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REGULATING MANIPULATION IN SECURITIES MARKETS: HISTORICAL PERSPECTIVES AND POLICY RATIONALES

Although stock market manipulation has been described as an art form which strikes at the heart of the pricing system on which all investors rely, there has been a notable lack of case law and literature in this country on the subject, and little discussion and scrutiny of relevant policy considerations or the effectiveness and adequacy of the overall scheme of regulation. The result is that the anti-manipulation provisions have operated in a conceptual vacuum.

The Federal Government's Corporate Law Economic Reform Program (CLERP) Consultation Paper, released on 3 March 1999, proposes a range of important initiatives for reform of Australia's financial markets as part of the drive to promote business and economic development. Of particular interest is the proposal to harmonise 'functionally similar' markets and products into a new integrated regulatory framework. Many of the reforms are now contained in the draft Financial Services Reform Bill, released on 11 February 2000.

The increasing prominence being given to market regulation by these initiatives makes this an opportune time to revisit the subject of the regulation of manipulation in securities markets.

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INTRODUCTION

Professor Berle noted nearly sixty years ago that a 'summary of the history is necessary to a clear understanding of the present law regarding manipulation in the security markets.'[1] That statement is as true today as it was then for market manipulation, and the law's attempts to discover, prevent and regulate it, are old phenomena. Manipulation of stock prices has long been a concern of the common law, which imposed the well-recognised rules relating to fraud upon the securities markets. It was detected in United States' capital markets in the 1930s and featured in the 1974 Report of the Senate Select Committee on Securities and Exchange[2] which investigated the excesses of the early 1970s mining boom in Australia.

The purpose of this article is to outline these historical developments, together with the common law's response and subsequent legislative attempts, both in the United States and Australia, to place the regulation of price manipulation under statutory control.[3] The various traditional rationales for regulating manipulation are examined. The article then explores the issue whether the law *ought* to prohibit manipulation in financial markets. The CLERP proposals for reform of financial market regulation are being introduced against a background of three decades of fundamental change in world financial markets and a paucity of case law dealing with manipulation under the *Corporations Law* and its predecessors. It is suggested that the proposed reforms in the draft Financial Services Reform Bill do not in significant respects reflect the lessons for regulatory strategy to be learned from the history of regulation of manipulative stock market practices.

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1 Adolphe Berle, 'Stock Market Manipulation' (1938) 38 *Columbia Law Review* 393.

2 Senate Select Committee on Securities and Exchange, *Australian Securities Markets and their Regulation* (1974). (Commonly and herein referred to as 'the Rae Committee').

3 What follows is not intended to be an exhaustive exploration of these events, merely an overview.

THE COMMON LAW APPLICABLE TO STOCK MARKET MANIPULATION[4]

The origins of the prohibitions against price manipulation may be found in the common law, which took a firm stand against interference with the free public market for financial securities.[5] Indeed the old common law recognised centuries ago that manipulation of stock prices was fundamentally a fraud upon the public.[6] The early English statutory crimes, borrowed from the Roman law, of engrossing, regrating and forestalling were recognised and punished.[7] Engrossing resembled our modern practice of cornering the supply. Forestalling consisted in intercepting sellers on their way to the market and buying their wares to keep them off the market. Regrating was the process of producing artificial scarcity by buying up supplies sufficient to control their flow into the market and thus affect the price.[8]

During the Napoleonic wars, a group of persons was tried in England for conspiracy to affect the price of the public funds and securities. The defendants were charged with spreading false rumours about the peace between England and France and the alleged death of Napoleon. In *R v De Berenger*[9] it was held to be an offence to conspire to raise the price of Government securities by false rumours with intent to injure purchasers. The Court of King's Bench held that a combination to use wrongful means (false rumours) for a wrongful purpose (to give false value to a commodity in the public market) was a crime. This was so even though it was not alleged that any loss had actually been caused to

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4 'The story, as always, must start with the common law': Louis Loss, 'The Fiduciary Concept as Applied to Trading by Corporate "Insiders" in the United States' (1970) 33 *Modern Law Review* 34, 40.

5 Paul Redmond, 'A Short History of Securities Regulation in Australia' in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia and New Zealand* (1994) 99.

6 John Flynn, *Security Speculation: Its Economic Effects* (1934) 212.

7 Ibid 213.

8 Ibid.

9 (1814) 3 Maule & Selwyn's Reports 67; Robert Baxt, H A J Ford and Ashley Black, *Securities Industry Law* (5th ed, 1996) 301–2.

particular purchasers of government securities. Indeed it was not necessary to show either that the government as such had been injured or that the defendants had benefited. Both the means used and the object sought were wrong. As a matter of the criminal law then, where two or more persons together engaged in market rigging, this was illegal at common law as a conspiracy to defraud. Thus the concept of a free, natural and open public market was created.[10]

Towards the end of the nineteenth century, 'the concept of market interference was extended to manipulation by trading alone, without accompanying rumours and misinformation.'[11] Thus in *Scott v Brown Doering McNab & Co*,[12] the unlawful transaction took the form of purchases of shares on the stock market at a premium the sole purpose of which, as the court found, was to mislead the public as to the market and to induce public buying. 'I can see no substantial distinction,' Lord Justice Lopes said, 'between false rumours and false and fictitious acts.'[13]

10 See generally Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (3rd ed, 1995) 932.

11 Redmond, above n 5, 100.

12 (1892) 2 QB 724. It was held in this case that the purchaser could not sue the brokers he had employed to assist him in the fraud. However the case contains a dictum to the effect that a third person induced to buy from the manipulators at an unfair price may sue any or all of them for damages: ibid 734. In reality the British courts have been reluctant to adopt the free market concept and plaintiffs purchasing in the open market have generally been unable to surmount the obstacles of reliance and privity, as is frequently the case in common law deceit actions: see generally Louis Loss, *Fundamentals of Securities Regulation* (3rd ed, 1988) 932–3.

13 Ibid 730.

UNITED STATES' DEVELOPMENTS[14]

The dearth of Australian case law and expert commentary on the anti-manipulation provisions in sections 997 and 998 of the *Corporations Law* renders comparative dimensions especially significant.[15] Great emphasis must be placed on the US regulatory framework with respect to price manipulation. The focus on the US is justified on the basis that it is by objective standards the pre-eminent comparative jurisdiction[16] it has a sophisticated jurisprudence on market manipulation, an acknowledged reputation for dealing effectively with abusive trading practices, and New York is one of the world's key equity markets.

Furthermore the United States, by virtue of its early historical connections with Australian attempts to place stock market manipulation under statutory control, is the most appropriate comparative jurisdiction in this field or regulation.[17] Indeed the derivation of much of the Australian legislative regime governing

14 The legislative history of the US securities laws, including the concerns about pools, is exhaustively traversed in Steve Thel, 'The Original Conception of Section 10(b) of the *Securities Exchange Act*' (1990) 42 *Stanford Law Review* 385 (herein referred to as 'The Original Conception'), and Steve Thel, 'Regulation of Manipulation under Section 10(b): Security Prices and the Text of the *Securities Exchange Act* of 1934' (1988) *Columbia Business Law Review* 359 (herein referred to as 'Regulation of Manipulation').

15 Vivien Goldwasser, 'The Regulation of Stock Market Manipulation and Short Selling in Australia' in Gordon Walker (ed), *Securities Regulation in Australia and New Zealand* (2nd ed, 1998) ch 15.

16 Precisely why the United States is the optimum comparative jurisdiction has been explained by a German scholar: see Gerhard Wegen, 'Congratulations from your Continental Cousins, 10b-5 Securities Fraud Regulation from the European Perspective' (1993) 61 *Fordham Law Review* S57, S58. Dr Wegen also argues that US regulatory jurisprudence may even find its way not only into Western Europe but also into Eastern Europe.

17 Australian legislation 'has been enacted under pressure of time and the draftsmen have largely relied on American and in some cases on English precedent': Geoffrey Hart, 'The Regulation of Stock Market Manipulation' (1979) 7 *Australian Business Law Review* 139, 140.

stock market manipulation may be traced to the United States' federal securities regulation enacted by the Roosevelt administration in 1933–1934, and the influence of Professor Louis Loss, the leading US authority on securities market regulation.

Professor Loss was consulted by the Attorney-General's Department in the early 1970s prior to the enactment of the Federal Labor Government's legislative reform package in company law and trade practices. Writing in 1973 Professor Loss observed that, given the similarity of the legal and financial systems as well as the basic cultures of the United States and Australia:

> It goes without saying that it would be a grave mistake for a country in Australia's position to ignore the rich American experience of the past forty years...the draftsmen in this country should critically examine the American emendations on the British model.[18]

Apart from the similarities between the two jurisdictions, which share the same common law heritage and whose judicial precedents are to a considerable extent interchangeable, Professor Loss also noted relevant differences, such as the smaller population of Australia, greater reliance on self-enforcement in the US by means of private actions, the relative 'independence' of the two administrative agencies,[19] and varying civil service traditions in the two countries.[20] Nevertheless he supported the translation into the Australian context of the legal principles of US securities regulation and its model of rulemaking authority by the Securities Exchange

18 Louis Loss, *Proposals for Australian Companies and Securities Legislation: Comments from the American Experience*, Cth Parl Paper No 190 (1973) 5.

19 The SEC enjoys extensive autonomy. The Australian regulator however is not as autonomous as its US counterpart, as it functions under the ultimate responsibility of a minister, a feature foreshadowed by Professor Loss in his 1973 report, and verified by contemporary practice.

20 Loss, above n 18. It should also be noted that, as the Australian Stock Exchange conducts the only significant equities market in this country, Australia, unlike the US, has a single national stock exchange.

Commission,[21] the national regulator. His views influenced many of the provisions of the Corporations and Securities Industry Bill. This was introduced into the Senate in December 1974 by the Attorney-General, Senator Murphy. Although the Bill eventually lapsed, subsequent Australian law, when drafted, drew extensively upon US federal securities law.

The substance of the provisions remains intact to this day. Thus section 997 of the *Corporations Law* broadly corresponds to section 123 of the Co-operative Scheme's *Securities Industry Code* 1980, the stock market manipulation prohibition based upon section 9(a)(2) of the *Securities Exchange Act* 1934; and section 998, the prohibition on false trading and market rigging transactions, broadly corresponds to section 124 of the Code, itself based upon section 9(a)(1) of the 1934 Act.[22] It is therefore appropriate to consider United States' developments before Australian history.

Federal securities regulation in the United States began in 1933.[23] The origins of the US system of extensive regulation of the

21 Referred to as the SEC.

22 Peter Meyer, 'Fraud and Manipulation in Securities Markets: A Critical Analysis of Sections 123 to 127 of the Securities Industry Codes' (1986) *Company and Securities Law Journal* 92, 94–5.

