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COURSE
11451B

Introduction to Financial Market Manipulation

Get grounded in the fundamentals of financial market fraud and corruption with this introductory course. You'll explore how markets function, where they're vulnerable to abuse, and what market manipulation actually looks like in practice. Whether you're new to this topic or looking to formalize your understanding, this course sets the stage for deeper exploration. It's particularly useful for CPAs and tax professionals who advise clients in investment, finance, or regulated industries and want to recognize the warning signs of manipulative behavior.

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify various forms of market manipulation.

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Chapter 1: AN OVERVIEW OF MARKET MANIPULATION

Chapter Objective

After completing this chapter, you should be able to:

- Identify various forms of market manipulation.

2.1 INTRODUCTION

Market manipulation is as old as markets. Joseph de la Vega's description of the Amsterdam Stock Exchange in 1688 provides a vivid illustration:

> *Among the plays which men perform in taking different parts in this magnificent world theatre, the greatest comedy is played at the Exchange. There, . . . the speculators excel in tricks, they do business and find excuses wherein hiding places, concealment of facts, quarrels, provocations, mockery, idle talk, violent desires, collusion, artful deception,*
>
> *betrayals, cheatings, and even tragic end are to be found.* – Joseph de la Vega (1688).

Many of the practices described by de la Vega would in today's markets be classed as market manipulation and in most jurisdictions would be illegal. Numerous other examples of market manipulation exist in history, such as when the influential Rothschilds sold large amounts of stock to create the false impression that Napoleon had defeated Wellington. Their actions caused prices to crash and allowed them to repurchase the stock at depressed prices (Griffin, 1980).

Today, market manipulation can be found in markets all around the world, in almost all asset classes, and in a wide variety of forms. The magnitude of manipulation's effects can be extraordinary; for example, the price of nearly bankrupt NEI Webworld Inc. shot up by 11,400% within a day in response to manipulators spreading rumors on the Internet.[1] Manipulation is not confined to small and illiquid companies; for example, multibillion dollar Lucent Technologies was successfully manipulated (Leinweber and Madhavan, 2001). The amount of funds used in manipulation and scale of profits can be immense; for example, in 2004 Citigroup netted €18.2 million profit from manipulation that involved placing €12.9 billion worth of sell orders in 200 different government bonds within 18 seconds and later repurchasing them.[2] Manipulation is also not confined to sophisticated market participants; for example, Jonathan Lebed, a teenager from New Jersey successfully manipulated stocks 11 times by posting messages on Yahoo Finance message boards and made profits of $800,000 (Lewis, 2001). Similarly, Navinder Sarao made profits in excess of $10 million from manipulating S&P500 futures contracts, trading from his parents' home in London. Nor is manipulation confined to individual securities; for example, in 1996,

Nomura Int. Plc. manipulated an entire market index (Australian All Ordinaries) by selling a $600 million basket of stocks (more than the average daily market turnover) within minutes of the close of trading.[4]

Recent examples of manipulation illustrate just how enormous the impact of market manipulation can be. Regulators and law enforcement agencies have uncovered manipulation of major financial benchmarks including LIBOR, other "IBOR" benchmarks such as EURIBOR and TIBOR, and foreign exchange rate benchmarks such as the key WM/Reuters forex benchmark rates. These benchmarks underpin the pricing of hundreds of trillions of *dollars*' worth of financial contracts and securities such as floating rate loans/bonds, swaps, forward rate agreements, futures, and options (e.g.,, Duffie and Stein, 2015). To put this into context, the notional value of the affected securities and contracts exceeds the total value of US GDP. It also exceeds the total market capitalization of all companies listed on US stock markets. In fact, it exceeds the value of global GDP and the value of all listed companies globally. The outcomes of decade-long investigations and legal proceedings include billions of dollars of fines, criminal sanctions including jail sentences, and reforms including new legislation and benchmark setting mechanisms. The direct losses to affected parties are in the billions of dollars. Yet the indirect costs of such manipulation cases, including loss of confidence and participation in markets, impacts on market liquidity, and regulatory/compliance costs, could be even larger.

Market manipulation takes many forms. Markets can be manipulated by trading or by placing orders in markets. But they can also be manipulated by releasing false information or performing misleading actions. Some forms of market manipulation involve inflating prices, some involve depressing prices, and some involve both, but at different times. Some manipulation schemes are contained within a single market, yet others involve multiple related markets (e.g., an underlying and derivative market, or a transparent and dark market) with manipulators making losses in one market in order to profit in another. Financial securities within markets can be manipulated, but so too can indices and financial benchmarks. Market manipulation occurs at many frequencies with some manipulations taking years to execute, while others are completed within seconds. Manipulation can be conducted manually, programmed and automatically executed by a computer algorithm, or involve human–computer collaboration. Some market manipulation schemes are carried out by a single individual, yet others involve complex collaborations by teams of market manipulators. Section 2.3 of this chapter develops a taxonomy of the different types of market manipulation and explains the main ways in which market manipulation is conducted.

