

"The Greatest Number of Market Manipulations Occur Through Misinformation"

An interview with Robert Fisher, Assistant Director, U.S. SEC Office of International Affairs

BUSINESS FILE

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Despite the fact that the Ukrainian market is still deemed to be underdeveloped, market manipulations occurring in the Ukrainian stock exchanges are performed to 'international standards'. Last year, Securities and Stock Market State Commission of Ukraine (SSMSC) developed a draft law "On Amendments to Certain Legislative Acts of Ukraine" to introduce liability for price manipulations on exchanges. From now on, tempering with market forces determining securities pricing carries penalties of up to 500 before-tax minimum wages (currently this amount being equivalent to UAH 8,500) and revocation of the professional license of a specialist guilty of this violation. According to stock market operators, the term 'manipulation' is defined so broadly in the draft law that practically every professional broker-dealer may be subject to enforcement under the new law. The regulator, however, is certain that abuse of insider information is rampant in the Ukrainian market. Moreover, under article 232-1 of the Criminal Code of Ukraine, "disclosure or utilization of non-public information about the issuer or its securities" is punishable by imprisonment for a term of up to three years. This provision is yet to be applied, though, and no one has been sentenced based on the provision of this article. To be able to track down such abuses in the Ukrainian market, SSMSC has recently invited officials of its U.S counterpart to Kyiv. Among the American experts representing the U.S. SEC was Mr. Robert Fisher, assistant director of the SEC Office for International Affairs, who gave a master class for SSMSC officials on counteracting securities exchange manipulations. Mr. Fisher agreed to give an exclusive interview to [The Business Magazine](#) on different forms of fraudulent activities on stock exchanges.

ON MARKET MANIPULATION

Q.: How do you define price manipulation in the stock market?

A.: I would say it is intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities. Obviously, manipulators' gains are investors' loss.

Q.: What schemes of defrauding investors are most frequently used by manipulators in the developed markets?

A.: One of the most frequent means is trade manipulation. For instance, a manipulator wants to drive up the price of shares of a particular issuer. This is achieved by buying more and more shares of this issuer, pushing the stock price up. But every time buying more shares, you know you pay the inflated price. Accordingly, the more shares you buy at that price, the more loss you incur. Theoretically, you are to dump all the bought shares at the peak of the price. But in practice, the moment you start dumping your shares, its price starts to tumble.

Therefore, it is difficult to make a profit relying on trade manipulations only. And it has been a proven fact that trade manipulation is typically used in combination with other illegal actions.

Q.: What actions specifically?

A.: Several types of actions. First of all, trade someone else's money to push the stock price up. For instance, acting as a fund manager. Another way is to enter into a separate contract, such as derivatives contract, to benefit from price movement. A third method is blend other actions with information-based manipulation to create asymmetric impact in price movement; i.e., try to induce "mania" or "panic" behavior in the market. Another method is using manipulative devices, such as wash sales. That is when you buy and sell for your own money, which means trades are performed back and forth among conspirators. One of the schemes that manipulators use frequently is boiler room sales (this term gained popularity following the movie called 'Boiler-room', where brokers made lots of cold calls to sell stocks of an obscure but allegedly lucrative company). Sometimes a shell

company is created that issues shares. Then a group of bad guys starts cold calling unsuspected marks giving them distorted information about the issuer and promise quick and guaranteed returns. Victims are typically unsophisticated investors, often pre or post retirement age. The masterminds of such schemes, on the other hand, are usually highly qualified specialists. Often the victims are in one country, the initiator in another country, the team of brokers implementing the scheme in a third country, and the money in a fourth country. There was a case that spanned 20 jurisdictions, and we failed to get back most of the illegal proceeds of that scheme, since the perpetrators moved proceeds from one country to another. They tend to favor those jurisdictions where there is a notion of 'account confidentiality'.

Q.: Can you tell us in which countries you find it the hardest to get access to information about bank accounts of suspects?

A.: If I disclose this information, this will be a dead give away to fraudsters as to which countries are the best to stash away illegal gains. We do not disclose this information, so I cannot answer this question. But regulators from different countries work with each other to assist in tracking down the fraudsters. IOSCO Memorandum of Understanding promotes information exchange among regulators the world over, with more than 40 states being signatories thereof. All the other IOSCO member states have until 2010 to sign this Memorandum.

Q.: Do fraudsters resort to manipulation with information?

