or sell the instrument. By doing so, traders will discount their new information (partly) in the price. As a consequence, the price will more accurately reflect the fundamental value of the financial instrument. Given the large amount of empirical research on financial markets

and their efficiency, it is right to say that financial markets are largely efficient: financial markets discount new information adequately in the price of the instrument, *i.e.*, the discounting process is fast and precise. Even though there is a growing literature of evidence against the efficient market hypothesis, it is still widely believed that the financial markets are predominantly efficient.

Defining the term ‘executing transactions that result in a certain price level’ forms the substance of Chapter 2. The interpretation of this element flows from the factual relation between transactions and price changes. A ‘transaction’ can be defined as an ‘obligatory agreement that acts as the foundation for the transfer of financial instruments’. Practitioners should distinguish between ‘executing transactions’ and ‘effecting transactions’. If the trader himself enters the order in the order book, thus not via a broker or intermediary, he executes a transaction. Otherwise, if the trader commissions someone to do this, he effects a transaction. Having defined ‘transaction’ and ‘executing’, the question remains as to how transactions may influence the price level of financial instruments. With the purpose of exploring this relation, a new concept called ‘price pressure’ will be introduced. A trader who executes transactions is able to build up price pressure, which is defined as the contribution to the total price change. The trader will first execute transactions, then exercise price pressure and finally influence the price. A trader is able to build up price pressure in two ways. Firstly, he may build up direct price pressure by executing transactions, moving the downward sloping demand curve, acting on the liquidity of the market, and/or acting on the bid-ask spread. Secondly, he could execute transactions that release market information, attract other traders, and so create indirect price pressure. A financial markets supervisor will at least have to determine the *extent* of the suspect’s price pressure when investigating a suspected case of manipulation. He should primarily determine the extent of the suspect’s *direct* price pressure since this is the foremost driver of the suspect’s *total* price pressure.

## *Part II*

Having explained the descriptive cores of the European prohibition on market manipulation, Part II proceeds to the interpretation of the normative cores of the prohibition. The second subquestion is: how should the normative core of the European prohibition on market manipulation be interpreted? The term ‘disseminating false or misleading information’ refers to the normative core of the prohibition on information-based manipulation and the term ‘executing transactions that result in an artificial or abnormal price’ refers to the normative core of the prohibition on trade-based manipulation.

Chapter 3 concerns the interpretation of ‘false and misleading information’. The first step is to define false information and misleading information. The delineation of true and false information has been the subject of debate for centuries. This study uses Tarski’s semantic approach of the truth to objectively distinguish between true and false information. In short, a statement is true when it corresponds to the facts. Therefore, true information can be defined as ‘information about a certain situation that is in line with the underlying situation’ and false information as ‘information about a certain situation that (with respect to one or more elements) conflicts with the underlying situation’. The second step is to distinguish between leading and misleading information. In the remainder of this study, information is leading if it is complete and processable. Conversely, information is misleading if it is incomplete and/or unprocessable. Incomplete

information is defined as ‘information about a certain situation that corresponds with the underlying situation, however, misses at least one (relevant) element with respect to the underlying situation.’ Unprocessable information is defined as ‘information about a certain situation that corresponds with the underlying situation, however, is inadequately presented or disseminated, so that the average receiver may interpret the information in such a way that he develops a view that conflicts with the underlying situation and/or develops a view that is incomplete with respect to the underlying situation.’

The subject of Chapter 4 is the precise definition of trade-based manipulation. There are several arguments why a grammatical interpretation, the foremost used European method of interpretation, of an ‘artificial or abnormal price’ conflicts with some economic foundations of the financial markets and is insufficient to define trade-based manipulation. Further, one of the most prominent academic definitions of trade-based manipulation, provided by Fischel and Ross, is troublesome. Therefore, a new standard will be designed to operationalize the prohibition on trade-based manipulation. Based on some economic insights, this study develops the ‘unsupported price pressure’ standard. The financial markets supervisor should first determine the extent of the exercised price pressure, then derive the extent of the justified price pressure, and finally determine whether the exercised price pressure is smaller or larger than the justified price pressure. If the exercised price pressure is smaller than or equal to the justified price pressure, there is a case of supported price pressure. However, if the exercised price pressure is larger than the justified price pressure, it is unsupported price pressure. Market participants who exercise supported price pressure bring the price to a natural and normal price level, while market participants who exercise unsupported price pressure bring the price to an artificial and abnormal price level. Only in the case of unsupported price pressure might there be a violation of the prohibition on trade-based manipulation.

### *Part III*

Having considered both the descriptive and normative cores of the European prohibition on market manipulation, the Dutch prohibition on market manipulation will be analysed. The third subquestion is: how should the Dutch prohibition on market manipulation and all the constituent elements be interpreted? Since the European legislature has designed the European prohibition to harmonize national legislation in the various Member States, the European prohibition is the driving force behind the interpretation of the Dutch prohibition.