Market manipulation is difficult to precisely define. In part, this is because it encompasses a very broad collection of highly varied trading strategies as noted above. But another reason, in particular for the vagueness in legal definitions, is to minimize the risk that manipulators circumvent the law by devising schemes that fall outside of a precise and narrow legal definition. The unifying feature of market manipulation techniques is that they involve trading, placing orders, or releasing

information for the purpose of creating a false or misleading appearance of the supply of, demand for, or price of a financial security or benchmark. It follows that an important distinguishing feature of market manipulation is the *intent* to mislead others or influence market prices or volumes. Section 2.2 of this chapter discusses the issue of defining market manipulation, provides examples of how manipulation is dealt with in legislation, and provides perspectives from the law and economics literature.

Finally, research on market manipulation has made considerable advances in terms of understanding how manipulation is conducted and what its effects are, but there are still many areas in which our understanding of market manipulation is limited. These include issues such as how widespread is market manipulation, how it responds to various forms of regulation, and how it affects corporate investment decisions and the real economy. Research on market manipulation is made difficult by the fact that manipulators often go to great length to conceal their actions and therefore there is often a lack of information about instances of market manipulation other than those prosecuted by regulators. Prosecution samples usually reflect a small non-random subset of all manipulation, which further complicates empirical research. Section 2.4 of this chapter provides an overview of the theoretical and empirical research on market manipulation and suggests future research directions.

2.2 DEFINITIONS OF MARKET MANIPULATION

There is no generally accepted definition of market manipulation. This may seem surprising given the long history of manipulation in world financial markets[5] and the fact that more than three quarters of a century has passed since the inception of the US federal securities regulation against market manipulation.[6] Legal definitions are often intentionally not explicit, and much of the finance and economics literature uses the term "market manipulation" in an imprecise manner. This situation has led to a longstanding debate over the definition of market manipulation.

2.2.1 Legal Interpretation and Provisions against Market Manipulation

Legal definitions vary across jurisdictions and in many cases are not explicit about what constitutes market manipulation. One reason for the vagueness in legal definitions is to minimize the risk that manipulators can circumvent the law by devising schemes that fall outside of a precise and narrow legal definition. The task of defining manipulation is largely left to the courts on a case-by-case basis.

For example, in the US, statutory law states that it is unlawful "to use or employ, in connection with the purchase or sale of any security .[7] . . any manipulative or deceptive device or contrivance." In Australia, statutory law prohibits "transactions that have or are likely to have . . . the effect of . . . creating an artificial price."[8] EU statutory law stipulates, "market manipulation shall mean transactions or orders to trade which give, or are likely to give, false or misleading signals as to the

supply of, demand for or price of financial instruments, or which secure . . . the price of one or several financial instruments at an abnormal or artificial level."[9]

Given that statutory law does not provide a precise definition of manipulation, one must turn to case law to understand what is viewed as manipulation by courts. For example, in the US, where perhaps the largest number of market manipulation cases have been brought to courts, case law has established a four part test for manipulation involving ability, intent to deceive, causation, and artificiality (Johnson, 1981).

Across a number of jurisdictions, arguably the two most important elements of market manipulation in case law, and often the most difficult to prove, are intent and artificiality. Intent distinguishes manipulative from non-manipulative trading. Legitimate, non-manipulative market participation can cause an increase in market activity or alteration of the market price. Therefore, both manipulative and legitimate trading can have the same effects on the market, but are distinguished by the fact that manipulation involves an impermissible purpose (Goldwasser, 1999). The purpose of trading in the case of market manipulation is to mislead or deceive others, or to influence (sometimes referred to as "set" or "maintain") a price or volume. Because intent can rarely be determined with certainty, this element causes significant difficulties in identifying and prosecuting market manipulation. Prosecution cases often rely on communications between market participants to infer their intention or purpose of trading.

The second element, artificiality, can be with respect to trading activity (e.g., creating the appearance of more trading than what would naturally take place), or price (e.g., altering the price by raising or depressing it). Generally speaking, an "artificial price" is created when two things occur. First, a market participant with an impermissible intention or purpose for trading engages in one or more trades or submits one or more orders to a market. And second, the orders or trades of that market participant have an effect on the market price. Consequently, the resulting market price does not reflect only genuine demand and supply, but also the "artificial" supply or demand injected by the market manipulator. It is widely accepted in the financial economics literature that buying or selling, or even signaling one's desire to buy or sell, is likely to have an effect on the market price, particularly when buying or selling in sufficiently large quantities relative to the market's liquidity. Therefore, evidence about the effects of a given market participant's trading or order submissions can involve quantifying whether the participant traded in sufficient quantities or placed order in such a way so as to impact prices. Artificial prices can also be created when false information disseminated for an impermissible purpose such as to deceive others or to influence the price received by market participants, who alter their orders or trades and thereby cause the price to be influenced by the false information.