A.: Most of market manipulation cases involve spreading false rumors. For example, one initially buys a major block of shares and starts false rumors about positive changes in the issuing company. Having driven the price up, one then dumps the block of shares and walks away with profit. Manipulations of this type often involve thinly traded shares of little known or start-up companies.

Q.: Could you name channels most frequently used for spreading false information about issuers?

A.: First of all, hype schemes use false press releases, with news that can have an impact on the stock price of a particular issuer. Such news may be pure figment of somebody's imagination. This could be, for instance, a statement to the effect that the issuer has registered high profit, closed a significant deal or has launched a new product. Another way is to use Internet resources, such as spam, message boards and chat rooms. There has been an interesting case recently, when a voice mail was used after an allegedly wrong number call, with the voice of the woman caller telling somebody of the way she has earned loads of money buying and selling the stock of a certain issuer. The caller was also eating a sandwich in the process, so the message sounded as natural as can be. This threw off many people who followed suit and bought the stocks, too. As a result of this scam, 'investors' ended up with worthless stocks on their hands, while the fraudsters earned about \$10 million on this manipulation.

Q.: Do you often have cases when professional analysts are involved in defrauding unsuspecting public?

A.: Cases like this do happen. For example, fraudsters may use promoters, such as purportedly independent financial advisers or analysts. For a certain fee from the fraud co-participants, they publish advice to buy stocks of a particular issuer, often with a recommendation to buy those fast.

ON INVESTIGATIONS

Q.: From what sources does SEC get information on the actual facts of market manipulation?

A.: Naturally, from market participants, who fell victim to the fraud. Also from our SROs, particularly from stock exchanges and broker-dealer associations. A sharp spike and a sudden drop in stock prices are red flags indicating a potential case of market manipulation. We do regular inspections of brokers, dealers and independent financial advisors, and often find violations in the course of such inspections.

Q.: How does SEC investigate price manipulations on the market?

A.: The first question to find out is who made money. This does not mean that everyone involved is to blame. But they are all suspects. Secondly, one needs to identify the source of disinformation. And then one looks into links between the parties.

Q.: How does SEC find out that insider trading occurred in the market?

A.: The principal source is market surveillance. When we see, for instance, significant block trading with stocks of an issuer, about whose operations there has been no publicly available new or significant information, we treat this as suspicious, and initiate an investigation. Again, we start with the information on who made most money from trades like these. The next step is to look into those persons who may have had access to key information, which has driven the price up. And if we can prove collusion of those who turned a profit and those who had access to the insider information, we start legal action against insiders. I can add that SEC takes successful action on about 50 insider trading cases every year.

Q.: What helps you to prove that it was indeed insider trading?

A.: Typically, insider trading evidence is circumstantial. It should be noted that an insider trade falls under both civil and criminal law. SEC has no jurisdiction to initiate criminal proceedings. In other words, we cannot send people to jail. What we do, we keep to civil law proceedings when we do a case. Sanctions typically require disgorgement of all trading profits received, slap a fine etc. Which means our standard of proof is not as high as that of a criminal doubt, where guilt is to be proved beyond any reasonable doubt. It is sufficient if we can prove in court that, in all likelihood, the suspects have committed fraud. Therefore, our evidence may be circumstantial, but when taken together, our cases can be very convincing. For example, we have once identified a trader who earned a bundle of money selling a block of stocks of an issue just before the announcement of its impending acquisition. Moreover, when we had the subpoena to have access to his trading and bank accounts, we found that he had had similar profitable deals on the eve of another three mergers and acquisitions. We threw the net wider and found that one and the same investment bank was involved in all the four deals. More importantly, one of the staff members of this investment bank was personally involved in all the above M&A cases, and when we established further that this person and the suspected trader graduated from the same university, we had a rock solid case. Having had access to their telephone calls print-outs, we saw that the trader got calls for his banker friend on the eve of the announcements of every single one of all the four deals. Taken together, all these bits of evidence,

although being circumstantial individually, constitute a solid evidence of the fact of insider trading.

Q.: It is against the law to charge a company or an individual in Ukraine, having circumstantial evidence only. Do you think this can make SSMSC life more difficult when it starts fighting insider trading?

A.: For such jurisdiction as yours, it indeed proves more difficult to bring order in this area. In countries that require nothing less than conclusive evidence, very few cases reach court, and even less have a guilty verdict.