23 Professor Berle makes the point, often overlooked, that the fundamental doctrines relating to fraud were established by the courts, independent of statutory rule. Thus whilst the 1934 Act contributed significantly to the application of remedies (for example by providing for the expulsion of a member of a national exchange who had illegally manipulated securities), and also added a potential plaintiff, the SEC, staffed to bring actions, s 17(a) of the 1933 Act and ss 9 and 10(b) of the 1934 Act added very little to the substantive law and 'do not vary the standards already established by the courts': Berle, above n 1, 400. Professor Berle states: 'It is worthwhile emphasising the fundamental, or common law, doctrine since the specific provisions of the Act of 1934 and the detailed rules adopted under that Act have somewhat overshadowed the fact that manipulation by the very devices prohibited was probably quite as unlawful before the enactment of the legislation as it now is': ibid 401. The position at common law by 1934 was that wash sales, matched orders, artificial activity, pegging operations, and mere false representations to the market all constituted fraud and deceit which

securities markets can be traced to the massive losses suffered by the public during the Depression. In the three-year period between September 1929 and July 1932, stocks listed on the New York Stock Exchange lost 83 percent of their total value, and fully half of the $50 billion worth of new securities floated in the United States during the 1920s proved to be worthless.[24] The losses were extensive, affecting some 20 million Americans who had tried to take advantage of postwar prosperity by investing in the stock market.[25] The Depression

> created electoral pressures causing political leaders to investigate the stock market before any knowledge of previous market failures was disclosed. Disclosure of market failures – specifically of moral

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would have given rise to civil action by the plaintiff, to injunction under an appropriate statute or to criminal action under appropriate state or federal laws: ibid 397.

States began legislating against securities frauds in the early twentieth century: Louis Loss, *Fundamentals of Securities Regulation* (1983) 8. Kansas passed the first state securities legislation in 1911. The legislation allowed the state securities commissioner to pass on the merits of the particular securities before it could be registered for trading. State merit legislation of this kind is known as 'blue sky law', supposedly because its initial impetus was a concern about eastern industrialists selling 'building lots in the blue sky in fee simple': ibid. Blue sky laws established state regulation of securities transactions within state borders. The fifty states have each adopted legislation that duplicates federal regulation of securities. The states regulate the distribution of securities, trading in securities by brokers and dealers, and fraudulent activities in connection with securities transactions. The resulting dual state and federal regulatory system 'has provided a strong capital market, but it contains many inefficiencies, duplications, and hindrances': David Ruder, 'Regulation of Corporations and Securities in Australia: Lessons from the United States' (paper presented at meetings held at the Law Offices of Baker & McKenzie, Sydney and Melbourne, 14–16 May 1990) 3.

See further Jonathan Macey and Geoffrey Miller, 'Origin of the Blue Sky Laws' (1991) 70 *Texas Law Review* 347.

24 Amar Bhide, 'Efficient Markets, Deficient Governance' (1994) 72 *Harvard Business Review* (6) 128, 129.

25 Ibid.

> deception and fraud by leading financiers – was important when it occurred. It generated the critical symbolic resources needed politically to define a regulatory program that expanded the state's control over the market.[26]

Ultimately the United States' Congress determined that regulations designed to ensure the honesty and integrity of the securities markets were necessary and in the public interest. Accordingly Congress passed the *Securities Act* of 1933, regulating the initial distribution of securities through registration requirements, the *Securities Exchange Act* of 1934 to deal with secondary market trading, and it created the Securities Exchange Commission.

As finally passed, the legislation established the principle of federal control over the stock market.[27] Whereas the traditional response to financial panics had been to prosecute frauds[28] and allow the victims to shoulder their own losses, the new legislation of the

26 James Burk, *Values in the Marketplace: The American Stock Market under Federal Securities Law* (1988) 43. The author traces the complex series of events leading to the adoption of the New Deal proposals for federal securities regulation, and in particular the role played by Ferdinand Pecora, counsel to the Senate Banking and Currency Committee investigating stock exchange practices. Pecora's particular achievement was securing disclosures of wrong-doing by highly placed and well-known stock promoters and investment bankers. 'It is difficult to exaggerate the importance of these disclosures. They created the perception that there was a market failure significant enough in proportion to warrant legislative action': ibid 39. The author also warns against oversimplifying the origins of federal securities regulation, which are more complex than the simple hypothesis of market failure. For example compromises were required to ensure the passage of the law, and these compromises established limits on the range within which the government could exercise its control: ibid 43–4.

27 *The Securities Exchange Act 1934* requires that every corporation having equity securities listed on a stock exchange or having more than $5 million in total assets and 500 or more shareholders be registered with and report to the SEC: Ruder, above n 23, 3.

28 In the pre-SEC era, the criminal attack on manipulation came under the mail fraud statute and special state legislation, primarily in New York: Loss and Seligman, above n 10, 932.

1930s was based on the premise of protecting investors before they incurred losses.[29] To this end the securities laws established an extensive disclosure regime to assist investors in making informed trading decisions.[30] Issuers of securities are required to provide information about directors, officers, underwriters and large shareholders, including remuneration, the organisation and financial condition of the corporation and certain material contracts of the corporation. Issuers are also required to file a number of reports. The information required is voluminous and includes descriptions of the corporation's business and activities and certified financial statements. An initial statement must be filed, followed by annual reports, quarterly reports, and reports of certain material changes in the corporation.[31] To discourage insider trading, the securities laws required every officer, director and 10 percent equity owner to report the securities they owned.[32]

Broad anti-fraud laws were enacted making it illegal to engage in insider trading or market manipulation. With respect to the latter, the legislation sought to eliminate manipulation and sudden and unreasonable fluctuations of security prices. It forbade traders on the exchanges from employing trading strategies supposedly useful for those trying to manipulate stock prices. It specifically prohibited a number of the types of transactions previously carried out, such as pools, wash sales and matched orders, identified in 1933 by the Senate Banking and Currency Committee investigating stock

29 Bhide, above n 24, 129.

30 The cornerstone of the statutes was disclosure. See Loss, above n 23, 7 noting that 'there is the recurrent theme throughout these statutes of disclosure, again disclosure, and still more disclosure.' The rationale behind the federal regulatory scheme was that investors are adequately protected if all aspects of the securities being marketed are fully and fairly disclosed, thereby obviating the need for time-consuming merit analysis of the securities being offered: see Thomas Hazen, *Treatise on the Law of Securities Regulation* (2nd ed, 1990) 6–7.

31 Ruder, above n 23, 3.

32 Such insiders had to turn over any short-term trading profits (those that resulted from purchases and sales within any six-month period) to the company. Criminal sanctions were imposed for failure to report such transactions: Bhide, above n 24, 130.

exchange practices.[33] In addition to prohibiting transactions designed to manipulate prices or to create an illusion of active trading, the laws also prohibited the making of material false and misleading statements and spreading rumours about market rigging.[34]

Congress also empowered the SEC to adopt rules leading to the maintenance of just and equitable principles of trade.[35] Within the ambit of this authority the Commission has promulgated a myriad of regulations defining practices which are manipulative, deceptive or fraudulent; regulations on short selling, stabilising transactions and similar matters and has adopted safeguards with respect to the financial responsibility of brokers and dealers.[36] Extensive regulation also occurs through the stock exchanges and the National Association of Securities Dealers, Inc. These self-regulatory organisations[37] provide the first line of regulation in the securities industry. They promulgate rules, engage in market surveillance, inspect the financial records of the broker-dealers, bring actions for censure, fines, suspension or expulsion from the securities industry and generally engage in cooperative regulation with the SEC. The Commission has oversight powers over the SROs.[38]

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33 The operation of 'pools' was one of the more serious abuses in the securities markets on which Senate investigators focused their attention in their 1933 hearings (see further n 19 above). Pools ran up the prices of securities on an exchange by a series of well-timed transactions, then unloaded their holdings on the public just before the price dropped. Pools, wash sales and matched orders are described at n 48 and n 50 below.

34 Stock exchanges were required to register with the SEC, agree to comply with the securities acts and help enforce compliance by members. Subsequent attempts by Congress to protect investors has been by way of regulating the financial institutions that manage funds.

35 Sidney Robbins, *The Securities Markets: Operations and Issues* (1966) 106.

36 Ibid.

37 Referred to as SROs.

38 Ruder, above n 23, 4.

Prior to the early 1930s, 'the securities markets were a jungle of deception and manipulation.'[39] Standards of honesty and fairness were widely abandoned by underwriters and dealers. The SEC reported that the 'orgy of speculation which had existed in the stock market, coupled with the fraud, manipulation and other malpractices then prevalent, could lead only to disaster.'[40] Whilst it is probably true to say that the anti-manipulation provisions of the *Securities Exchange Act* 1934, section 9 and in particular section 10(b), 'have been effective in preventing a recurrence of the widespread manipulation on exchanges which flourished in the 1920s',[41] securities price manipulation has by no means been eradicated. Professor Loss has aptly described the chequered history of manipulation as follows:

> Although a few large scale manipulations were detected in the early years of the Commission's history, the Commission was able by 1950 to express the belief that manipulation was no longer 'an appreciable factor in our markets.' This sanguine belief was not retained for long. Eleven years later the Chairman referred to 'evidences of a substantial amount of manipulation.' In April 1967, the American Stock Exchange announced that, in cooperation with the SEC ... it was conducting an investigation of trading in certain listed stocks 'which may have been influenced by alleged manipulative activities'. There were rumours of underworld involvement ...

39 Robbins, above n 35, 106.

40 The Securities and Exchange Commission, 'A 25 Year Summary of the Activities of the Securities and Exchange Commission, 1934–1959' 1961, quoted by Robbins, above n 35, 106, XV.

41 David Ratner and Thomas Hazen, *Securities Regulation: Cases and Materials* (4th ed, 1991) 859; Irwin Friend, 'The SEC and the Economic Performance of Securities Markets' in Henry Manne (ed), *Economic Policy and the Regulation of Corporate Securities* (1969) 185, 195.

> More significantly, in October 1988, Chairman Ruder announced the formation of a task force on penny stock manipulation, one consequence of which was the Penny Stock Reform Act of 1990 ... At approximately the same time, the Commission initiated a series of significant *non*penny stock manipulation cases against Boyd L Jefferies, Drexel Burnham Lambert, Inc, and Michael Milken, among others. To judge from this type of historical experience, manipulation seems no more capable of total eradication than its first cousin, 'fraud'.[42]

In recent years, as attempts to manipulate have become increasingly subtle and complex, the operation of traditional manipulative strategies is no longer the predominant concern of regulators in the United States. A major focus of concern today, at least with respect to stocks listed on the New York Stock Exchange, is the extent to which large transactions by institutional investors, such as pension funds, mutual funds and insurance companies, produce undesirable fluctuations and distortions in the market price of particular securities. Such program trading results from changes in investment patterns and other economic factors, rather than from the type of premeditated fraud with which the original securities legislation was concerned.[43] Computerised program trading thus raises for regulators, courts and others a raft of new and difficult issues in the regulation of stock market manipulation.[44]

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42 Loss and Seligman, above n 10, 945. References cited omitted.

