ARTICLES

Applying Germany's Market Manipulation Rules to Disruptive Trades on the Eurex and MTS Platforms

By David C. Donald[*]

A. Introduction

Until recently, cheap fiction and corporate finance most famously met in the creative accounting of companies like WorldCom and Enron. Now, however, both the spoof James Bond, Austin Powers, and the securities regulators of Germany, the United Kingdom, Italy and France face common, twin malevolence: *Doctor Evil and Mini Me*. These reportedly were the names of a trading strategy devised at the London based European government bond desk of Citigroup Inc. to correct – as reported in the *The Wall Street Journal Europe* – what a senior bank executive had referred to as their not "making enough money for the firm."[1] According to the *Journal*, "Citigroup wanted to use the futures market to push up prices for bonds traded on the cash market, which tend to follow futures prices. Then they would dump a large amount of bonds in the cash market, reaping profits from their holdings and forcing down prices, to the detriment of other market participants."[2] At 10:00 am on August 2, 2004, six Citigroup traders launched "Mini Mi" by building up positions in the Eurex futures market, then at 11:29 am they unleashed the "Dr. Evil" trading program, which placed sell orders for various European government bonds, with a total aggregate value of € 83 billion, of which only € 12.4 found buyers; once "the price of the bonds had fallen because of the flood of sell orders, Citigroup bought back € 3.8 billion in bonds . . . and is estimated to have made around € 15 million in profit."[3] The spot sales were primarily conducted on the MTS fixed-income trading platform,[4] and constituted 42% of the platform's total

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[1] Silvia Ascarelli, *Citigroup Euro-Bond Push Sparked Market Firestorm*, WALL ST. J. EUROPE, 3 February 2005, at A1.

[2] *Id.*, at A6.

[3] *Id.*

[4] "The emergence of pan-European trading platforms has been an important force in the process of integrating the secondary market for European government bonds. The most important among them are

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value for the day; the traders had cash positions of only about € 8 billion in the securities for which they placed sell orders of up to € 83 billion, which could have left them with a much larger short position than the € 4.4 billion they eventually had.[5]

This assault by the world's largest financial institution on the market for European government debt is interesting in a number of ways. First, it struck at the very heart of the European Union's six year old euro-zone financial market, a € 4.9 trillion government bond market stretching over 12 jurisdictions. It brought a swift and strong official response: the President of the European Central Bank, Jean-Claude Trichet, demanded a thorough inquiry,[6] the German Financial Services Supervisory Agency (*Bundesanstalt für Finanzdienstleistungsaufsicht*, or BaFin) referred the matter to the Frankfurt district attorney's office for possible criminal prosecution,[7] and investigations are underway by the U.K. Financial Services Authority, the Italian *Commissione Nazionale per le Società e la Borsa* (CONSOB), and the French *Autorité des marchés financiers* (AMF).[8]

As such, it presents a good opportunity to study European cooperation on the prosecution of "trade-based" manipulation, which has historically been more difficult to regulate than both "information-based" and "action-based" manipulation.[9] The primary drawback of the case as a test for the European rules is that the trades occurred before new rules on manipulation were fully implemented

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MTS in the cash market, and EUREX in the futures market. MTS is a quote-driven, electronic trading platform . . . . Currently, MTS is the parent company that partially owns subsidiaries in all the euro-area countries and in Denmark, and trades government bonds in several Eastern European countries through its division "New EuroMTS" (since November 2003). MTS S.p.A. is owned by financial intermediaries . . . . The breakthrough in MTS's business model was the creation of EuroMTS, a pan-European inter-dealer platform that offered trading facilities for the largest and most liquid European government bonds and subsequently became the standard setter for European benchmark bonds, that is, the newly issued bonds at the 5- and 10-year maturities." Marco Pagano & Ernst-Ludwig von Thadden, "The European Bond Markets under EMU" (Working Paper, November 2004), Forthcoming in the OXFORD REVIEW OF ECONOMIC POLICY.

[5] *Id.*

[6] Ralph Atkins & Päivi Munter, *Trichet calls for 'thorough' Citigroup inquiry*, THE FINANCIAL TIMES, 4 February 2005, at 1.

[7] Edward Taylor & Mitchell Pacelle, WALL ST. J. EUROPE, 26 January 2004, at A1.

[8] Ascarelli, *supra* note 1, at A1. The French Treasury has announced that it considers Citicorp's behaviour to have "tarnished the European markets," and it gave Citicorp a lower rating in the secondary market (sixth place) than it would have otherwise. *See* Adam Bradbery & Anne Hardy, *French Treasury Scolds Citigroup Over Bond Trade*, WALL. ST. J. EUROPE, 15 February 2005, at M1.