Two recent developments in the scope of market manipulation provisions and definitions in the law are noteworthy. The first is the provisions introduced with the Dodd–Frank Act prohibiting a form of market manipulation known as "spoofing" and adding further prohibitions on reckless or disorderly

trading at the close.[10] Spoofing involves placing orders with the intention to cancel those orders before they execute and is often implemented with a computer algorithm (more details in the next section of this chapter). While spoofing existed well before the Dodd–Frank Act and may have been illegal under existing legislation, the addition of anti-spoofing provisions increased clarity about the legal stance in relation to this form of market manipulation. Furthermore, the rapid increase in algorithmic trading made it important that the legal framework be up to date with respect to manipulation techniques that are used by algorithmic traders, such as spoofing.

The second recent legislative development is the enactment of the Market Abuse *Regulation (*MAR) in Europe, which came into effect in July 2016.[11] The MAR updates the regulatory framework for market abuse in Europe, establishing new offenses, and facilitating easier enforcement. Importantly, with respect to market manipulation provisions, it expands the prohibited activities to include benchmark manipulation and attempted manipulation. These provisions address the difficulties faced by prosecutors taking action against the recent benchmark manipulations (LIBOR, EURIBOR, the WM/Reuters foreign exchange benchmark rate, and so on). In some jurisdictions, financial benchmarks, although highly important to the financial system and susceptible to manipulation, fall outside of market manipulation provisions that focus on traded financial instruments. The new provisions in MAR address this shortcoming. The inclusion of provisions against attempted market manipulation increases the power of prosecutors by facilitating prosecution of cases in which the intent to manipulate can be established but the actual outcomes are difficult to measure or the manipulator is unsuccessful in influencing the price. Similar to the anti-spoofing provisions introduced in the US, the MAR also explicitly prohibits a range of market manipulation techniques that could be undertaken by algorithmic or high-frequency traders using order submissions and cancellations as the core part of the strategy.

In summary, the law in most developed markets generally considers market manipulation as actions or trades undertaken for the purpose of influencing a price or creating a misleading appearance of the supply of or demand for a financial security.

2.2.2 Economics and Legal Studies Perspective

The law and financial economics literature contains considerable debate about how to define manipulation. In a departure from mainstream legal thought, Fischel and Ross (1991) argue that market manipulation is too vague a concept to form the basis for criminal charges. They point out that there is no objective definition of manipulation and suggest that manipulation could only be defined as dishonest intent to move stock prices. In a sense, this definition is consistent with the essence of many laws in force today against market manipulation, in which intent to influence prices is one of the most important elements. Fischel and Ross argue that irrespective of intent, trades should not be prohibited as manipulative; but fictitious trades (e.g., trades in which the buyer and seller is the same person) and spreading false information should be classified as fraud. Their reasoning is that (i) purely trade based manipulation is unlikely to be successful; and (ii) rules that

prohibit manipulation deter some legitimate trading. Dozens of subsequent prosecution cases that show purely trade-based market manipulation is not just a theoretical possibility, but can be highly profitable, casts doubt over their reasoning.

Thel (1994) delivers a strong rebuttal. Based on evidence in the economics literature Thel argues that manipulation is easier to accomplish than Fischel and Ross claim and provides some striking examples. Thel points out that manipulators can sometimes control prices with trades and in doing so profit either from pre-existing contracts that are contingent on prices, or by inducing other market participants to trade at manipulated prices.