43 Ratner and Hazen, above n 41, 859.

44 See generally Lawrence McCabe, 'Puppet Masters or Marionettes: Is Program Trading Manipulative as Defined by the *Securities Exchange Act* of 1934?' (1993) 61 *Fordham Law Review* S207; Joseph Walker, *Selling Short: Risks, Rewards, and Strategies for Short Selling Stocks, Options, and Futures* (1991); and Henry McMillan, 'Regulatory Responses to Program Trading and Index Arbitrage: Circuit Breakers and Rule 80A' in Kenneth Lehn and Robert Kamphuis (eds), *Modernizing US Securities Regulation* (1992) 439.
It should be noted that neither ASIC nor the ASX has formulated its own policy on computerised program trading. Malcolm Rodgers, Special Policy Adviser, Regulatory Policy Branch, Office of the Chairman,

THE AUSTRALIAN HISTORICAL CONTEXT

In Australia the need for regulation in this area was recognised some forty years after the United States' Senate Committee on Banking and Currency appointed in 1932 uncovered major abuses in the securities markets of that country. The 1974 Report of the Senate Select Committee on Securities and Exchange[45] is the major detailed public study in Australia on the conduct of stock market manipulation. The Report had its genesis in the boom in shares of exploration and mining companies, most notably Poseidon NL, during the period 1969 to 1972 which disclosed shortcomings in the regulation of securities markets:

> The speculative activity spread rapidly to other mining and mineral exploration companies. Newspapers carried stories of fortunes gained or lost overnight. There was undoubtedly a great deal of abuse of the investing public through the flotation of nearly worthless new issues and manipulative activities in post-issue trading on stock exchanges.[46]

The Rae Report noted that:

> ... [t]he deliberate manipulation of the market for listed shares on the organised exchanges 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.[47]

Stock market manipulation has traditionally been understood to involve certain distinct market practices originally identified in the

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ASIC, has advised that the regulator has not formulated a policy on program trading as this issue has not arisen in Australia, but it is following the US debate on the matter.

45 Rae Committee Report, above n 2.

46 Redmond, above n 5, 93.

47 Rae Committee Report, above n 2, vol 1, 207.

United States and subsequently in Australia. These practices were documented by the Rae Committee, which described three particular market practices as manipulative. These were pooling, churning in shares, and organised runs on shares.[48] The Committee noted that the practices exhibited common features and all were:

> designed to stimulate artificially market turnover and share prices for the purpose of profiting, at the general public's expense, from the distortions inflicted on the market.[49]

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48 *Churning (in the Australian sense)/pass the parcel*: churning occurs where the manipulator acquires a holding of shares and then places both buy and sell orders either through one broker or several brokers in order to create an impression of large turnover. These orders are usually placed at progressively higher prices. The technique is also called 'pass the parcel'.
Churning (in the US sense): brokers generally charge a fee on a commission basis. The commission is usually a percentage of the total amount of each trade the broker performs on behalf of the client. The more trades that are generated, the greater the fees that can be earned by the broker. This creates an incentive for the broker to encourage more trades than are strictly in the client's best interests. Churning involves brokers placing excessive buy and sell orders for shares at about the same price or at slightly rising prices in order to build up the turnover, without regard to the customer's investment objectives in order to generate commissions.
Organised runs: these occur where groups of people create activity in a share by spreading rumours and actively 'pushing' a stock to cause a sharp rise in the price of the share. The purpose is to attract buyers at rising prices to enable the organisers of the run to sell their shares for a quick and substantial profit. Note: a 'run' is the term used to describe a spirited rise in one stock.
Pooling: pools occur where a group of investors/manipulators trade shares back and forth among themselves, usually through one broker, thereby raising volume and giving the impression of active trading in a stock in order to create other investor interest. The objective is to raise the price of the shares and so provide the opportunity for the manipulators to sell their shares at a profit. The technique is similar to churning (as understood in the Australian context) and pass the parcel.

49 Rae Committee Report, above n 2, vol 1, 207.

Other forms of market manipulation were matched orders and wash sales.[50] It should be said at the outset that it is unfortunate that the Rae Committee's definitions do 'not coincide with the terminology used by the American commentators and legislature.'[51] This has caused considerable confusion in relation to the meanings attributed to the various manipulative practices. For example, 'churning' in shares was said to occur by the Rae Committee whenever a trader acquired shares and then proceeded to place both buying and selling orders for the same shares at about the same price, or at slightly rising prices in order to build up turnover.[52] The conduct thus described as churning in the Rae Committee Report is in fact the conduct described as a 'wash sale' for the purposes of the United States literature and legislation.[53] In the United States:

> 'Churning' is said to occur whenever a broker or dealer is in a position to determine the volume and frequency of transactions on a customer's account by reason of the customer's willingness to follow the suggestions of the broker or dealer and he abuses the customer's confidence by over-trading. The essential element of the prohibited conduct is excessive trading so as to indicate a purpose of the broker to derive profit for himself while disregarding the interests of the customer.[54]

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50 *Matched orders/pre-arranged trades and wash sales:* (these practices were first identified in US case law). A *matched order* involves associated parties entering an order for the purchase/sale of shares with the knowledge that similar or corresponding orders will be entered into by other associates. *Wash sales* involve transactions in which there is no change in beneficial ownership in order to create a misleading appearance of active trading in the security.

51 Meyer, above n 22, 94.

52 Ibid 93; Ch 8, 8.2 of the Rae Committee Report.

53 Meyer, above n 22, 94. Similarly the conduct described by the Rae Committee as 'pools' is included within the definition of 'matched orders' in the United States: ibid.

54 Ibid 93. 'The insider trading cases generate the big headlines, but the burning of customers and the churning of their accounts hurts Wall

More recently the ASX has identified some principal modern techniques of market manipulation, such as warehousing and ramping, which developed during the 1980s.[55] In the 1990s, concerted program trading was regarded by some commentators as being manipulative. With the rise in importance and power of institutional investors, a modern manifestation of the pools could also reappear. The danger is that:

Street more': Paul Gibson, *Bear Trap: Why Wall Street Doesn't Work* (1993) 159.

55 Refer to House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (1991) para 2.1.5 (the 'Lavarch Committee'); and Redmond, above n 5, 98–9.

Warehousing and parking: these occur when one party holds shares really controlled by someone else whose identity is not disclosed. *Warehousing* is the purchase of securities by one party for or on behalf of another party. In warehousing, a substantive transaction has occurred accompanied by an informal arrangement or tacit agreement that the manipulator will indemnify the other party against loss. On the other hand, *parking* involves only sham transactions where the broker-dealer temporarily transfers stock to another broker-dealer or to customer's accounts, often without their authorisation, and 'repurchases' them later at no loss. No *bona fide* transaction has occurred.

The practices of parking and warehousing securities have been utilised by broker-dealers and others as part of manipulative schemes to limit the float of a security. By concealing beneficial ownership, these practices are ideally suited to disguising a manipulator's control of a security. The manipulator avoids alerting the market to the fact that he or she holds more than five percent of the outstanding stock. This failure to disclose operates as a fraud on the market due to the concealment of a material fact.

Ramping/ marking (up) the close: this is the term applied to transactions resulting in a quick movement in the share price just before the close of trading. A bid is placed or a parcel is purchased at or near the close which changes the closing price (the bid is often dropped the following morning or a day-only bid is used). The aim is to mislead the market by giving the impression of strength or a high degree of interest in the stock, enabling the shares to be sold at an artificial list price the next day or bolstering the price for the purpose of the financial statements of a company as at a particular day.

> Unlike their averse corporate managers, who tend to favour steady earnings and stock price growth, institutional investors who possess *de facto* control can benefit from volatile swings in stock price and could manipulate corporate affairs to create profitable trading opportunities. The enactment of the *Securities Exchange Act* of 1934 was motivated to a considerable degree by Congressional dissatisfaction with the behaviour of 'notorious market pools', which were essentially trading syndicates formed by large investors to manipulate stock prices. Absent restrictions on liquidity, the growth of institutional ownership creates the preconditions under which such pools could reappear.[56]

It is necessary to an understanding of the development of securities regulation in this country to appreciate that Australian company law and by extension its securities regulation, being historically a State matter, has been characterised by a lack of uniformity from State to State.[57] Shortly after the Senate resolved on 19 March 1970 to appoint the Rae Committee to inquire into and report on the

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56 John C Coffee, Jr, 'Institutional Investors as Corporate Monitors: Are Takeovers Obsolete?' in John Farrar (ed), *Takeovers, Institutional Investors, and the Modernization of Corporate Laws* (1993) 78.
A serious problem revealed by the Salomon scandal in government securities was the ability of trading houses with considerable market power to *create* the anomalies by which they profited. 'Proliferating marketplaces – options exchanges, unpublicized markets in London, Reuters computers -- opened wide the opportunities to move prices in one market by manipulating another. As the 1980s wore on, proprietary trading by the big houses came to look more and more like the "pools" activity that dishonoured the stock exchange in the 1920s': Martin Mayer, *Nightmare on Wall Street: Salomon Brothers and the Corruption of the Marketplace* (1993) 70.

57 The Commonwealth has been regarded as having limited jurisdiction under the Constitution to make laws with respect to the incorporation and regulation of companies: *Huddard Parker & Co Pty Ltd v Moorehead* (1909) 8 CLR 330; *New South Wales v Commonwealth* (1990) 169 CLR 482. See generally Redmond, above n 5, 90–110.

desirability and feasibility of establishing a national securities and exchange commission to act against *inter alia* market manipulation and other injurious practices, the four Liberal Party states enacted legislation with respect to the securities industry.[58] The *Securities Industry Acts* of 1970 and 1971 provided for the licensing of persons carrying on the business of dealing in securities or the business of investment advice. They also prohibited a number of undesirable practices such as false trading, market rigging, fictitious dealing and the spreading of false information about securities.[59]

In July 1974 the Rae Report was published and in December 1974 the Commonwealth Attorney-General, Senator Murphy, introduced the Corporations and Securities Industry Bill into the Senate. In the explanatory memorandum to the Bill published by the Attorney-General, it was made clear that the Bill sought to implement the two broad objectives of national policy recommended by the Rae Report for legislation. These were to provide for the regulation of public companies and the securities industry in Australia on a *national* basis, and secondly to maintain, facilitate and improve the

58 Geoffrey Hart, 'The Regulation of Stock Market Manipulation' (1979) 7 *Australian Business Law Review* 139, 140. The state legislation consisted of the *Securities Industry Acts* of 1970 and 1971 (Qld, NSW, Vic, WA). The Acts specifically prohibited some practices and were similar in scope, but they were not uniform and contained some important differences. With the passage of the *Securities Industry Acts* of 1970, the general law prohibitions relating to fraud were strengthened by statutory prohibitions on manipulative activity. Broadly the practices that were banned were as follows: false trading and false markets; market rigging transactions; market fictions; and bogus transactions in Queensland: see further Baxt, Ford and Black, above n 9, 302.