[9] *See infra* note 33 and accompanying text.

into national law. For example, the German manipulation provision is § 20a of the Securities Trading Act (*Wertpapierhandelsgesetz*).[10] It was added to the Act in 2002 by legislation that drew on an early draft of the EU Directive (2003/6/EC) that was later adopted in 2003 with some changes,[11] so the German law did not contain provisions matching the final draft of the Directive at the time the "Dr. Evil" trades took place. The European rules in their definitive form were required to be and were in fact implemented into German law in October 2004,[12] but because the trades took place in August of that year, they will be prosecuted under the 2002 rules. This situation appears to have been reflected in most countries where the trades took place. In Italy, a new provision was also adopted in 2002,[13] before the EU rules were final, in the United Kingdom, although existing law might well have

[10] The 2002 text of the section, in the author's translation, is as follows: "§ 20a *Prohibition of Exchange and Market Price Manipulation.* (1) It is prohibited for any person to: 1. provide incorrect information regarding circumstances that are significant for the valuation of a financial asset, or fail to disclose such information contrary to applicable provisions of law, if the disclosure or failure to disclose such information is capable of influencing the domestic exchange or market price of a financial asset or the price of a financial asset on an organized market in another Member State of the European Union or in another contracting state to the Agreement on the European Economic Area; or 2. undertake any other deceptive practice in order to influence the domestic exchange or market price of a financial asset or the price of a financial asset on an organized market in another contracting state to the Agreement on the European Economic Area."

[11] European Parliament and Council Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation (market abuse), O.J. (L 96) 16.

[12] Art. 18 of 2003/6/EC gave the Member States until 12 October 2004 to "bring into force the laws, regulations and administrative provisions necessary to comply with this Directive." Germany implemented the Directive with The Investor Protection Improvement Act of 28 October 2004 (*Das Gesetz zur Verbesserung des Anlegerschutzes vom 28.10.2004*, printed in the German Federal Law Reports, BGBl, vol. I, page 2630).

[13] Article 181 of the Unified Text Governing Financial Intermediation (Legislative Decree no. 58 of 24 February 1998) was abrogated by Article 8 of Legislative Decree no. 61 of April 11, 2002, which moved the applicable provision to the Civil Code and there inserted a new Article 2637 (Manipulation – *Aggiotaggio*): "Any person who disseminates false information, conducts simulated transactions or uses other devices (*operazioni simulate o altri artifici*) that are specifically suited (*concretamente idonei*) to cause a material change in the price of financial instruments, whether listed or not, or to significantly prejudice (*incidere in modo significativo*) public trust in the financial stability of banks or banking groups shall be punished with imprisonment from between one and five years" (author's translation). Like the German law, this amendment was prepared when 2003/6/EC was still in draft, but unlike the German law – as discussed below – the Italian provision does not require willing commission of the manipulation. However, Article 2637 is expressly limited to "simulated transactions," and would thus seem to reduce the possibility of prosecuting the type of real trades involved in "Dr. Evil" and "Mini Mi." Against this understanding of the Italian position is reference to CONSOB's prosecution of trade-based manipulation since Italian law began prohibiting manipulation in 1991. *See* Marcello Minenna, "The detection of market abuse on financial markets: a quantitative approach," CONSOB Working Paper Series (*Quaderni di Finanza*), no. 54, May 2003, available from quaderni_finanza@consob.it.

been the model for the final EU rules,[14] the actual implementing regulations were not adopted before the trades were made,[15] and in France a very rudimentary fraud provision was not supplemented by a rule modeled on the EU Directive until November 2004.[16] The purchases on the pan-European Eurex market and the sales and purchases on the pan-European MTS platform still offer an opportunity to test Europe's new market abuse rules in theory, which the brief observations in this paper do in a preliminary manner, restricting themselves to application in Germany and assuming the facts presented by the *Wall Street Journal* as reported from information that paper received from the Frankfurt district attorney's office. Once the reports of all of the regulatory agencies and the verdicts of the various courts are in final form, the treatment of Dr. Evil and Mini Mi should tell us much about how the euro-zone market is actually regulated.

B. The European Rules on Market Manipulation

A brief summary of the European rules and their regulatory context may be useful. As is well known, the euro replaced the somewhat theoretical EMU to become the single currency of 11 European Union Member States on January 1, 1999, and then notes and coins were issued effective January 1, 2002.[17] "The euro-area unweighted

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[14] *See* Part VIII, Penalties for Market Abuse, Financial Services and Market Act 2000, 2000 c. 8.

[15] On the implementation of 2003/6/EC in the United Kingdom, *see* Joe Coffey & Jonathan Overett Somnier, *Driving You MAD -- A Road-Map Of The Market Abuse Directive (I)*, 17.1 COMPLIANCE MONITOR (2004) and The Financial Services Authority, "UK Implementation of the EU Market Abuse Directive (Directive 2003/6/EC), Consultation Document (June 2004).