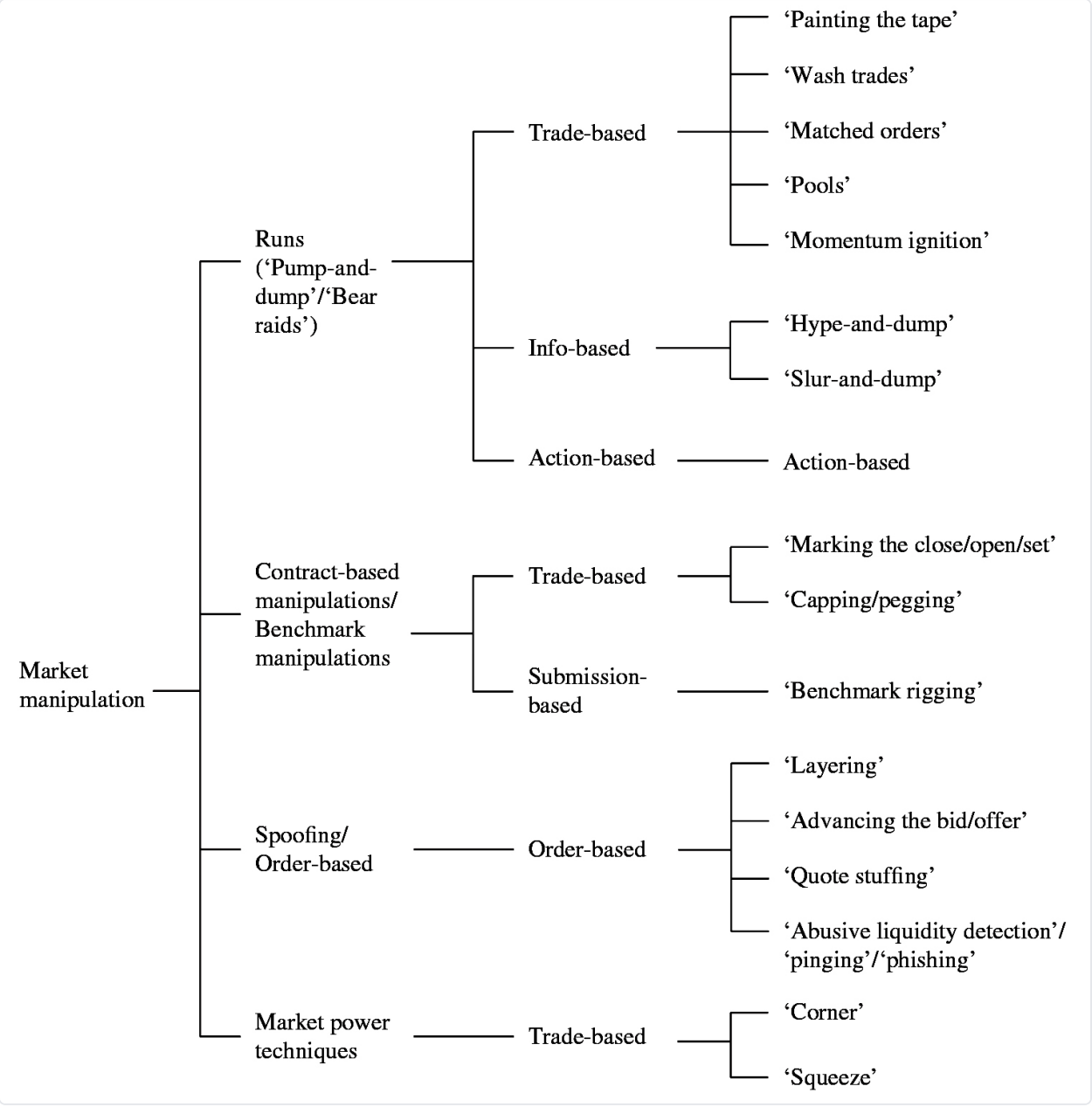
Thel uses the term "manipulation" to mean trading undertaken with the intent of increasing or decreasing the reported price of a security. Cherian and Jarrow (1995) define manipulation as trading by an individual (or group of individuals) in a manner such that the share price is influenced to his advantage. Many subsequent papers implicitly use the term "market manipulation" to refer to trading strategies or actions taken to influence the price to one's advantage.

In forming their view about what forms of trading should or should not be prohibited, Kyle and Viswanathan (2008) consider the welfare effects of trading. They propose that trading strategies should only be illegal if they undermine economic efficiency both by decreasing price accuracy and reducing liquidity. Unless both of these conditions are satisfied, the trading strategy is not unambiguously socially harmful and therefore, according to Kyle and Viswanathan, should not be prohibited.

2.3 A TAXONOMY OF THE TYPES OF MARKET MANIPULATION

The term "market manipulation" encompasses a wide variety of different strategies. To map out the relations between the various forms of market manipulation, Figure 2.1 provides a taxonomy of the most common types of market manipulation. The taxonomy is an expanded version of the framework set out in Putniņš (2012), accounting for recent forms of market manipulation. This section first describes the two broad levels on which manipulation can be grouped into categories and then defines the individual techniques.

FIGURE 2.1 TAXONOMY OF MANIPULATION TECHNIQUES.



2.3.1 Categories of Market Manipulation

At the broadest level, manipulation can be divided into four categories: runs, contract-based or benchmark manipulations, spoofing, and market power techniques. Within these groups, manipulation can be further broken down according to the main mechanism used to facilitate the manipulation: trade- based, information-based, action-based, submission-based, and order-based forms. And within these mechanisms are a number of individual manipulation techniques. These