59 H A J Ford, *Principles of Company Law* (1986) 691. Some of the provisions of the earliest State Securities Industry Acts reflected US law. For example, s 71(1) of the *Securities Industry Act* 1970 Victoria and NSW captured the essence of s 9(a)(2) of the *Securities Exchange Act* 1934. Section 71(1) provided as follows: 'A person shall not effect, take part in, be concerned in or carry out, either directly or indirectly, any transactions in any class of securities which have the effect of raising or lowering the price of securities of that class for the purpose of inducing the purchase or sale of securities of that class by others.' See further Hart, above n 58, 146–7.

performance of the capital market in the interests of economic development, efficiency and stability.[60]

As indicated earlier, many of the provisions of the Corporations and Securities Industry Bill were influenced by United States' federal securities regulation enacted by the Roosevelt administration in 1933–1934 and the influence of Professor Loss.[61] In particular the Bill provided for a Corporations and Exchange Commission (CEC) constituted along similar lines to the SEC. However the Bill eventually lapsed when the Whitlam Labor Government lost office in November 1975.[62] Meanwhile the four Liberal Party States, facing harsh criticism of their administration of companies and securities in the Rae Report and the imminent prospect of federal securities legislation, enacted new and uniform Securities Industry Acts in 1975.[63]

At the federal level, the incoming Liberal-Coalition Government did not favour unilateral Commonwealth legislation, preferring instead a cooperative regime for the regulation of companies and securities. In 1976 it proposed a scheme which would promote uniformity in the law and its administration, and to this end provision was made for the Commonwealth to enact companies and securities legislation for the Australian Capital Territory, and then

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60 Australian Industries Development Association, *The Corporations and Securities Industry Bill 1975,* paras 1.1, 1.2. The purpose of this publication was to suggest alternatives to the Bill and amendments should it be proceeded with. It should be noted that various areas covered by the Bill drew upon recommendations for change made, not only by the Rae Report, but also by the Eggleston Report, and the report by Professor Louis Loss, above n 18.
The Attorney-General explained that in drafting the Bill certain of the recommendations of these various reports had been implemented and that regard had been paid to relevant legislation of the States and Territories as well as to legislation of other countries, particularly the US and the UK: ibid paras 1.3, 1.4. Also see William Paterson, 'Aspects of the *Corporations and Securities Industry Bill* 1974' (January 1975) *Company Law Bulletin* 1.

61 Redmond, above n 5, 94.

62 Ford, above n 59, 691.

63 See further Redmond, above n 5, 96.

each State to adopt the Commonwealth legislation as its own law. The approach taken involved an agreement in 1978 between the Commonwealth and the States (the Northern Territory joined in 1986), called the Commonwealth–State Scheme for Co-operative Companies and Securities Regulation, or Formal Agreement.[64]

The Co-operative Scheme legislation came into effect in 1980. It was designed to improve administrative efficiency and to create a body capable of regulating the securities industry on a nationwide basis. It sought to overcome the reluctance of some of the States to voluntarily handing over their powers in this area by recognizing that both the Commonwealth and the States respectively had legitimate roles and interests in the regulation of companies and the securities industry. Apart from uniform and complementary Commonwealth and State legislation, the Scheme sought to introduce uniform administration by State and ACT corporate affairs authorities under the umbrella of the National Companies and Securities Commission,[65] the body charged with controlling the operation of the Scheme. The NCSC inturn operated under the supervision of a Ministerial Council comprising Attorneys-General from the Commonwealth and the States.

For many practical purposes, such as the lodgment of documents, the effect was the same as if there had been one body of companies and securities industry law. However a number of structural problems remained. Ministerial accountability was diffused through the Ministerial Council comprising ministers from the various states: there was no single national legislature involved, and no single minister responsible for the legislation. Furthermore, as administration of the scheme rested to a large extent with the local registering authority of each State or Territory under delegation from the NCSC, it became apparent with time that it was unnecessarily duplicative, inefficient and expensive to have a

64 The entire legislative package of the Commonwealth Acts and State Application Acts was referred to as a Code. For example, in Victoria the companies legislation was referred to as the '*Companies (Victoria) Code*'.

65 Referred to as the NCSC.

division of functions between the NCSC and State corporate affairs commissions. It was asserted that the scheme had 'failed' in that it had not introduced commercial certainty and had not brought about any significant reduction in business costs.[66] The procedure for amendment was also said to be retarding the legislative process, resulting in 'common denominator' proposals.[67] Limited financial and personnel resources allocated to the NCSC also contributed to the lack of effective regulation.

Although it represented a considerable improvement on previous legislative structures, the Co-operative Scheme came under increasing pressure during the 1980s. It was a cumbersome compromise arrangement which sought, somewhat unsatisfactorily, to balance national and state interests. Rapid changes in the corporate and financial environment, including the development of an increasingly global financial market, resulting in more sophisticated corporate and market dealings, also made it obvious that a truly integrated national scheme was necessary.[68] This was finally achieved on 1 January 1991 with the commencement of operation of the *Corporations Law*, but only after intense political debate and hostility on the part of many of the States and a High Court challenge to the constitutional validity of the new scheme.[69]

Chapter 7 of the *Corporations Law* today regulates secutities the securities exchanges, participants in the securities industry, the conduct of securities business as well as the revised prospectus requirements for securities issues. It consists of provisions that closely correspond to the *Co-operative Scheme's Securities Industry Code* 1980 – thus section 997 of the *Corporations Law* broadly corresponds to section 123 of the Code, the stock market manipulation prohibition based upon section 9(a)(2) of the *Securities Exchange Act* 1934, and section 998 of the *Corporations*

66 Senate Standing Committee on Constitutional and Legal Affairs, *The Role of Parliament in Relation to the National Companies Scheme* (1987) 3.

67 Ibid 5.

68 Ibid 5.

69 *New South Wales v Commonwealth* (1990) 8 ACLC 120.

Law, the prohibition on false trading and market rigging transactions, broadly corresponds to section 124 of the Code, itself based upon section 9(a)(1) of the 1934 Act.[70]

The Australian Securities and Investments Commission[71] is a Commonwealth statutory corporation created by the *Australian Securities and Investments Commission Act 1989* (Cth). It has prime responsibility for the administration and enforcement of the new national scheme.[72] The legal regulation of stock markets is also supplemented at a more informal level through the activities of the Australian Stock Exchange Limited,[73] in particular through ensuring that its Business Rules and Listing Rules are observed.[74] Indeed the system of regulation in this area is one of co-regulation.[75] The Australian system of co-regulation involves official regulatory oversight by ASIC as well as self-regulation on the part of the ASX. It is characterized by an overlap between the powers and responsibilities of the two bodies and the very high degree of co-operation that exists between them It is widely acknowledged that both ASIC and the ASX are 'central to the detection and investigation of market malpractice and enforcement

70 Meyer, above n 22, 94–5.

71 Referred to as ASIC.

72 See generally Roman Tomasic, James Jackson and Robin Woellner, *Corporations Law: Principles, Policy and Process* (3rd ed, 1996) ch 2. The national regulator's role was expanded in July 1998 to cover all consumer protection matters in securities, future, life and general insurance, superannuation and deposit-taking activities.

73 Referred to as the ASX.

74 See in particular Tomasic, Jackson and Woellner, above n 72, 778–80.

75 Ibid 778. The regulatory structure in Australia contemplates a role for a self-regulatory organization such as the ASX, which conducts the only significant equities market in this country. A predominantly self-regulatory model of securities regulation, such as the one which operates in the City of London, is thought inappropriate to a market as geographically diverse and volatile as that found in Australia. Ibid 778–9. The Australian system of co-regulation of securities markets is explained and evaluated in Vivien Goldwasser, 'The Enforcement Dilemmma in Australian Securities Regulation' (1999) 27 *Australian Business Law Review* 482, 487 *et seq.*

of the *Corporations Law*.'[76] The nature of the respective and complementary roles of the two bodies lies at the heart of the regulation of Australian securities markets.

RATIONALES FOR REGULATION

Although there is a subsequent section which asks whether the law ought to prohibit manipulation, it is appropriate initially to examine the traditional rationales for regulating manipulation in securities markets.

The insidious and widespread effects of stock manipulation have for long been thought to strike at the heart of the integrity of security markets. 'Securities laws outlaw fraudulent and deceptive conduct as matters both of business ethics and of public morality, and for its undermining of confidence in the integrity of the market.'[77] The need for regulation to control abusive trading practices arises principally because transactions in securities exchanges (and in the over-the-counter markets of the United States) are affected with a national public interest. In explaining this interest, the *US Securities Exchange Act* of 1934 cites several factors, all predominantly economic in nature, in its introductory sections which describe the necessity for regulation. For example:

> Control of the markets is necessary in order to protect interstate commerce, the national credit, the Federal taxing power, and the national banking system and the Federal Reserve System.
>
> Transactions, conducted in large volume by the public, in the securities markets involve the use of

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76 The Lavarch Committee Report, above n 55, para 2.5.25

77 Paul Latimer, 'Securities Regulation Laws: What Are They Trying to Achieve?' in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia* (1994) 167. The Rae Committee noted that regulation must not be seen purely in economic terms. More effective company and securities laws were required on grounds of fairness and commercial morality: Rae Committee Report, above n 2, vol 1, para 15.2.

> credit, affect the financing of trade, industry, and transportation in interstate commerce and influence the volume of interstate commerce and national credit.
>
> The prices established are disseminated throughout the United States and foreign countries and constitute a basis for determining the amount of certain taxes and the value of collateral for bank loans.
>
> Prices of securities are susceptible to *manipulation* which gives rise to excessive speculation resulting in sudden and unreasonable fluctuations. This condition, in turn, can cause alternatively unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation and industry; can hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes ... and can prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system ...
>
> *Manipulation* and sudden and unreasonable fluctuations of security prices and excessive speculation may precipitate and intensify national emergencies, which, in turn, produce wide-spread unemployment, and the dislocation of trade, transportation, and industry.[78]

The drafters of the United States' securities legislation of 1933 and 1934 were convinced that because there was a direct link between excessive speculation, the stock market crash of 1929 and the Great Depression of the 1930s, regulatory controls were required to ensure the honesty and integrity of the securities markets in the

78 *Securities Exchange Act* 1934, s 2 (emphasis added).

national interest to prevent national emergencies.[79] That premise for regulation remains unchanged to this day. Woven through the whole fabric of federal regulation are the two basic aims of Congress, namely that stock markets should be fair and honest and that they should be orderly. A fair and honest market, where the opportunities and risks are the same for all investors, large and small, and all are protected from fraud, creates a level playing field to which investors in the US markets have always been attracted.[80] The economic thrust of an orderly market was, according to Congress, one which is free from sudden and excessive price oscillations, and consequently a market which contributes to the confidence and trust of the investing public.[81] The thrust of this regulatory scheme then was to facilitate a fair and orderly market where prices were 'truly responsive to the expected influence of

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79 Daniel Fischel and David Ross, 'Should the Law Prohibit "Manipulation" in Financial Markets?' (1991) 105 *Harvard Law Review* 503; Michael Mann, 'What Constitutes a Successful Securities Regulatory Regime?' (1993) 3 *Australian Journal of Corporate Law* 178.

80 Mann, above n 79, 178; Robbins, above n 35, 154. Indeed President Roosevelt, in recommending passage of the 1933 Securities Bill, emphasised that the proposed act should give impetus to honest dealing in securities and thereby bring back public confidence in the securities markets: Louis Loss and Joel Seligman, *Securities Regulation* (3rd ed, 1989) vol 1, 218. Roosevelt anticipated that the full disclosure of material investment information about new issues would reduce investors' concerns that they could be defrauded or treated unfairly and thus help to facilitate an increased level of corporate securities sales: Ibid. During the early 1960s, as part of the successful campaign to persuade Congress to extend the periodic disclosure provisions of the 1934 Act to over-the-counter firms above a minimum size, it was again suggested by SEC spokespersons that investor confidence in over-the-counter firms' securities had suffered because the overwhelming preponderance of securities fraud cases had occurred in such securities: ibid 218–9.