[16] The base, statutory provision is Article L 465-2 of the *Code Monétaire et Financier*, which in the author's translation states: "Any person who directly or indirectly, through a third party, effects or attempts to effect any action (*manœuvre*) for the purpose of prejudicing (*ayant pour objet d'entraver*) the normal operation of a market for financial instruments by inducing others into error shall be punished with the penalties provided for in the first subsection of Article L. 465-1." The new regulation is found in Title III (Market Manipulation) of Book VI of the General Regulations of the French Financial Market Authority, issued on 24 November 2004, and *available at* http://www.amf-france.org/documents/general/5621_1.pdf. For a relatively up-to-date presentation of the French market manipulation rules, *see* Philippe Portier & Raphaële Navelet-Noualhier, *Chapter on France*, *in* SECURITIES TRANSACTIONS IN EUROPE ¶ 80-175 (2004). An interesting older article comparing the philosophies of the French and U.S. rules on market manipulation is Hubert De Vauplane & Odile Simart, *The Concept of Securities Manipulation and its Foundations in France and the USA*, BROOK J. INT'L L. 203 (1997).

[17] During the interim period, the Mark, Franc, Lira and others were technically only variously denominated expressions of the euro. For a history of the transition, *see* HANSPETER K. SCHELLER, THE EUROPEAN CENTRAL BANK: HISTORY, ROLE AND FUNCTIONS (2004), *available at* www.ecb.eu, and Hal S. Scott, INTERNATIONAL FINANCE: LAW AND REGULATION 144 *et. seq.* (2004). Greece became the 12th member of the euro-zone in January 2001. SCHELLER, at 17; for additional accounts of the transition from national currencies to the Euro (and from those left out), see the "letters from Italy, Germany and

average of the share of assets invested in bond funds with a Europe-wide strategy rose from 17 percent in 1998 to 60 percent in 2002."[18] While the single currency and related supranational infrastructure were being introduced, the European Union was also working to make its financial regulatory system more centralized and efficient.[19] An expert committee led by Baron Alexandre Lamfalussy published its "Final Report of the Committee of Wise Men on the Regulation of European Securities Markets" on February 15, 2001,[20] recommending introduction of a four level approach for regulating the European securities markets.[21] Level one "framework principles" would be enacted like most European legislation, using the full collaboration procedure between the European Council and the European Parliament,[22] where required, then at level two the European Commission would adopt more detailed "implementing" rules after receiving advice from a newly formed Committee of European Securities Regulators (CESR – pronounced "Caesar", as in Julius);[23] at a level closer to the market participants, CESR would on level three cooperate to issue statements on joint interpretation, and finally level four would be constituted by the national authorities cooperating on enforcement (which is where "Dr. Evil" is now certainly being discussed). The relatively new market manipulation rules exemplify quite well how this "Lamfalussy Framework" of rules, cascading from the abstract to the concrete, operates in practice. On January 28, 2003, the European Council and Parliament issued a Directive on insider dealing and market manipulation (2003/6/EC), which the Member States had to implement into their national legislation by October 12, 2004.[24] After receiving detailed recommendations from CESR, the European Commission itself (i.e., without the lengthy Council/Parliament consultation) then issued a number of "level two" implementing measures for 2003/6/EC:

England", in 3 GERMAN L.J. (1 February 2002), available at: http://www.germanlawjournal.com/article.php?id=135.

[18] Pagano & von Thadden, *supra* note 4, at 12.

[19] *See* EILÍS FERRAN, BUILDING AN EU SECURITIES MARKET 1 *et. seq.* (2004).

[20] The text of the Report is *available at* http://europa.eu.int.

[21] For discussions and evaluations of the four-level approach, *see* Guido Ferrarini, "Contract Standards and the Markets in Financial Instruments Directive (MiFID): An Assessment of the Lamfalussy Regulatory Architechture," Institute for Law and Finance Working Paper Series, No. 39 (2005), *available at* http://www.ilf-frankfurt.de/publications/ILF_WP_039.pdf; FERRAN, *supra* note 19, at 61; and Niamh Moloney, *Current Developments -- European Union Law*, 53.4 INT'L AND COMP. L.Q. I.B (2004).

[22] For a description of the EU legislative process, *see* PAUL CRAIG & GRÁINNE DE BÚRCA, EU LAW 139 *et. seq.* (3rd ed. 2003).

[23] *See* CESR's website *at* http://www.cesr-eu.org/.

[24] *See* Art. 18, EU Directive 2003/6/EC, *supra* note 11.