Chapter 5 examines the Dutch prohibition on information-based manipulation. The working definitions of ‘disseminating’ and ‘information’, and the various legal consequences are first considered in detail. Secondly, it becomes clear that the Dutch prohibition makes an odd distinction between information and signals. A supervisor should determine if the information was false or misleading. If so, an investigation would determine whether the false or misleading information was so valuable that one can speak of false or misleading signals. Thirdly, the prohibition includes both market participants who disseminate information *which gives* false or misleading signals and market participants who disseminate information *which is likely to give* false or misleading signals. The supervisor could ignore the ‘likely to give’ version, since it is largely superfluous and lacks a decent legal dogmatic foundation. Fourthly, the Dutch legislature has introduced

the element ‘as to the supply of, demand for or price’ while the European legislature has explicitly removed this element. Since the Dutch legislature employs a broad interpretation of this element, there is no conflict with European law. Fifthly, the *mens rea* element falls apart in a ‘know’ version and a ‘should have known’ version. The first version demands proof of at least willful blindness (*voorwaardelijk opzet*) and the second version demands proof of recklessness (*bewuste schuld*) or negligence (*onbewuste schuld*). Chapter 5 closes with an explanation of the special regime for journalists, which regime provides them with more protection against any liability.

Chapter 6 is a clarification of the Dutch prohibition on trade-based manipulation. This chapter first takes a closer look at the working definitions of ‘transactions’ and ‘executing’, and the various legal consequences. Secondly, Chapter 6 recapitulates how the ‘unsupported price pressure’ standard should be employed in order to explain the element ‘artificial or abnormal price level’. The supervisor will have to prove that the transactions resulted in unsupported price pressure. A supervisor who is successful in proving this will also be successful in demonstrating the causal relation between the transactions and the price level. Thirdly, the Dutch legislature has decided that the prohibition applies to both market participants who *bring* the price *to* a certain level and market participants who *secure* the price *at* a certain level. This is an intelligent decision and anticipates irrelevant discussions on the exact difference between ‘bringing’ and ‘securing’. Finally, the prohibition lacks a *mens rea* element. Some scholars have argued that manipulative behavior cannot be defined objectively, that is, without reference to *mens rea*. Other scholars use dogmatic grounds to reason that the definition of a felony should always include a *mens rea* element. There are counterarguments. One can objectively define trade-based manipulation by using the ‘unsupported price pressure’ standard. Further, the Dutch legal system does not prescribe that any definition of a felony includes a *mens rea* element.

#### *Part IV*

Part IV touches on the effective application of the Dutch prohibition on market manipulation. The fourth subquestion concerns the introduction of a threshold value: is it desirable to bring in a materiality standard in the Dutch prohibition on market manipulation? If so, how should this materiality standard be applied? The use of a prohibition is limited by a materiality standard, since it will exclude minor forms of imperfect information and unsupported price pressure.

Chapter 7 inquires into the potential role of a materiality standard in the prohibition on information-based manipulation and the prohibition on trade-based manipulation. It is clear that the legislature, whose task is to enact a new prohibition, should factor in the consequences of new regulation. Yet the European legislature has not given any account of the costs of the prohibition and has not explicitly equipped the prohibition with a materiality standard. Evidently, a rigid prohibition or a rigid enforcement of the prohibition could deter market participants from disseminating information and executing transactions, which may have a negative impact on the functioning of the financial markets. Therefore, it would be wise to introduce a formal materiality standard in the prohibition on information-based manipulation and an informal materiality standard in the prohibition on trade-based manipulation. A supervisor intending to apply the

prohibition on information-based manipulation should first determine the value of the imperfect information and then decide whether this value exceeds the threshold. The value of imperfect information correlates, among other factors, with the concreteness, the reliability, and the life span of the information. Further, a supervisor intending to apply the prohibition on trade-based manipulation would be wise to assess the materiality of the unsupported price pressure, but only if he is capable of making this assessment. If so, he will first have to determine the extent of the unsupported price pressure and then decide whether this value exceeds the threshold.

Chapter 8 addresses the problem of the materiality standard. One should bear in mind that a market participant could create immaterial imperfect information or immaterial unsupported price pressure while this outcome results in material damages. The question is whether a supervisor should also factor in the materiality of the damages. Based on welfarist principles and the goals of the prohibition it would be better to take damages into account. The prohibition has two general and two specific goals. The first general goal is to contribute to an adequate functioning of the financial markets and the second general goal is to create a level playing field. Furthermore, there are two specific goals. Firstly, the prohibition should prevent market participants from causing welfare shifts. Secondly, it should prevent market participants from gaining unsupported profits. The materiality standard would need to be adjusted in order to respect the last two goals. If market participants produce irrelevant imperfect information, thereby creating significant welfare shifts or gaining a significant unsupported profit, the prohibition is applicable. And when market participants exercise irrelevant unsupported price pressure, thereby creating significant welfare shifts or gaining a significant unsupported profit, the supervisor would be wise to apply the prohibition. In both situations, the supervisor will have to check whether the extent of the welfare shift and/or the unsupported profit exceeds the threshold.

#### *Part V*

The prohibition on trade-based manipulation does entail a few exceptions. The fifth subquestion refers to these exceptions: how should each exception be interpreted and is it desirable to formulate certain accepted market practices? There are exceptions for monetary policy, stabilization activities, and buy-back programs. In addition, the European legislature has equipped the national supervisors with an authority to select certain market practices and formulate so-called accepted market practices. Behavior that falls within such accepted market practice is indemnified against liability.