81 Nicholas Wolfson, Richard Phillips and Thomas Russo, *Regulation of Brokers, Dealers and Securities Markets* (1977), para 11.03; Robbins, above n 35, 154. This must be taken to represent the theoretical ideal of an orderly market. In practice, stock markets are not immune from sudden price oscillations.

past and future events.'[82] By focusing on market integrity and full disclosure, it was anticipated that the regulatory system could foster economic growth and development without running the risk of becoming out-dated and unresponsive.[83]

Thus the recurring themes of the *national public interest*, which is inextricably linked to various economic issues and in particular the *maintenance of an efficient market*, together with the *protection of investors* and the resulting *investor confidence* in the integrity of the securities markets, constitute the theoretical underpinnings of legislative intervention to control abusive trading strategies.[84] Indeed, so entrenched are these rationales for regulatory control in this area that it is now widely accepted that the social value in preventing fraud, manipulation and deception of all kinds in the sale of securities is too obvious to require detailed elaboration.[85]

In the Australian legislative context, the legal policy foundations of the system of securities regulation in Chapter 7 of the *Corporations*

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82 Robbins, above n 35, 45. Stock prices may reflect the expected influence of future events where, for example, the government has flagged a significant change in mining, tariff or taxation policy.
In describing the behaviour of stock prices Robbins notes that, in theory at least, the prices of stocks are the outcome of the buying and selling decisions of large numbers of 'investors based on their judgments concerning the effects of an endless parade of rapidly changing events, both real and imaginary': ibid 44. This theory however has been only partially true. In a significant number of instances, prices have been affected by external monopolistic practices, such as pools, corners, insider trading and market manipulation: ibid.

83 Mann, above n 79, 178.

84 Robbins, above n 35, 125; Friend, above n 41, 186.

85 Not even the most avid proponents of the free market and *caveat emptor* would object to legal sanctions against fraud and sharp practice of all sorts. For fraud is not only objectionable on moral grounds, but also from an economic point of view in that it derogates from the voluntariness of investment transactions and thereby leads to an inefficient allocation of resources: A C Page and R B Ferguson, *Investor Protection* (1992) 35.

Law have not been as clearly articulated in the legislation.[86] However a leading Australian commentator has suggested that

> some of the implicit policies are those of creating confidence and fairness in the operation of securities markets, investor protection from fraud or misrepresentation, the provision of adequate standards and procedures for securities exchanges and dealers, the provision of information about securities through a system of disclosure and these policies are backed up by the establishment of various accountability and control mechanisms.[87]

According to the *Australian Securities and Investments Commission Act 1989* (Cth), s 1(2), the function of the Australian Securities and Investments Commission in enforcing the securities laws is stated to be, *inter alia,* to maintain, facilitate and improve the performance of securities markets 'in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy' and also 'to maintain the confidence of investors in the securities markets ... by ensuring adequate protection for such investors'. Following the expansion of the national regulator's role in July 1998 to cover all consumer protection matters in securities, futures, life and general insurance, superannuation and deposit-taking activities, an additional objective is to promote the confident and informed participation of consumers in the financial system.

Section 3 of the former *Securities Industry Code 1980* provided that the Code should be read and construed together with the Formal Agreement entered into on 22 December 1978 between the

86 As Professor Tomasic has succinctly put it: 'The legal policy foundations of the system of securities regulation in Chapter 7 of the *Corporations Law* are not as apparent as the policies underlying the takeover provisions in Chapter 6': Roman Tomasic and Stephen Bottomley, *Corporations Law in Australia* (1995) 603.

87 Ibid; also see Ashley Black, 'Regulating Market Manipulation: Sections 997–999 of the *Corporations Law*' (1996) 70 *Australian Law Journal* 987, 988–9.

Commonwealth and the States, and which was annexed to the *National Companies and Securities Commission Act 1979* (Cth). Recital A to the Agreement states in effect that it is in the interests of the public to promote commercial certainty and to bring about a reduction in business costs and greater efficiency in the capital markets and enhance investor confidence through suitable provisions for investor protection.

The views of the Committee of Inquiry into the Australian Financial System are also worthy of note.[88] Its final report states that the 'system could not operate effectively, let alone efficiently, unless investors at large had confidence in the underlying solvency of financial institutions generally and in the overall stability of financial markets generally.'[89] The Rae Committee Report recommended that legislative action to ensure that securities markets are properly regulated

> should be in pursuance of two broad, sometimes conflicting, objectives of national policy.
>
> (i) The first is to maintain, facilitate and improve the performance of the capital market in the interests of economic development, efficiency and stability.
>
> (ii) The second is to ensure adequate protection of those who invest in the securities of public companies and in the securities market.[90]

An ASIC spokesperson has outlined the perceived rationales for regulation of our financial markets in the following terms:

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88 Committee of Inquiry into the Australian Financial System, *Australian Financial System: Final Report of the Committee of Inquiry* (1981). (The 'Campbell Committee Report').

89 Ibid. The report also stated: 'Market practices should be as free of regulation as is consistent with the objective of maintaining investor confidence': ibid para 1.26.

90 Rae Committee Report, above n 2, vol 1, para 16.15.

> The Law aims, by protecting investors, to increase the level of investor confidence and promote the integrity and efficiency of the market by facilitating a free flow of investment funds into commercial and industrial ventures which promote economic growth ...
>
> [t]he ASC has recognised that without confidence in market participants, people will not be prepared to invest, and without investment the economy will stagnate.[91]

It may be deduced therefore that the regulation of the securities markets in Australia has two primary objectives, which broadly coincide with the policy rationales for regulation of the securities markets in the United States: the maintenance of an efficient market and the protection of investors in the national public economic interest.[92]

SHOULD THE LAW PROHIBIT MANIPULATION IN FINANCIAL MARKETS?

Maintaining a legislative prohibition against market manipulation is not universally accepted as being essential or desirable as a matter of policy.[93] Indeed several commentators have questioned the

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91 Address by Michael McShane, Manager, Corporate Regulation, ASIC, 10 May 1995 at the ASX Forum, *ASC Digest 1995,* vol 4, SPCH 71.

92 Meyer, above n 22, 93; it has been argued that investor protection and the resulting confidence are in fact the overriding goals of the United States regulatory scheme: Mann, above n 79, 178.
It is interesting to note in this connection that a new and highly specific national interest principle has been identified and articulated in New Zealand in the 1990s – the attraction of foreign capital to 'an island nation far from the historic centres of world capital' – to operate alongside its traditional policy rationale of small investor protection: Gordon Walker, 'The Policy Basis of Securities Regulation in New Zealand' in Gordon Walker and Brent Fisse (eds), *Securities Regulation in Australia and New Zealand* (1994) 171.

93 Black, above n 87, 988–9.

soundness of basic manipulation theory.[94] Professor Fischel and David Ross argue that stock manipulation, however defined, is too vague a concept to form the basis for valid criminal charges. In a sharp departure from mainstream legal thought, they advocate that stock manipulation as a legal concept should be abandoned altogether – actual trades should not be prohibited as manipulative irrespective of the intent of the trader. And fictitious trades, such as wash sales and matched orders, should be analysed as a species of fraud.[95]

As the *Securities Exchange Act* prohibits, but does not define, manipulation, Fischel and Ross tackle various commentators' definitions of stock price manipulation.[96] They reject the 'inducing

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94 Fischel and Ross, above n 79; at least one court of appeals has entered the debate: see *United States v Mulheren,* 938 F2d 364 (2d cir 1991). The Second Circuit, in reversing Mulheren's conviction, displayed its uneasiness with the concept of a crime that supposedly exists inside the defendant's head: Steve Thel, '$850,000 in Six Minutes: The Mechanics of Securities Manipulation' (1994) 79 *Cornell Law Review* 219, 294. Also see Junda Woo, 'Law Theorists Call Stock Manipulation A Vague Concept, Seek to Abolish Term' *Wall Street Journal* (New York, USA), 6 March 1992, A7A, recording reaction to the Fischel and Ross article.

95 Fischel and Ross, above n 79, 507.

96 Defining manipulation is no simple task. Indeed, despite the recent focus on manipulation in overseas jurisdictions and its long history in world financial markets, no satisfactory definition of the term exists. The *Corporations Law*, like the *US Securities Exchange Act* 1934, prohibits manipulation and several of its provisions have been crafted to achieve this purpose, yet neither statute attempts to define it with any precision. The result is that the meaning and scope of manipulation is a matter of sharp controversy.
As a term of art stock market manipulation broadly describes a variety of schemes which 'may arise out of an intentional interference with the free forces of supply and demand for marketable securities': Australian Stock Exchange, Circular to Member Organisations, 21 June 1990. The US Supreme Court has said, *obiter,* that the word 'manipulative' is 'virtually a term of art' reflecting Congress's intention 'to prohibit the full range of ingenious devices that might be used to manipulate securities prices': *Ernst & Ernst v Hochfelder* 425 US 185, 199 (1976). It has been said that manipulation 'connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the

price of securities': See further Jack Treynor, 'Market Manipulation' [1992] *Financial Analysts Journal* 6. Professor Thel uses the word manipulation to mean 'buying a security for the purpose of increasing the reported price or selling a security for the purpose of decreasing the reported price': Thel, above n 94, 221 n 17. Jarrow states that a market manipulation trading strategy is one that generates positive real wealth with no risk: Robert Jarrow, 'Market Manipulation, Bubbles, Corners, and Short Squeezes' (1992) 27 *Journal of Financial and Quantitative Analysis* 311.

Professor Thel states that it is 'hard to define the word manipulative concisely for the purpose of the Act. It is not simply "a general term comprising a range of misleading practices" ... manipulative practices are those that undermine the proper functioning of the securities markets': Steve Thel, 'Regulation of Manipulation under Section 10(b): Security Prices and the Text of the *Securities Exchange Act* of 1934' (1988) *Columbia Business Law Review* 359. Professor Thel further states that, although he is at odds with Norman Poser's view that the Supreme Court is correct in holding that deception is an essential element of manipulation under s 10(b), 'in his book on insider trading, Henry Manne used the word manipulation in the way it is defined in this article': ibid 361.

In a later part of the article, Professor Thel suggests that the word manipulative 'may not even mean the same thing in every place that it appears in these statutes. For example, it seems particularly inappropriate to give the word the same meaning in section 14(e), which makes manipulative conduct illegal, as one would give to it in section 10(b), under which nothing is illegal unless it contravenes an SEC rule': ibid 378. And again, referring to the amendments introducing s 14(e) and s 15(c), Professor Thel states that the 'language enacted in these amendments and the record of their adoption provides evidence to support almost any reading of the word manipulative. For example the language of s 15(c)(1) of the Act, first adopted in 1936, suggests that manipulative devices are a subgroup of fraudulent devices. The language of s 15(c)(2) of the Act, first adopted in 1938, is closer to that of ss 10(b) and 14(e) of the Act, and suggests that manipulation and fraud are distinct problems': ibid 380.