- A regulation (i.e., directly applicable without national legislation) defining the boundaries of safe harbour for share buy-back programs and stabilization activities;[25]
- A directive (i.e., needs implementation by national legislation) fleshing out the definitions of "public disclosure," "inside information," and "market manipulation";[26]
- A directive fleshing out requirements as to investment recommendations and disclosure of conflicts of interest;[27] and
- A directive specifying accepted market practices, defining "inside information" in connection with derivatives on commodities, rules on creating lists of "insiders", and other matters under 2003/6/EC.[28]

Directive 2003/6/EC covers the three categories of market manipulation that are often found in the legislation and literature: information-based manipulation, action-based manipulation, and trade-based manipulation.[29]

Article 1(2)(c) of 2003/6/EC goes to *information-based manipulation*, and defines the outlawed "manipulation" to include "dissemination of information . . . which gives,

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[25] Commission Regulation 2273/2003 of 22 December 2003, implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments, O.J. (L 336), 33.

[26] Commission Directive 2003/124/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation, O.J. (L 339), 70.

[27] Commission Directive 2003/125/EC of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest, O.J. (L 339) 73.

[28] Commission Directive 2004/72/EC of 29 April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions, O.J. (L 162) 70.

[29] "The kinds of manipulation that the [Securities Exchange] Act effectively outlawed fall naturally into two categories. The first can be described as action-based manipulation, that is, manipulation based on actions that change the actual or perceived value of the assets. . . . The second category can be described as information-based manipulation, that is, manipulation based on releasing false information or spreading false rumors. . . . However, there is a third category of manipulation that is much more difficult to eradicate. We refer to this third category as trade-based manipulation. It occurs when a trader attempts to manipulate a stock simply by buying and then selling, without taking any publicly observable actions to alter the value of the firm or releasing false information to change the price." Franklin Allen & Douglas Gale, *Stock-Price Manipulation*, 5 THE REVIEW OF FIN. STUDIES 503, 505-506 (1992)

or is likely to give, false or misleading signals as to financial instruments. . . ." Article 1(2)(b) prohibits *action-based manipulation* by forbidding "transactions or orders to trade which employ fictitious devices or any other form of deception or contrivance." Article 1(2)(a) presents a substantially longer description in addressing the more elusive *trade-based manipulation* by prohibiting "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, by a person, or persons acting in collaboration, the price of one or several financial instruments at an abnormal or artificial level . . . ." followed by very important exceptions based on intention and market usage.[30]

This European rule eliminates what Loss & Seligman call the "troublesome" criteria required by the U.S. provision in § 9(a)(2) Securities Exchange Act of 1934,[31] that the manipulation have the purpose of inducing others to purchase or sell,[32] and thus makes the market itself and its reputation for efficiency the primary beneficiary of the rule.

It is difficult to provide a concise definition of trade-based manipulation because there is no false or fictional element: it is simply a kind of trade that "signals", and the semantic content of its signal is false or misleading. As Allen & Gale point out, trade-based manipulation "is much more difficult to eradicate" than the information and action based types;[33] after all, the intent of trading is to make a

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[30] The definition goes on "unless the person who entered into the transactions or issued the orders to trade establishes that his reasons for so doing are legitimate and that these transactions or orders to trade conform to accepted market practices on the regulated market concerned." Art. 1(2)(a), 2003/6/EC.

[31] Section 9(a)(2) Exchange Act reads, in relevant part: "It shall be unlawful for any person, directly or indirectly . . . to effect . . . a series of transactions in any security registered on a national securities exchange or in connection with any security-based swap agreement . . . creating actual or apparent active trading in such security, or raising or depressing the price of such security, *for the purpose of inducing the purchase or sale* of such security by others.

[32] Loss & Seligman point out that this is the most litigated element of the trade-based manipulation provision. LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 1131 (5th ed. 2004).

[33] "The argument is simple. When a trader tries to buy a stock, he drives up the price. When he tries to sell it, he drives down the price. Thus, any attempt to manipulate the price of a stock simply by buying and selling requires the trader to 'buy high' and 'sell low.' This is the reverse of what is required to make a profit." Allen & Gale, *supra* note 29, at 506. Also, our common understanding of what is unfair appears to center on false information and dissimulating actions. The very first English manipulation case, *Rex v. de Berenger* (3 Maule & S. 67, 74, 105 Eng. Rep. 536, 539 (K.B. 1814), discussed in Loss & Seligman, *supra* note 32, at 1121) involved both a stunt by impostures (action-based) and false information regarding the end of the Napoleonic wars. Another element to consider is that the flow of information in connection with listed companies and the sale of securities is generally considered fair game for regulation in most developed jurisdictions, and is subject to requirements governing offerings (such as the provisions found in §§ 5, 11, 12 and 17 of the U.S. Securities Act of 1933), disclosure requirements for continued

profit and many economists conclude that no *fraudulent* profit can be made from mere trading, regardless of how aggressive it is. Fischel & Ross argue that "manipulative trades are extremely difficult, perhaps impossible, to identify. This difficulty stems from one simple fact -- it is hard to read people's minds."[34] In 1947, the U.S. Securities and Exchange Commission (SEC) responded to this problem by turning to a careful evaluation of objective evidence: "Since it is impossible to probe into the depths of a man's mind, it is necessary in the usual case (that is, absent an admission) that the finding of manipulative purpose be based on inferences drawn from circumstantial evidence."[35] More than 50 years later, CESR also recommended this approach. In fleshing out the concept of market manipulation used in 2003/6/EU, the implementing Directive 2003/124/EC spends most of its ink on trade-based manipulation, by presenting objective factors that should be taken into consideration when deciding whether manipulation in fact exists.[36] These include whether the orders or transactions:

- represent a significant proportion of the daily volume in the relevant securities on the market concerned (Art. 4(a));
- are effected by someone with a significant position in the securities and cause a significant change in the price of the securities or an underlying asset (Art. 4(b));
- are washouts (no change in beneficial ownership) (Art. 4(c));
- represent reversals of position constituting a significant portion of daily volume or are connected to a significant change in the of price in the securities on the relevant market (Art. 4(d));
- are concentrated in a short time span leading to a change in price that is then reversed (Art. 4(e));
- change the representation of the order book available to market participants, and are removed before they are executed (orders only, Art. 4(f)); or
- are made at or around a specific time when reference prices, settlement prices and valuations are calculated, and lead to price changes effecting such prices and valuations (Art. 4(g)).

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listing and takeovers (such the as provisions found in §§9, 10, 13, 14, 14, 17 and 18 of the U.S. Exchange Act of 1934) and manipulation's close relative, insider trading (regulated in the United States with the series of rules issued under § 10(b) Exchange Act).

[34] Daniel R. Fischel & David J. Ross, *Should the Law Prohibit "Manipulation" in Financial Markets?*, 105 HARV. L. REV. 503, 519 (1991).

[35] In the Matter of the Federal Corporation, 25 SEC 227, 330 (1947).

[36] *See* Art. 4, 2003/124/EC.

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C. The German Rules on Market Manipulation

The market manipulation provisions of EU Directive 2003/6/EC were brought into German law in October of 2004 by amending § 20a of the Securities Trading Act and abrogating § 20b of that Act.[37] New § 20a(1) Nr. 2 stays very close to the language of 2003/6/EC, stating that it shall be prohibited to: "Undertake transactions or issue buy or sell orders that are likely (*die geeignet sind*) to give false or misleading signals as to the supply of, demand for or the exchange or market price of financial instruments,[38] or create (*herbeizuführen*) an artificial price level . . . ."[39] The exceptions set forth in § 20a(2) also track the EU Directive very closely:

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[37] Investor Protection Improvement Act, *supra* note 12. For a discussion of this Act and its legislative history, *see* Gerald Spindler, *Kapitalmarktreform in Permanenz – Das Anlegerschutzverbesserungsgesetz*, 48 NEUE JURISTISCHE WOCHENSCHRIFT 3349 (2004).

[38] The term "financial instruments" derives in this context from Art. 1, no. 3 of 2003/6/EC, and has been implemented in § 20a(1) to mean securities, money market instruments, options, swaps and a number of other instruments and derivatives listed on a German exchange or traded on the German over-the-counter market and securities listed on an exchange in a Member State of the European Union.

[39] The text of the provision as amended in October 2004 is, in relevant part and in the author's translation: "§ 20a Prohibition of Market Manipulation (1) [1]It shall be prohibited to:

1. disseminate false or misleading information regarding circumstances that are material for the valuation of a financial instrument, or to omit disclosure of such circumstances contrary to exiting law, if the information or the omission is likely to affect the domestic exchange or market price of a financial instrument or the price of a financial instrument on an organized market in another Member State of the European Union or another contracting state to the Agreement on the European Economic Area,

2. undertake transactions or issue buy or sell orders that are likely to give false or misleading signals as to the supply of, demand for or the exchange or market price of financial instruments or create an artificial price level, or

3. dmploy other deceptive practices that are likely to affect the domestic exchange or market price of a financial instrument or the price of a financial instrument on an organized market in another Member State of the European Union or another contracting state to the Agreement on the European Economic Area.

[2] Sentence 1 applies to financial instruments that are

1. admitted to trading on a domestic securities exchange, or included in a regulated market or an over-the-counter market, or

2. admitted to trading on an organized market in another Member State of the European Union or another contracting state to the Agreement on the European Economic Area.

[3]An application for admission or a public announcement of admission to trading on an organized market, or inclusion in a regulated market or an over-the-counter market, shall be treated as admission.