Chapter 9 begins with an analysis of the exception for monetary policy. Certain government agencies that execute transactions as part of their monetary exchange rate or public debt management policy are indemnified against liability. The European legislature has designed a broad exception without a decent explanation. This raises various questions. For example, why should a local government agency be indemnified against liability if it manipulates the market? Local governments probably execute some transactions, but they act more or less as regular market participants. The second exception is that for stabilization activities. Banks are eager to execute stabilizing transactions as part of a new share issue if the price in the secondary market is about to drop below the share issue price in the primary market. Banks will buy large

numbers of shares in the secondary market in order to exercise upward unsupported price pressure. The exception indemnifies these banks against liability as long as they meet the execution requirements. The third exception is the exception for buy-back programs. An issuer who announces a buy-back program usually forces the price up. Further, if the issuer actually buys back shares, he may further force up the price. The exception is not applicable to the announcement. In addition, the exception does not apply if the issuer exercises unsupported price pressure. Therefore, the exception is for the most part of little use.

Chapter 10 investigates if and how the application of the prohibition on trade-based manipulation can be limited by the legislature by selecting market practices and formulating 'accepted market practices'. The particular prohibition-exception structure is new in Dutch criminal law. Subordinate to the scope of the prohibition on trade-based manipulation, the need for a list of accepted market practices becomes more or less urgent. In any event, if the prohibition does not apply to a certain market practice, it is safe to say that there is no need to formulate an accepted market practice. Since the applicability of the prohibition has been limited to cases of unsupported price pressure, it is a requisite to decide whether there are any other market practices, besides stabilization activities, that result in unsupported price pressure and should be exempted. In this study's view, it is unlikely that there are any important market practices to be exempted. Yet, if there is an important market practice, the Dutch legislature should enact secondary legislation (*Algemene Maatregel van Bestuur*) in order to accept it. A suspect who believes that his behavior falls within the scope of an accepted market practice is not required to provide proof. Nevertheless, he should put forward facts and circumstances so that the applicability of the accepted market practice becomes plausible. He should also provide arguments to establish that his reasons were legitimate.

## *Part VI*

While the earlier parts are more theoretical in nature, Part VI combines theory and practice. The sixth subquestion concerns all the issues of proving trade-based manipulation: what are the necessary steps for proving trade-based manipulation? Given the 'unsupported price pressure' standard and the materiality standard, we explore how a supervisor should furnish proof of trade-based manipulation in practice. A supervisor can use direct or indirect methods of proof. Presumably, the direct methods of proof will be less successful than the indirect methods of proof.

Chapter 11 explores which direct and indirect pieces of evidence are relevant to prove trade-based manipulation. The supervisor will have to establish that the suspect executed transactions and caused unsupported price pressure. Firstly, the supervisor could furnish direct proof of unsupported price pressure by initially determining the extent of the exercised price pressure and justified price pressure, whereupon he shows that the exercised price pressure was larger than the justified price pressure. If the supervisor is successful, he may take into account the materiality of the unsupported price pressure. For example, he could decide to ignore immaterial forms of unsupported price pressure, provided that they do not result in significant welfare shifts and/or significant unsupported profit. The last step is to qualify the behavior. A supervisor who furnishes proof of unsupported price pressure also furnishes proof that the price has been brought to an artificial or abnormal level or has been secured at that level. Nevertheless, direct proof of trade-based

manipulation will probably be rare since it is hard to retrieve all the necessary data and estimates. Therefore, supervisors will generally have to work with indirect pieces of evidence. A supervisor has strong indirect proof of trade-based manipulation if he can produce recorded statements or proof of when the suspect displayed extreme trading behavior and in addition extreme price pressure. A supervisor will have sufficient indirect proof when the suspect's behavior is archetypal behavior.

Chapter 12 discusses how the supervisor should establish proof of trade-based manipulation by qualifying the suspected behavior as archetypal behavior. This is one of the most important methods of indirect proof. Throughout this study, I refer to archetypal behavior as a combination of exceptional behavior and a sensitive situation. A suspect displays exceptional behavior if his trading behavior deviates from his normal trading behavior. Further, a sensitive situation is a situation in which unsupported price pressure will probably result in unsupported profits. If a supervisor tracks down a suspect who displays archetypal behavior, the supervisor will have sufficient evidence of unsupported price pressure and of trade-based manipulation. There are various forms of archetypal behavior, which can be derived from theoretical models and case law. Firstly, a manipulator is able to buy and sell "ABC" shares on the exchange. For example, an issuer can buy ABC shares to raise the issue price of ABC shares in the shadow of a Secondary Equity Offering. Secondly, a manipulator is able to buy ABC shares on the exchange and sell shares off the exchange. For example, a market participant can buy ABC shares on the exchange in order to influence a contractual sale of ABC shares off the exchange. Thirdly, one can think of someone exercising unsupported price pressure to influence the outcome of takeovers and public bids. A bidder and a target have various incentives to exercise unsupported price pressure.