Professor Loss, after an extensive analysis of the regulation of market manipulation, concludes that the word manipulative has no precise meaning in s 10(b). He states that the matter of market manipulation is '[r]elated to the field of fraud – but not altogether a part of it as a matter of legal analysis': Louis Loss and Joel Seligman, *Fundamentals of Securities Regulation* (3rd ed, 1995) 843. It has also been said that manipulation, like fraud, takes a variety of forms and cannot be exactly defined: Thel, 'Regulation of Manipulation', 361.

people to trade' definition as too broad because it could catch even a mutually beneficial trade.[97] Another popular definition, 'forcing a security's price to an artificial level' is also rejected despite its intuitive appeal, since it might punish a trader who genuinely – though mistakenly – believes a stock's value is higher or lower than its price.[98] The authors conclude that there is no objective definition of manipulation – only dishonest intent to move stock prices can be called manipulative.[99]

Relying on the writings of Myron Scholes, a Stanford University professor whose research shows that trading often has no effect on securities prices, they further argue that single individuals are almost powerless to move stock prices. Thus people would not engage in manipulative trading even if it were legal, because it is extremely difficult to profit by manipulating security prices with trades. Profitable manipulations require two conditions: trading must cause the price of the relevant security to rise; and the manipulator must be able to sell at a price higher than the price at which the securities were purchased.[100] However the relationship between trading and price movements is complex and purchases seldom move securities prices higher. If they do, it is difficult to effect sales at the inflated price. Accordingly manipulative schemes are unlikely to be successful.[101] Given that trading is costly, it is argued, people will not even attempt to manipulate security prices.[102] Moreover, on a cost–benefit analysis, prohibiting manipulative trades is not justified: it results in significant

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97 Fischel and Ross, above n 79, 507.

98 Ibid 508–9.

99 Ibid 506.

100 Ibid 512. The authors concede that, unlike such trade-based manipulations, contract-based manipulations – schemes in which the trader's profit results from the ability to trigger a contractual right or benefit by trading – are more properly the subject of legal concern.

101 Cf the findings of the Rae Committee, above n 2, ch 8, which found a direct correlation between manipulative practices such as pools, churning and organised runs and boosted reported turnover and price. Such manipulative schemes were at times widely practised and highly profitable.

102 Fischel and Ross, above n 79, 512–19; Thel, above n 94, 221.

enforcement and other social costs which outweigh any minimal benefits that the prohibition might yield. Because manipulative intent is difficult to identify, a rule prohibiting manipulative trades is expensive to administer and deters some appropriate and beneficial trading.[103]

Fischel and Ross concede that manipulation is possible if a trader makes false statements that would influence a stock's price, but they point out that false statements are already specifically prohibited under fraud statutes. They also note that if several people collude to move prices, that is also fraud. Manipulation alone, the authors say, is so unlikely to occur and so difficult to detect that it should be declared lawful.

Several securities law specialists have balked at that suggestion, although they agree that manipulation is ill-defined.[104] Critics of the Fischel/Ross proposal point out that manipulation convictions not only are plausible but do take place every few years.[105] Professor

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103 Fischel and Ross, above n 79, 522–3. Examples of appropriate trading that might be deterred include situations where the activity in question creates a false and misleading impression but the primary purpose is the defence of a legitimate interest, eg share support operations to fend off a hostile take-over or to prevent an unreasonable decline in share prices to stave off creditors: How Chih Lee, 'Market Manipulation in the US and UK: Part 2' (1993) 14(7) *Company Lawyer* 123, 124.

104 Woo, above n 94.

105 Ibid. Arthur Matthews, a partner at the Washington DC law firm of Wilmer, Cutler and Pickering, said: 'You're talking about maybe one out of every 40 securities convictions are manipulation cases ... [manipulation is] very hard to prove': ibid. Professor Thel is reported as having stated: 'It's difficult for a person to [manipulate stock prices], but it's not if they have a lot of resources behind them, and that's what has been happening': ibid. Professor Thel believes that the SEC should define specific manipulative acts. Professor Norman Poser said one example of pure manipulation occurs when a trader breaks up a 500-share purchase into 100-share blocks to make it seem as if several people are jumping into the market. When other people begin buying the stock and the market rises, the trader sells at a profit. 'It's basically deceptive', Professor Poser is reported as having said. 'There's no social value in it, and it should be prohibited': ibid.

Thel in particular has delivered a strong rebuttal of the position advanced by Fischel and Ross. He argues that despite the difficulty of manipulating price with trades, trading and price are connected. Manipulators can sometimes control prices with trades, and by doing so reap profits either by taking advantage of pre-existing contracts in which rights are contingent upon reported security prices or by inducing other market participants to trade at manipulated prices.[106] Relying on the evidence in the economic literature, Professor Thel states that manipulation is easier to accomplish than Fischel and Ross admit.[107] Indeed he posits that manipulation is 'theoretically possible, and it probably occurs fairly often.'[108] At the same time he concedes that manipulative intent is hard to identify, and the possibility of erroneous prosecution may discourage some appropriate trading.[109] Above all, a rule prohibiting intentional manipulation is an incomplete solution to the underlying problem because price-affecting trades may cause damage by undermining the integrity of trading on a market for securities, regardless of the reason for which those trades are undertaken.[110]

Responding to Fischel and Ross' argument that the legal prohibition of manipulation creates extraordinary and unacceptable costs because of the need to delve into the state of mind of the trader, and furthermore that because severe sanctions turn on such state of mind, fear of prosecution casts a shadow over innocent and useful trading, Professor Thel argues that it is important to put the argument in perspective. According to Thel, the US government brings relatively few securities manipulation cases.[111] Thus the

106 Thel, above n 94, 221, 296–7.
107 Ibid 221–2.
108 Ibid 223.
109 Ibid.
110 Ibid. The damage to the integrity of the market arises because the manipulative activity affects the price at which all trades take place in the market within the relevant time period.
111 Ibid 292. Although 'the pervasive problem of market manipulation was a principal focus of the SEC Enforcement Division in the 1980s': Harvey Pitt and Karen Shapiro, 'Securities Regulation by Enforcement: A Look at the Next Decade' (1990) 7 *Yale Journal on Regulation* 149,

deterrence to legitimate trading is minimal. Former SEC Commissioner Edward Fleischman on the other hand has argued along lines similar to Fischel and Ross that the costs of the existing regime have been understated and the benefits of regulation have been exaggerated. He does not conclude, however, that market regulation should be abandoned altogether. Instead he argues that broad standards protect the public and promote liquidity better than detailed rules and advocates the use of generic rules to regulate manipulation.[112]

Professor Thel observes that these difficulties 'suggest that the law should respond carefully to manipulative trading.'[113] He argues that those who crafted the US securities laws recognised the need both to carefully calibrate the law so as to eliminate destructive practices without interfering unduly with appropriate trading, and to allow the law to develop as market practices change.[114] Hence the balance struck by the *Securities Exchange Act*, which makes it illegal to engage in a few clearly defined practices for specific purposes but otherwise charges regulators with studying the problem and devising appropriate rules in response.[115] The SEC in turn 'has

256, there are (to the author's knowledge) no available statistics as to what percentage of all SEC securities cases have been market manipulation cases. There is only anecdotal evidence suggesting that one out of every forty securities *convictions* are manipulation cases: Woo, above n 94. (Also refer to n 105 above). This, however, only highlights the difficulty in proving the offence. The Commission has indeed suffered a number of setbacks, notably in *United States v GAF Corporation* 928 F2d 1253 (2nd cir 1991) and *United States v Mulheren* 938 F2d 364 (2d cir 1991). Overall, towards the end of the 1980s, the Commission began pursuing market manipulation cases with greater frequency: Pitt and Shapiro, 300. And at least from the Australian perspective, where there is a paucity of cases dealing with manipulation, there is 'a substantial body of United States case law dealing with prosecutions for market manipulation': Black, above n 87, 1005.

112 Thel, above n 94, 295–6, referring to a letter from Commissioner Edward Fleischman to President George Bush dated 25 March 1992 (on file with the *Cornell Law Review*).

113 Ibid 223.

114 Ibid.

115 Ibid 297.

promulgated a series of rules against particular trading practices, *most of which do not turn on a trader's motives.* These rules are supplemented by rule 10b-5 when manipulators use novel or particularly outrageous practices.'[116]

Despite the controversy as to the soundness of regulating price manipulation, Australian regulators like their US counterparts regard fraud and manipulation in relation to the securities industry as a major concern and one which warrants government intervention:

> Maintaining credibility in our securities markets is a crucial factor in the economic process. With this in mind governments spend millions of dollars every year to ensure the integrity of its capital markets. In order to maintain confidence in our markets, market participants should aim to minimise the risk of fraud and inappropriate market practices. Fraud control and minimising the risk of fraud must start with the individual and have the active support of the firm and government.[117]

The maintenance of honest and orderly markets is a matter of 'enlightened self-interest since a well-regulated market run on an ethical basis attracts the investor.'[118] Without regulation to ensure investor protection and confidence:

> [O]ur markets would cease to exist. If investors believed that prices were driven by backroom agreements rather than supply and demand, or if they believed that only "insiders" trading on confidential information could profit, they would take their

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116 Ibid (emphasis added). Professor Thel contends that, for the most part, this response is precisely what Fischel and Ross have shown is necessary: ibid.

117 McShane, above n 91.

118 John Farrar, Mark Russell and Lindsay Hampton, *Company Law and Securities Regulation in New Zealand* (1985) 345.

> money elsewhere. Without confidence in the markets, investors would, understandably, simply decline to participate.[119]

The historical evidence suggests that, absent regulation, stock markets would be marginal institutions.[120] Financial markets in Europe and the United States developed around debt issues, not equity. Prior to the 1920s, equities were regarded as unduly speculative and 'there were no large-scale markets in common stock ... shares were viewed as akin to interests in partnerships and were simply conveniences for trading among business associates rather than instruments for public issues.'[121] The impact and example of US regulation fundamentally altered this state of affairs.[122] In 1992, over US $850 billion of capital was raised in US markets alone.[123] Securities markets have become the capital raising vehicle of choice for many public companies and utilities today. Indeed 'both as vehicles for government sponsored privatisation or simply as means for capital raising, the role of bank financing has been vastly overshadowed by the direct use of the securities markets'.[124]

It should never be forgotten however that markets, although necessary and important, are like any speculative activity easily corrupted.[125] In the absence of effective regulatory structures, 'markets will be susceptible to fraud, mismanagement and even

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119 Mann, above n 79, 178–79; 'Casinos with reputations for rigged games eventually drive patrons away': Bhide, above n 24, 130. In a similar vein, Black has recently argued that if manipulative practices lead to a loss of confidence in the integrity of the securities market, then investors would either look to other investment options, or would demand higher risk premiums, in either case increasing the cost of capital to listed companies: Black, above n 87, 988.

120 Bhide, above n 24, 131.

121 Ibid (quoting Jonathon Baskin).

122 Friend, above n 41, 186.

123 Mann, above n 79, 179.

124 Ibid.

125 See generally Mayer, above n 56; and Robert Teitelman, 'The Last Days of Pompeii?' (August 1993) *Institutional Investor* 19.

collapse based on the misdeeds of a greedy few.'[126] Thus the law should not lightly abandon its quest to prevent manipulation of financial markets.[127]

THE REGULATORY ENVIRONMENT: A TIME OF TRANSITION

There does not publicly exist any verifiable information on the extent to which market manipulation is currently occurring in Australia.[128] The complexity and subtlety of manipulative strategies, the secrecy in which they are conducted, and the fact that very few cases are brought before the courts, undoubtedly continue to confound attempts to gauge the extent of such malpractices in Australian securities markets. There is little doubt however that manipulative practices are occurring. Indeed it is probably the case that securities markets are more open to manipulative abuse than the public suspects. The Lavarch Committee Report tabled in 1991 noted that anecdotal evidence, and the experience of the ASX Surveillance Division, indicated that manipulative practices were continuing despite legislative prohibition.[129]

The Attorney-General's Department commented in its submission to the Committee that in cases of stock market manipulation, there are few sign posts: 'the practices may be spread over a long period of time, the purpose of the activity may not be obvious and the activity may involve a long series of transactions or the careful placing of a particular false rumour'.[130]

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126 Mann, above n 79, 179.