(2) [1]The prohibition of subsection (1), sentence 1, no. 2 shall not apply if the transaction conforms to the permissible market practice on the relevant organized market or on the relevant over-the-counter market

"The prohibition . . . shall not apply if the transaction conforms to the permissible (*zulässige*) market practice on the relevant organized market or on the relevant over-the-counter market (*Freiverkehr*) and the person who entered into the transactions or issued the orders to trade has legitimate reasons for so doing."[40] The subsection then goes on to limit the exception somewhat with a further definition: "Permissible market practices shall be only those conventions that reasonable discretion (*vernünftiges Ermessen*) would expect to find on the relevant market and that the Federal [Financial Services Supervisory] Agency recognizes as permissible market practice within the meaning of this provision. No market practice shall be deemed impermissible solely because it has not been expressly recognized in advance" (§ 20a(2) Securities Trading Act). Share repurchase programs and stabilization activities as provided for in Commission Regulation 2273/2003[41] are expressly exempted.[42] In commenting on the introduction of the new § 20a, the Director of the Securities Trading Regulation at the German Federal Financial Services Supervisory Agency, Georg Dreyling, welcomed what he refers to as having the provision "de-subjectivized" (*entsubjektiviert*).[43]

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and the person who entered into the transactions or issued the orders to trade has legitimate reasons for so doing. [2]Permissible market practices shall be only those conventions that reasonable discretion would expect to find on the relevant market and that the Financial Services Supervisory Agency recognizes as permissible market practice within the meaning of this provision. [3]No market practice shall be deemed impermissible solely because it has not been expressly recognized in advance.

(3) [1]Trading in a company's own shares in the context of a buy-back program and measures to stabilise the price of financial instruments shall in no case constitute a violation of the prohibition in subsection (1), sentence 1, if they are conducted pursuant to the requirements of Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments (O.J. EU Nr. L 336 p. 33). [2]The provisions of Regulation (EC) No 2273/2003 shall apply *mutatis mutandis* to financial instruments that are included on the over-the-counter or the regulated market."

[40] As the violation of § 20a triggers liability for criminal sanctions, the "guilty until proven legitimate" formulation used in this provision was hotly debated and apparently only accepted because it was decreed from on high by the European government. Further, the introduction of "safe harbors" in the form of market practices that the regulatory authority declares to be legitimate caused quite some concern because the concept of "safe harbor" was difficult to classify within German legal doctrine. *See* Spindler, *supra* note 37, at 3453 and Rudolf Streinz & Christoph Ohler, *§ 20a WpHG in rechtsstaatlicher Perspektiv – europa- und verfassungsrechtliche Anforderungen an das Verbot von Kurs- und Marktpreismanipulationen*, 27 WM 1309, 1312 (2004).

[41] *See supra* note 25, Arts. 3-11.

[42] § 20a(3) Securities Trading Act.

[43] Georg Dreyling, *Die Umsetzung der Marktmissbrauchs-Richtlinie über Insider-Geschäfte und Marktmanipulation*, 1 DER KONZERN 1, 4 (2005). For a discussion of the implementation of 2003/6/EC into German law with a focus on the supremacy of European law in relation to national law and the permitted relationship between the two systems, *see* Streinz & Ohler, *supra* note 40. For a general discussion of the structure and activity of the Federal Financial Services Supervisory Agency, *see*

When one makes a quick and rough application of the new § 20a Securities Trading Act, supplemented by the interpretive guidelines found in Commission Directive 2003/124/EC,[44] to the facts of "Dr. Evil" and "Mini Mi" discussed above, the trades signified by these bond-spoof characters seem to constitute actionable manipulation. Citigroup is the world's largest financial institution and its sale of €12.4 billion in government bonds on August 2, 2004 drove the market price down by about 15 cents in a matter of minutes (*see* Art. 4(b), 2003/124/EC).[45] Dr. Evil reportedly compromised the MTS "liquidity pact" so severely that it would be difficult for "reasonable discretion" to expect such action on the market,[46] and Citicorp has provided no legitimate explanation for the trading strategy than the public remark of its CEO, Mr. Charles Prince, that it was "a completely knuckleheaded thing to do" (*see* § 20a(2) of the Securities Trading Act).[47] Dr. Evil constituted about 42 % of the daily volume on the MTS platform on August 2 (*see* (Art. 4(a), 2003/124/EC).[48] Citicorp reversed itself from purchasing forward, to selling spot, to then purchasing spot in a matter of a few hours (*see* (Art. 4(d) and (e), 2003/124/EC).[49] Citicorp earned approximately € 15 million when the price quickly rose again after recovering from the impact of its heavy sales.[50]

I. Manipulation in a Not-So-Efficient Market

The discipline of trade-based manipulation has faced criticism for a number of reasons, including that it is impossible to fraudulently profit from actual trades and that no one is damaged by the trades in any case. The facts available on the "Dr.

Kenneth K. Mwenda, *Legal Aspects of Unified Financial Supervision in Germany*, 4 GERMAN L.J. 1009 (2003), *at* http://www.germanlawjournal.com/article.php?id=327.

