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THE OFFENCE OF MARKET MANIPULATION: SOME ASPECTS OF THE LAW AND ITS ENFORCEMENT

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Introduction

Market manipulation involves the unwarranted interference in the operation of demand and supply for securities in a stock market.

Interference in the market may be achieved where manipulators disseminate misleading or false information about an issuer or its securities or through artificial transactions intended to convey false information regarding the forces of demand and supply for the market or price of securities.

Market Manipulation

The offence of market manipulation was introduced into the laws of Sri Lanka for the first time through the Securities and Exchange Commission of Sri Lanka Rules, 2001 (Gazette Extraordinary No. 1215/2 of 18 December 2001) ("SEC Rules") issued under the Securities and Exchange Commission of Sri Lanka Act, No. 36 of 1987 (as amended). Rule 12 of the said rules reads "*No person shall create, cause to be created or do anything that is calculated to create a false or misleading appearance or impression of active trading, or a false or misleading appearance or impression with respect to the market for or the price of any securities listed in a licensed stock exchange".*

Section 128 of the Securities and Exchange Commission of Sri Lanka Act, No. 19 of 2021 (SEC Act), is an almost verbatim repetition of Rule 12 of the SEC Rules issued under the former Act. However, the phrase "calculated to create" under the former Act is replaced with "intended to create" in the new SEC Act. The aforesaid replacement has unequivocally introduced the element of *mens rea* (the mental element) in proving the offence.

Additionally, no person should shift the market price by the sale or purchase of any security that does not involve the change in the beneficial ownership of those securities, or by means of fictitious transactions[1]. Further, *'Artificial transactions'* have been explained to have the effect of raising, lowering or pegging, fixing, maintaining or stabilising the price or volume of securities of the company for the purpose of inducing other persons to acquire or dispose of the securities of the company or a related company[2].

Civil and Criminal Proceedings

Interestingly, the amendments to the law on market manipulation in Sri Lanka marks the shift in dealing with the offence under criminal to civil proceedings by the Securities and Exchange

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Commission ("SEC"). On the other hand, criminal proceedings under the new law will be instituted by the Attorney General in the High Court. In the past, the higher burden of proof required in a criminal proceeding, in conjunction with the complexity of the offence, induced regulators to exercise their power of compounding[3 and 4]. This was also an attempt to circumvent the delays in criminal court proceedings, as illustrated in *Magpek Exports Limited v SEC*, which took over twenty years to conclude since the initial institution in 1997[5].

Thus, the new SEC Act empowers the SEC to institute civil proceedings in the Commercial High Court where the SEC considers it necessary[6], and the action instituted shall be proved on a balance of probability[7].

The new SEC Act has also enabled the SEC to enter into an agreement with the offender, instead of resorting to civil actions in court. The agreement shall collect an amount three times the gain made or the loss avoided by such person (with or without admission of liability). One third of the money *inter alia* will be used to compensate or restitute the victims of the offender's action. The balance shall be utilized to reimburse the SEC for all costs of the investigation in respect of the contravention and to credit the compensation fund of the SEC.

If the SEC has to resort to initiating civil proceedings in the Commercial High Court and succeeds in proving the contravention of the law on a balance of probability against a person, such person in addition to paying three times the ill-gotten gain or the loss avoided, will have to bear the cost of a civil penalty up to a maximum of one hundred million rupees. As such, it might be better for such person to upfront come to an agreement with the Commission to pay three times the ill-gotten gains or the loss avoided rather than having to pay an additional amount in civil penalties.

The SEC Act has to firstly act as an effective deterrent on a person against committing market abuse and secondly overcome the challenges the capital market regulator has faced under a criminal system, which requires a high evidentiary burden to be discharged for a successful prosecution. The third factor is to adopt quick and timely enforcement actions that has a compensatory bent towards victims of the offender's actions as the law has provided for the disgorgement or the "clawing back" of the ill- gotten profits or the losses avoided by persons engaged in acts of market manipulation, insider dealing and securities fraud.

Ascertaining the Proper Forum

The question will naturally arise in the mind of a reader as to how the SEC will set about implementing the enforcement mechanisms provided under Part V of the new SEC Act. In the future, will a person who commits acts of insider dealing, market manipulation or securities fraud face both a criminal and a civil sanction, or only a civil sanction without an accompanying criminal prosecution?

The writer's view is that both options have been made possible under the SEC Act although it will be up to the SEC to decide on whether a matter in addition to civil action should be referred to the Attorney General for a criminal prosecution as well like in the United States. In the United States, it is the US SEC that decides on whether to share a matter with the US Department of Justice for prosecution. All civil sanctions are imposed by the US SEC and criminal prosecutions are initiated by the US Department of Justice. Whether the SEC will follow a similar method will

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depend on the facts and circumstances surrounding the commission of each offence and of course the nature of the evidence gathered.

In the alternative, whether the SEC will follow the policy of referring all matters to the Attorney General's Department for the Attorney General to decide on the suitability of indicting a person on charges of insider dealing or market manipulation will remain to be seen.