127 Thel, above n 94, 296.

128 Regulators with whom the author has had discussions were reluctant to speculate .as to the extent of manipulation occurring in Australian securities markets.

129 Lavarch Committee Report, above n 55, para 2.5.21. The Rae Committee in the 1970s also noted that deliberate manipulation of the market for listed securities had at times been widely practiced in Australia: Rae Committee Report, above n 2, para 8.1.

130 Ibid para 2.4.20.

Professor Baxt, then Chairman of the Trade Practices Commission, commented in his submission that:

> There is little doubt that there are manipulative practices occurring in the Australian securities market ...(however) ... I do not have first hand evidence of those practices.[131]

It should be accepted as aciomatic therefore that '[w]e do not know how often prices are manipulated, how much harm manipulation does or how existing manipulation rules influence behavious'.[132] Nevertheless models have been developed which show that manipulation may be common.[133] Indeed it is probably the case that securities markets are more open to manipulative abuse than the public suspects.[134] Unlike insider trading which can be detected 'by observing large or unusual trading patterns immediately prior to the public announcement of a meaningful corporate event',[135] stock market manipulation reflects 'the more subtle problems'[136] involved in the operation of the market. One of the underlying difficulties of course is that manipulative *intent* – the crucial element under current formulations of the prohibition that differentiates lawful

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131 Ibid para 2.5.18.

132 Thel, above n 105, 287.

133 Ibid 222. There is also a considerable body of recent literature in the field of financial economics analysing various aspects of the mechanics of market manipulation.

134 David S Ruder, then Chairman of the SEC, testified before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations, 100th congress, 2d Session 259 (8 June 1988), in the course of its hearings on the SEC's enforcement problems, that the tree types of abuse most commonly encountered included insider trading, market manipulation and false financial reporting: Peter Millspaugh and Bradley Belt, 'Policing Foreign Trader Abuse in US Markets Enforcement Strategy Perspectives' (1992) 19 *Securities Regulation Law Journal* 366, 366–7 n 1.

135 Honathan Macey and Hideki Kanda, 'The Stock Exchange as a Firm: The Emergence of Close Substitutes for the New York and Tokyo Stock Exchanges' (1990) 75 *Cornell Law Review* 1007, 1034.

136 Ibid.

from abusive trading – is extraordinarily difficult to identify[137] and accordingly 'the study of actual manipulative trading may be unavoidably anecedotal'.[138]

Australia's enforcement record contrasts sharply with that of the United States' SEC. The US statutory regime has produced a rich body of case law, principally under the broad anti-fraud rule 10b-5, dealing with stock market manipulation.[139] This position is not explicable on the basis that there is proportionally less manipulative activity occurring on the Australian stock market than in the United States. On the contrary the Australian stock market, being smaller and less liquid both generally and in particular stocks, is likely to be more susceptible to manipulation.[140] The discrepancy is also not entirely explicable by reference to the undoubted difficulties in detecting manipulative trading, which exist equally under both the Australian and the US statutory regimes.[141] Indeed the discrepancy may largely be explained in terms of the more flexible legislative regime that operates under the ant-fraud provisions in the United States compared with Australia. As an Australian commentator observed over a decade ago, a 'substantial review and rationalisation of the anti-fraud provisions'[142] is long overdue in this country.

The most significant problem is to determine the meaning of sections 997 and 998 of the *Corporations Law*.[143] These provisions contain numerous internal deficiencies and create difficult problems of classification and proof. As noted earlier, the central element of manipulative intent – *an intention* to affect prices *for the purpose of*

137 Clearly the motive with which trading is conducted may not be apparent, and the same trade may be carried out with different motives.

138 Thel, above n 105, 223.

139 Black, above n 87, 1005.

140 Ibid.

141 Ibid.

142 Meyer, above n 22, 102, also see Michael Hains, 'Submission to the Australian Securities Commission' (1992) *Butterworths Corporation Law Bulletin* 297 who argues for a reformulation and a redrafting of ss 997 and 998.

143 For a detailed analysis of these sections, see Goldwasser, above n 15.

inducing others to buy or sell – is especially problematic. The aim is to discover whether conduct has been intentionally engaged in to induce others to trade, which has resulted in a price which does not reflect basic forces of supply and demand. Proof of manipulative intent however is usually based on circumstantial, rather than direct, evidence. Therefore in the context of the current Australian statutory regime governing stock market manipulation, the effect of reliance on concepts such as a specific manipulative *intent to induce* is to require highly complex psychological analysis which overcomplicates the issue and nullifies the effect of the prohibition.

Regulators with whom the author has had discussions have also indicated dissatisfaction with the existing legislative regime. Indeed one senior regulator observed that 'the area is desperate for some law.'[144] The difficulties are particularly acute with respect to section 997 which (together with its predecessors) has produced only two successful prosecutions since the early 1970's.[145] Section 998 is regarded as 'a lot easier to prosecute' than section 997 even where the facts of the case come within the parameters of section 997.[146] Yet section 998 has also generated few cases.[147] It will be

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144 Jim Berry, head of ASX Surveillance Division, Sydney Office, 15 July 1996. Only one regulator expressed a contrary view. Geoff Green of ASIC was of the view that the electronic monitoring system run by the ASX was paramount in the regulation of manipulation. Since it has had a dramatic preventative effect on the marketplace, registering some 30,000 triggers a year for irregular trading patterns, he thought that the importance and state of the legislation was relatively insignificant: 15 December 1995.

145 *Mark Richard Howard v Bruce Emerton Miles* (unreported, ACT Magistrates Court, Dainer SM, 30 July 1990); *R v Michael Robert Shearer* (unreported, District Court Adelaide No 36/98, David J, 18 June 1998). These cases are discussed in Goldwasser, above n 75.

146 Mark Steward, ASIC Solicitor, Victorian Regional Office, 21 November 1996. Other regulators have expressed similar views.

147 *North v Marra Developments Ltd.* (1981) 148 CLR 42; *R v Dennis Brian Jones* (unreported, District Court of Western Australia, Williams DCJ, No 1348 of 1990, 10 December 1990); *Endresz v Whitehouse* (1994) 12 ACLC 803; (1997) 15 ACLC 936; *R v Anthony James Lloyd* (unreported, District Court of Western Australia, Jackson DCJ, No 152 of 1993, 11 September 1995); *ASC v Paneth & Oths* (unreported,

recalled that the offence provisions were drafted in the 1970's. The requirement of inducement in section 997 derives from section 9 of the *Securities and Exchange Act* which was drafted in 1934. Significant changes have occurred in the markets since that time to warrant a review of the scope of those offences.

Regarding enforcement, the prohibition against market manipulation is enforceable in Australia through a range of sanctions. The principal weapons in the remedial arsenal are criminal sanctions on conviction, applications for court imposed discretionary injunctive relief and compensation on behalf of investors. These powers, although substantial, fall far short of those available to the United States' SEC. In particular the SEC has used the civil remedies available to it both statutorily and at common law to great effect – it brings a few hundred actions each year and in the great majority of cases, the alleged wrongdoer is either found liable or consents to a judgment being entered against him without an admission of liability. The Commission concentrates on its civil and administrative powers, and criminal prosecutions are brought only in the most serious cases. This approach results in very swift and effective action in the case of minor breaches while maintaining a strong deterrent effect in general. By contrast, in Australia where almost exclusive reliance is placed upon the criminal process, it will be recalled that very few cases of alleged manipulation have ever been prosecuted. Clearly the wholesale criminalisation of our securities laws should be questioned. Criminal prosecution has proved to be an inefficient and cost-ineffective way of dealing with complex commercial cases.

Finally it must be acknowledged that, notwithstanding the undisputed need for vigorously enforced securities laws the

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Federal Court, Olney J, VG 3301 of 1996, 11 July 1996); *Fame Decorator Agencies Pty Ltd v Jeffries Industries Ltd* (1998) 16 ACLC 1235 (New South Wales Court of Appeal upholding the decision of Cohen J in *Fenwick v Jeffries Industries Limited* (1995) 13 ACLC 1334); and *Australian Securities Commission v Nomura International PLC* (1999) 29 ACSR 473.

The facts of these cases are discussed in Goldwasser, above n 75.

intensely dedicated and aggressive spirit that has been sustained by the SEC throughout nearly six decades, together with the agency's freedom from political influence, responsiveness to new trends, and flexibility in promoting prompt and effective settlements, have not been prominent features of the enforcement landscape in Australia.[148] The SEC has, from the beginning developed a tradition of a professional elite consisting of exceptional young lawyers that complements the essential core of professionals who consider themselves to be career civil servants.[149] Australia on the other hand suffers a personnel problem, exacerbated by cost-cutting exercises engaged in by successive federal governments, which have resulted in the ongoing depletion of skilled manpower from the national regulator.

In the view of the acknowledged shortcomings in enforcement[150] and the deficiencies in the existing legislative regime,[151] any meaningful reform must be extensive, encompassing changes both to enforcement policy and to the substantive law. The climate of the 1990s and beyond – which, like the 1930s in the United States, has become a period of reassessment and revision – creates optimal conditions for subjecting this area of the regulatory regime to a realistic appraisal of what it can and should accomplish.

Against this background, on 11 February 2000 the Minister for Financial Services and Regulation, the Hon Joe Hockey, released the draft Financial Services Reform Bill, which will be introduced into the parliament in the winter sittings 2000 with a proposed commencement date of 1 January 2001. The draft Bill is the culmination of an extensive reform program examining current regulatory requirements applying to the financial services industry. The broad policy direction for what was known as the Corporate Law Economic Reform Program 6 (CLERP 6) reforms[152] is now

148 Goldwasser, above n 75.
149 Loss, above n 18, 8.
150 Goldwasser, above n 75.
151 Goldwasser, above n 15.
152 Refer to the sixth paper released under the Government's Corporate Law Economic Reform Program, in December 1997, entitled *Financial*

contained in the Bill, which provides for a single licensing regime for financial service providers, minimum standards of conduct for financial service providers dealing with retail clients, uniform financial product disclosure obligations to retail clients, and flexibility for authorization of market operators and clearing and settlement facilities.

Of particular relevance to the present discussion are the reform proposals in relation to the market misconduct provisions of the *Corporations Law*. These are not yet contained in the draft Bill. However the commentary accompanying the Draft Bill includes a description of the approach that will be taken in relation to this matter.[153] This approach reflects an about-turn by the Government following submissions made to its original proposals contained in the Consultation Paper entitled *Financial Products, Service Providers and Markets: An Integrated Framework* (Consultation Paper), released on 3 March 1999.

The Consultation Paper made it clear that no revision of the current provisions was being contemplated and that the existing offences contained in Part 7.11 Division 2 of the *Corporations Law* (the *securities* provisions) would largely be retained in their present form but would be extended to apply to all financial products. The commentary to the Draft Bill, however, informs us that the intention is now not to retain the securities provisions after all, but to extend the *futures* provisions to all financial products traded on a financial products market. However a leading authority on futures regulation has said of the offence provisions that this 'is an area neglected in the past, but it is in need of substantive reform'.[154]

Markets and Investment Products: Promoting Competition, Financial Innovation and Investment (1997) (CLERP 6).