[44] The German Financial Services Supervisory Agency published a guidance regulation for the 2002 version of § 20a, "*Verordnung zur Konkretisierung des Verbotes der Kurs- und Marktpreismanipulation* (KuMaKV) of 18 November 2003 (BGBl vol. I, page 2300), *available at* http://www.bafin.de/, and will almost certainly do so pursuant to new § 20a(5). Such a regulation will follow the lead of the EU second level implementing Directives, and may not conflict either with such Directives or with Commission Regulation 2273/2003 on safe harbors for buy-backs and stabilization.

[45] Pagano & von Thadden, *supra* note 4, at 16.

[46] *Id*. at 16.

[47] Ascarelli, *supra* note 1, at A6.

[48] *Id*.

[49] *Id*. and Pagano & von Thadden, *supra* note 4, at 16.

[50] Ascarelli, *supra* note 1, at A6.

Evil" trading program would seem to refute both assertions. Fischel & Ross argue that the manipulative trader cannot profit, as "the price rises simultaneously with the block trade and subsequently falls," creating a "sure-to-lose strategy" for the would-be manipulator."[51] Indeed, in 1970, Fama explained that according to his findings, "the strong-form efficient markets model, in which prices are assumed to fully reflect all available information, is probably best viewed as a benchmark against which deviations from market efficiency (interpreted in the strictest sense) can be judged."[52] Shleifer notes that under this efficient capital market hypothesis (EMH), investors are assumed to act rationally in the market, and if they do not, their irrational action is assumed to merely constitute a random noise that can be corrected by expert arbitrageurs, bringing prices back to their fundamentals.[53] Thus, the manipulating trader will either be unable to trade ahead of the market, or if she does, skilled arbitrageurs will quickly correct any imbalances. In discussing one of Shleifer's arguments against the EMH, Gilson & Kraakman point out that the EMH assigns arbitrageurs the role of policing the efficiency of the market, while they "have a quite different goal: to make money. . . . if overly optimistic noise traders are in the market . . . one can profit by anticipating the direction of the noise traders' valuation error, and taking advantage of that error through long, not short, positions with the goal of selling the shares to noise traders at a higher future price. The result may be to drive up the price of already overvalued stocks, and to prolong the length and increase the extent of bubbles."[54] This creates an opportunity for manipulation, as Langevoort clarifies: "Behavioral finance gives ample reason to suspect that trade-based schemes can succeed by triggering positive momentum-trading activity by others. Noise traders often confuse past price moves with future profit opportunities--this is what 'positive feedback' trading is all about."[55] Indeed, evidence recently published by Froot & Ramadorai shows that market values are heavily influenced in the short term by the investment flows of institutional investors, and that such movements can be quite

[51] Fischel & Ross, *supra* note 34, at 518.

[52] Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 JOURNAL OF FINANCE 383, 415 (1970).

[53] ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIOR FINANCE 2-3 (2000).

[54] Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: the Hindsight Bias*, 28 J. CORP. L. 715, 729 (2003).

[55] Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U.L.REV. 135, 161 (2002).

independent of business fundamentals.[56] Such momentum can go up, as led by the Eurex purchases in "Mini Mi" or down as in the case of the "Dr. Evil" sales.

At the front end of such momentum trading, Allen & Gale show how manipulation can be effective "even though there is no price momentum and no possibility of a corner," provided there is incomplete information: "Investors are uncertain whether a large trader who buys the share does so because he knows it is undervalued or because he intends to manipulate the price."[57] Unlike the equity market, however, where participants can easily be suspected to have inside information about such events as takeovers, mergers, and developments affecting financial results, inside information significant enough to materially affect the value of a euro-zone government bond (such knowledge of a strong hike in key ECB interest rates to counter the euro's slide in July 2004) would seem unlikely. As Pagano & von Thadden point out, however, "Citigroup was able to earn this sum [€ 15 million] because it had a fleeting informational advantage over the rest of the market: the information about its own future trading strategy, which is price-relevant because of the sheer size of the orders that it can place."[58] This understanding of Citicorp's ability to kick-start momentum would be in line even with a "semi-strong" form of the EMH.[59]

Can trade-based manipulation cause damage beyond normal market losses? Fischel & Ross argue that manipulative trades create "no objectively harmful act or bad outcome" and thus should not be punished.[60] Moreover, Mahoney explains that experienced traders like market makers protect themselves against counter-parties who possess superior information by increasing the bid-ask spread, which forces block-traders who desire to avoid paying this penalty to prove to the market-maker that they have a motive other than superior information for entering into the sale.[61]

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[56] Kenneth A. Froot & Tarun Ramadorai, "Currency Returns, Intrinsic Value, and Institutional Investor Flows," Journal of Finance (forthcoming). (Revised from NBER Working Paper no. 9101, August 2002 and Harvard Business School Working Paper no. 04-036, December 2003).