Another possibility is for the Attorney General to decide to indict if a matter can be brought before the Permanent High Court at Bar established to hear, try and determine prosecutions on indictment against any person in respect of financial and economic offences specified in the Sixth Schedule to the Judicature (Amendment) Act, No. 9 of 2018, and leave the rest to be dealt with by the SEC under the civil alternatives provided under the SEC Act. Any act constituting an offence under the SEC Act has been included in the Sixth Schedule to the Judicature (Amendment) Act.

In order to bring a matter before the Permanent High Court at Bar the Attorney General will first have to consider the nature and circumstances of the offence, the gravity, the impact caused on the victims and the impact such offence had on the State and refer the information relating to the commission of the offence to the Chief Justice for a direction as to whether criminal proceedings in respect of such offence should be instituted in the Permanent High Court at Bar. Where the Chief Justice so directs, a trial before the Permanent High Court at Bar can be held upon indictment by the Attorney General and be concluded by having the trial day to day to ensure expeditious disposal thereof. What is important here is that the Attorney General can invoke this procedure notwithstanding anything to the contrary in any written law. (Vide section 2 of the Judicature (Amendment) Act No.9 of 2018).

Requisite Standard of Proof

Although the recognition of the offence of market manipulation under the new SEC Act is a welcome move, proving the offence remains challenging. Articulating a more general or precise definition of market manipulation is difficult. While some forms of market manipulation such as the spreading of false statements popularly known as "*pump and dump"* schemes or *"thrash and cash"* schemes may be comparatively straightforward, many others may be highly complex or sophisticated practices designed to artificially distort the market price of a security.

In some instances, interference with the price forming mechanism has been recognised by academic commentators as acceptable and even desirable. For example, the operation of price stabilisation rules applicable to market makers or even underwriters are regulated and are therefore permissible activities. Another example is where a company decides to purchase its own shares in order to deliberately push the price up. Thus, the offence of market manipulation is obscured where the company genuinely believes that its shares are undervalued and causes the price to move in the right direction.

A core feature of manipulation is to move the price further away from its "correct level". However, ascertaining this level of a security is gruelling. Academic commentators have suggested that although some aspects of market manipulation should be prohibited (especially where fraud is present) other aspects of market manipulation done to control or minimise price distortion effects should be deregulated[8].

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As such, Section 185 of the SEC Act provides *"notwithstanding anything to the contrary in this Act, a market maker licensed as a market intermediary shall not be considered as committing an offence under sections 128 or 129 of the Act when carrying out the functions relating to its licensed activity"*[2]. Sections 128 and 129 are the provisions prohibiting false trading and market rigging transactions and acts of market manipulation under the said SEC Act.

The difficulty in ascertaining artificial transactions has caused regulators to rely on an effects-based criteria. In the 1930's, the United States Congress has identified certain types of behaviour to be manipulative. These include;

a) wash trades or sales - transactions not intended to change in beneficial ownership,
b) matched orders - orders for the purchase or sale of a security with the knowledge that an order of substantially the same size, time and price has or will be entered into by the same or different parties,
c) short sales - involves borrowing a security whose price you think is to fall from your brokerage and selling it on the open market[9], and
d) trading in a security for the purpose of inducing the purchase or sale of such security by others.

However, these indicators are not exhaustive and may not be conclusive. Thus, commentators have simplified the offence to three categories; (a) interference with the free play of demand and supply; (b) induce people to trade; and (c) force a security price to an artificial level[10].

The difficulties in establishing objective criteria for manipulation is a catalyst in the adoption of a subjective test; thereby focusing on the improper intent of the trader.

In light of the challenges associated with the offence of market manipulation, it could be argued that the new SEC Act has made considerable attempts to combat the hurdles faced. The SEC has moved away from the high burden of proof in criminal proceedings, adopted subjective tests, and given meaning to the term 'artificial transaction'. However, the deeper meanings to the terms interjected in the provisions remain ambiguous and can only be dealt with on a case-by-case basis depending on the facts and circumstances of each case.

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References

1. Securities and Exchange Commission of Sri Lanka Act, No.09 of 2021 S 128 (1), (2).
2. ibid S 129.
3. Securities and Exchange Commission of Sri Lanka Act No.36 of 1987 S 51A (as amended).
4. Compounding is the cessation of a prosecution after an offender pays a sum not exceeding one third of the sum imposable by the Magistrate as a fine to the SEC, which sum is thereafter credited to the compensation fund of the SEC.
5. Magpek Exports (Pvt) Ltd v SEC HCMA 217/2007.
6. The Commission shall take into consideration the nature and manner of the contravention, the impact of the Commission of the offence had on the market and the extent of the loss caused to any investor.
7. Securities and Exchange Commission of Sri Lanka Act, No.09 of 2021 S 152 (2).
8. DR Fischel and DJ Ross, 'Should the Law Prohibit "Manipulation" in Financial Markets?' [1991] 105 Harvard Law Review 503.
9. The intention is to buy the same stock back later for a lower price than you initially sold it for, and pocket the difference after repaying the initial loan. However, in emerging markets outside Sri Lanka this practice is permitted amongst specified persons and are subject to rules.
10. DR Fischel and DJ Ross.

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