153 At the time of writing, the draft Financial Services Reform Bill and the accompanying commentary were only available as an electronic document on the Treasury's homepage: <http://www.treasury.gov.au>.

154 Michael Hains, 'Derivatives Regulation in Australia' in Gordon Walker (ed), *Securities Regulation in Australia and New Zealand* (2nd ed, 1998) 684.

The CLERP reforms thus fail on a fundamental level since there has been no attempt at critical evaluation of any of the market misconduct provisions of the *Corporations Law*. Substantive reform of the legislation is long overdue and should be implemented within the context of a more systematic and incremental approach to developing legislation.[155] However the CLERP proposals ignore the important issues of substance in favour of the rhetorical appeal of harmonization.

In Australia traditional attempts to define manipulation with precision have failed to produce an effective and meaningful regime of regulation. Manipulation is difficult to define, but manipulative practices and schemes are usually readily identifiable. Statutory formulations of the provisions are therefore required which are broad and flexible, conferring upon regulators and the courts a generous discretion in their implementation. The success of the broadly formulated US provisions – section 10 (b) and rule 10b-5 – in dealing with abusive stock market practices, some interpretive difficulties notwithstanding, is testament to the need for legislative provisions with inherent adaptive capacities.[156] The government's proposed reforms illustrate that this is one of the lessons which has yet to be learned from the history of the regulation of stock market manipulation. An important opportunity has been missed. No doubt it will be a long time before a completely new model which incorporates fundamental reform for the regulation of market malpractice will be considered.

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155 Nicholas Korner, 'Domestic Regulation and Global Financial Markets: The Impact of the CLERP Reforms', Commentary for 1998 Law Council of Australia Corporate Law Workshop, Sydney, 13 September 1998 (unpublished paper) 3.

156 I have argued elsewhere in favour of a broad generic anti-manipulation provision designed to operate as a civil penalty provision: see Vivien Goldwasser, 'The Regulation of Stock Market Manipulation: A Blue-Print for Reform' (1998) 9 *Australian Journal of Corporate Law* 109. It is suggested that the proposed generic provision dealing with stock market manipulation should provide as follows:

> A person shall not, in or in connection with any dealing in securities, manipulate the market for, or the price of, any securities.

Another concern is the central pillar of the Government's strategy harmonised regulation of all 'functionally similar' financial markets and products. It proposes to replace existing *Corporations Law* categories, securities, futures and other derivatives, with a new integrated regulatory framework based on 'functionally similar' markets and products, with categories based on 'market operation' and 'financial intermediation'.[157] This model provides the blueprint for regulation of all financial markets and investment products. However there is reason to believe that the premise on which the proposals are based, that there should be harmonized regulation of all 'functionally similar' financial markets and products, is misconceived.[158] Especially worrisome is the Government's admission that *flexibility* in the regulatory framework will be required in order to accommodate *differences* which arise between different types of financial markets and products, as well as new and innovative products.[159] To ensure flexibility, a number of mechanisms are proposed to allow products to be taken *outside* the scope of the definition of 'financial product'.[160] Hence differentiated application of uniform principles is acknowledged and anticipated – in other words, inconsistent application within an overall regulatory framework specifically created and designed to promote consistency.

On the other hand, the proposal to introduce a civil penalty regime for the market misconduct provisions of the *Corporations Law* is a welcome step in ensuring greater flexibility in the sanctions for securities law violations.[161] Although the final draft provisions have

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157 For a detailed discussion, see Vivien Goldwasser, 'CLERP 6: Implications and Ramifications for the Regulation of Australian Financial Markets' (1999) 17 *Company and Securities Law Journal* 206.

158 Korner, above n 155. This paper comments upon the approach adopted by CLERP 6 (n 152 above) to policy issues posed by globalisation of financial markets.

159 Consultation Paper, above n 154, 3; also refer to CLERP 6, above n 152, 40.

160 Consultation Paper, above n 154, 11. The ability to exempt products will be either via regulation or an ASIC exemption power: ibid 4.

161 The civil penalty regime is not without its problems however: see Goldwasser, above n 157, 209 *et seq*.

not yet been published, it is to be hoped that they will mitigate the problems created by the present emphasis on criminal sanctions in regulating market misbehaviour. It is also encouraging to see that consideration is being given to including, as an additional remedy for less serious contraventions of the market misconduct provisions, the power for ASIC to impose an administrative penalty and/or administrative stop orders. Implementation of such a proposal would bring Australia's enforcement strategy closer to the US model, which has proved over time to be very successful in ensuring that appropriate enforcement mechanisms are in place.[162]

The CLERP proposals for reform of financial market regulation are being introduced against a background of three decades of fundamental change in world financial markets. The transformation is most notable with regard to the structure and identity of participating institutions, the techniques of trading and dealing, trading volume, product innovation and the introduction of sophisticated information technology: all hallmarks of the new era. Arguably the greatest challenge is that posed by the convergence of technology and the increasing globalisation of financial markets. Maintaining regulatory standards is difficult when markets exist primarily on computer networks, with investors increasingl;y accessing cross-border markets via the information super-highway; with institutional investors trading directly with one another in off-the-floor activities, away from the exchanges and public scrutiny.[163]

The government has made a modest start in response to the pressures to adjust market rules to prevailing conditions in world financial markets. Apart from reforms already in place to facilitate electronic commerce, for example in relation to disclosure documents such as prospectuses, it is now responding to the pressures created by the growth of e-trade by giving consideration to new enforcement powers relevant to electronic commerce. These include a new provision to deal with false or misleading 'spamming' which gives rise to market manipulations and pyramid

162 See generally Goldwasser, above n 75.

163 Richard O'Brien, 'Who Rules the World's Financial Markets?' (March–April 1995) *Harvard Business Review* 144, 151.

schemes. The provision will specifically address the use of spamming or chat rooms as a commercial tool, in situations where the communication's commercial motivations are not revealed. Consideration is also being given to a provision allowing ASIC to serve a written notice on an internet service provider requiring it to immediately stop providing services, where ASIC has formed the view that the information contravenes, or is placed on the internet in contravention of, the *Corporations Law*. No doubt much more will need to be done to adapt the mechanisms through which our financial markets are regulated to the rapid advances in technology that will drive the future direction of market regulation.

In addition to the introduction of meaningful statutory provisions backed up by appropriate enforcement mechanisms ther is a need for a very clear articulation of the legislative purposes and objectives of market regulation. Defining what purposes the market should serve, and whose interests are to be protected, lessens uncertainty as to the course market regulation should take. Marking a departure from past practice, the Government has very clearly identified the objectives of the Corporate Law Economic Reform Program. These are, broadly, to ensure that Australia's corporate and financial market laws are consistent with promoting a strong and vibrant economy, and to facilitate investment, employment and wealth creation whilst protecting investors and maintaining confidence in the business environment. The purpose of the *Financial Services Reform Bill* is to put in place a flexible and adaptable framework that encourages innovation and competition in markets and clearing and settlement facilities. These reforms are designed to play a significant role in the Government's push to make Australia a global financial center. In other words, CLERP is designed to provide a stronger economic focus to the reform agenda.

CLERP dismantled the *Corporations Law* Simplification Program, including the Task Force, established by the previous Labor federal government. The Corporations Law Simplification Task Force had accepted the policies already inherent in the *Corporations Law*, noted earlier, and set out to simplify them. The objective then was

to streamline the law, procure consistency and coherence, maintain effective protection for investors and bring cost benefits to both business and regulatory authorities. Although the Simplification Program ultimately became more than merely a plain English rewrite and change of layout, CLERP embodies a new emphasis on substantial reform of policies in pursuance of the government's stated economic objectives.

CONCLUSION

Market manipulation is among the oldest and most widely recognised practices in global capital markets. Manipulation victimizes individual investors, erodes public confidence in the market's integrity and undermines market efficiency. The recurring themes of the national public interest, which is inextricably linked to the maintenance of an efficient market, and the protection of investors together constitute the theoretical underpinnings of legislative intervention to control abusive trading strategies. These rationales continue to justify regulatory control in this are a notwithstanding controversy as to the soundness of basic manipulation theory.

Although regulation is bound to be imperfect, securities markets that are firmly established, carefully regulated and responsive to the public interest make an immeasurable contribution to a national economy. On the other hand if 'professional insiders are free to manipulate prices, the economic role of the markets is not even subject to the restraints of the probability table, but becomes a pawn of gambling motivations'.[164] Indeed those markets which have not succeeded in creating at least an illusion of effective regulation have seen their market's integrity impaired.[165] A certain amount of

164 Robbins, above n 35, 48.

165 The illiquidity of some European markets, such as the Belgian market, is attributed to the fact that restraints on insider trading, disclosure requirements and manipulative practices have traditionally been weak: Bhide, above n 24, 131.
Although Japan has one of the biggest capital markets in the world, its reputation in financial circles was impaired by recent scandals. It has

regulation is needed then to enable the securities market to perform its price-determining functions, free from manipulative influences by those who seek to corrupt it for their own benefit.[166] The issue of how much substantive regulation is appropriate is far more difficult, but it is the critical issue.

History has shown that flexibility is the hallmark of the unique system of securities regulation and enforcement that has proved remarkably durable and successful in the United States. There is much to be said for the introduction in Australia of a broad and flexible anti-manipulation provision and its exposition by the courts. Freed from excessive legal restrictions in the form of complex statutory provisions that defy enforcement, successful regulation of manipulative abuse would then be possible in accordance with the spirit of the law. The aim throughout would be to achieve a delicate balance in which destructive practices would for the most part be eliminated without undue interference with legitimate and appropriate trading. Yet the government's approach to market misconduct under CLERP, though it may represent an improvement in some respects over the current model, will ensure that the law continues to respond cautiously to the difficulties associated with the regulation of manipulation and other forms of market abuse.

Governments and regulators must respond to the fundamental changes in the nature of our trading markets with a commensurate fundamental re-evaluation of the nature of market regulation. The exponential growth in the opportunities and potential rewards from

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therefore been suggested that '[i]n order for Japan to maintain its legitimacy in the "transnational" world of financial services, it needs to restructure its methods of regulating securities laws': Nicole Ramsay, 'Japanese Securities Regulation: Problems of Enforcement' (1992) 60 *Fordham Law Review* S255, S277. Also see Andrea Borch, 'Market reform is in the air – but is it real?' (August 1993) *Institutional Investor* 21, discussing recent attempts by various Asian markets to restore some measure of fairness, transparency, corporate accountability and integrity to their capital markets behaviour.

166 Norman Poser, *International Securities Regulation: London's 'Big Bang' and the European Securities Markets* (1991) 6.

violating the securities laws, the increasing integration of national markets and their intermediaries into regional, if not global, networks, and the enormous advances in informational and transactional technology, necessitate the adoption and implementation of new and innovative strategies to deal with changing circumstances.[167] There is still a great deal to be done to ensure that the regulation of our financial markets can meet the challenges of a complex and continually changing commercial world.

167 See Vivien Goldwasser, 'Current Issues in the Internationalisation of Securities Markets' (1998) 16 *Company and Securities Law Journal* 464.