Q.: Even before the SSMSC insider information regulation came into force, an interesting episode came about in Ukraine. Several market participants asked SSMSC to take action against an issuer for resorting to insider information. That issuer had announced an impending reorganization, as a result of which the holdings of minority shareholders might be diluted, and they could not buy stocks of the additional issue to avoid dilution. The stock price immediately went south. Thereupon, the management of the issuing company capitalized on the situation, bought up outstanding shares and later called a general shareholder assembly and cancelled the reorganization decision. Accordingly, the stocks price went up again. SSMSC did not think it was [an illegal use of] insider information (See BM 44 dated 10/30/2006, pg. 64-67). What would SEC do in a situation like this?

A.: For correct response, one needs to do a proper investigation and establish all pertinent facts. I should point out that once we initiate an investigation into similar cases, they do not always come out eventually the way we thought them to be initially, based on the preliminary information. Very often the conclusion we come to is that there have been no violations at all. Moreover, we refrain from inflicting potential damage on a corporation or an individual involved, so all our investigations are confidential, and no one should be aware of the fact that an investigation of a certain company is in progress.

Q.: Many companies in Ukraine are unwilling to disclose information. As a result, many analysts do not have other option but meet with the management of companies so as to learn about their development plans at first hand. In fact, the brokerage house as an employer of an analyst like this gets access to insider information, based on which it decides whether or not to buy or sell stocks of the relevant company. Well, then how is this effort of analysts is different from the efforts of those insider information abuse cases that you described?

A.: What is good about this is that your analysts are interested in doing quality market analyses. At the same time, one should remember that an issuer might abuse such relations, which can result in insider trading. For this reason, we have passed a new rule in the U.S. It is called a 'fair disclosure' rule, which means that if a representative of a company management discloses to an analyst some information that has not been made public previously, this information must be made available to the general public immediately. We had heated debates about the above regulation, but SEC approved it just the same, despite the fact that it dampens the interest of companies in having quality market research.

ON ANONYMITY

Q.: So far, brokers working through Ukrainian exchanges rarely use DVP. Instead, they normally trade with those counterparts that they know. Stock market professionals claim this system, like no other, creates an opportunity for price manipulations. Would you agree that that with no DVP trades and no anonymity of parties to transactions, it is easier to manipulate with prices?

A.: Anonymity is an issue for major broker-dealers, more than for others. For instance, according to the results of a fundamental research by one of the big brokerages, it comes to a conclusion that it is worth buying stocks of a certain issuer. So this major broker intends to buy a major block of such stocks. If the other brokers learn that this is what is going to happen, this information would drive the stock price up and create problems for the buyer. Therefore, big brokers prefer to keep mute, so that the other market participants are not aware who is behind a specific trade. And this is quite natural, since the market is interested in major players (like investment funds) performing research, identifying attractive stocks, and getting certain benefits from this work. But the regulator should know who the party or parties are behind major deals, so as to make sure there is no insider trading involved. Besides, I believe no associated persons of a company should be permitted to do undisclosed trading with their company stocks. In the U.S., it is mandatory for such persons to disclose all such deals. Should such trades be driven by insider information, enforcement is due against the associated persons involved.

Q.: PFTS Index has dropped more than 30% since the beginning of 2008. Moreover, some experts claim willful bearish operations are to blame. If you were a Ukrainian regulator, would you order an investigation after such claims?

A.: This would depend on what specific information I came to receive. I do not think brokers as a group have any interest in driving stock prices down. They make money depending on the volume of trades. When prices rally, people tend to do more trading. So I would not suspect brokers of foul play collectively. At the same time, there is a possibility of so-called 'bear raids', when a manipulator is trying to drive down the price of stocks of a specific issuer. For this to happen, one does short sales, which means you sell when the price is high, and buy when the price is low. But you may ask how is it possible to sell stocks which you have not yet bought. Well, for starters, you may borrow stocks from a broker, and sell at a high price. Then, when the price falls, you buy them at a lower price and return the stocks to the lender. This is how you may profit from short selling. At the same time, if short sales are permitted in your market, this may help deal with 'bubbles' in the event of inflated prices.

Q.: Well, short selling is not permitted in Ukraine.

A.: The market where short sales are not permitted is more likely to have optimistic 'bubbles', which duly burst in the end. So if short selling is not an option, you would not be able to implement successfully your bear strategy. Unless brokers have come up with a way to do short sales, of which the regulator is not yet aware.

This presentation expresses the author's views and does not necessarily reflect those of the U.S. SEC.