[57] Allen & Gale, *supra* note 29, at 506. *See also* Steve Thel, *$850,000 in Six Minutes--the Mechanics of Securities Manipulation*, Cornell L. R. 219, 241 (1994), and Fischel & Ross, *supra* note 34, at 513.

[58] Pagano & von Thadden, *supra* note 4, at 16.

[59] *See* Fama, *supra* note 52, at 404.

[60] Fischel & Ross, *supra* note 34, at 519.

[61] Mahoney explains the strategic setting of the bid/ask spread: "Imagine that a market maker trades in a stock that has a value either of $20.00 or $30.00, each with probability 0.5. The market maker does not know the true value, but other traders may, and the market maker is aware of the latter fact. . . To avoid regret, he must determine the conditional expectation of the stock price, given the order flow he observes. Intuitively, a preponderance of buy over sell orders causes the market maker to increase his

Thel puts it succinctly: "If market makers supply immediacy, then the bid-ask spread is a cost of trading immediately."[62] The "Dr. Evil" trades, however, took place on a platform among co-owning platform participants. Pagano & von Thadden explain that a key strength of the MTS platform is "a mutual commitment that MTS labels a 'liquidity pact'. Dealers commit to quote continuously two-way firm prices with a maximum spread, and issuers commit to an issue listing size at least equal to € 5 billion for benchmark bonds and to a random allocation of bonds amongst bond dealers for quoting obligations."[63] If this is true, Citicorp would have been able to dump its block in the MTS without paying a premium spread as a risk fee to its counter-parties. This dealt a strong blow to the MTS participants' trust in this key feature of the platform by locking them helplessly into damaging trades that they sensed were manipulative.[64]

The above theoretical considerations, when applied to the facts of "Dr. Evil" and "Mini Mi", appear to support allegations both that there was a causal connection between the Citicorp trades and the movement of the market (in § 20a language, transactions "likely to give false or misleading signals" to the market) and that the action was unreasonable (not § 20a "conventions that reasonable discretion would expect to find") as well as injurious to the relevant markets involved.

II. Applying the 2002 Rules to "Dr. Evil"

The verdict on Dr. Evil could, however, be quite different under the 2002 version of § 20a Securities Trading Act, which was in force until October 2004, and which will be applied to the Citicorp trades. The 2002 version of § 20a(a), no. 2 prohibits

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estimate of the stock's value, while a preponderance of sell orders causes the reverse. . . . [H]e sets bid and ask prices so as to generate zero expected profits, assuming competition among market makers. The zero expected profit condition means that the profits the market maker earns from uninformed traders just equal the losses to informed traders. In game theory parlance, informed and uninformed traders "pool" in the sense that the market maker cannot distinguish them ex ante and quotes the same prices to each." Paul G. Mahoney, *Market Microstructure and Market Efficiency*, J. CORP. LAW 541, 546-47 (2003).

[62] Thel, *supra* note 57, at 234-35.

[63] Pagano & von Thadden, *supra* note 4, at 14. An agreement to hold a spread ceiling, as used to promote liquidity in the MTS market thus allows a participant who is willing to abuse the pact to get immediacy without paying for it because the "pact" prevents the other market maker participants in the platform from raising the spread to protect themselves.

[64] "Normally, when they suspect that they may be receiving orders from an informed trader, market makers protect themselves by widening their quotes or refusing to trade. But the MTS market-makers were committed to quote firm prices for large amounts and keep tight spreads, and this allowed Citigroup to trade such a large amount before they could react." Pagano & von Thadden, *supra* note 4, at 16.

employing "any . . . deceptive practice in order to influence the domestic exchange or market price of a financial asset or the price of a financial asset on an organized market." The words "in order that," which translates the German "*um*", establishes a requirement that the act be committed "willingly", which here translates what a leading treatise on the Securities Trading Act calls "*Absicht im technischen Sinne*" or, "*dolus directus ersten Grades.*"[65] The requirement for meeting this degree of intentionality is that the perpetrator intends to commit the crime itself, i.e., illegally influence market price (what in U.S. law is referred to as "willingly"),[66] rather than just commit the actions that have been criminalized, i.e., engage in activity that would cause such criminalized influence on the market price (what in U.S. law is referred to as "knowingly").[67] A conviction for trade-based manipulation under § 20a of 2002 thus requires that (i) the trades are deceptive, (ii) committed with a willing desire to influence the market, and (iii) in fact influence the market in an objectionable manner.[68] The required degree of intentional action, in particular, has been very difficult to prove.[69] The facts presented by *The Wall Street Journal* do seem to indicate a willful intent to move prices. On July 16, a Citigroup officer told the traders to "devise strategies to make more money," and after consulting among themselves the traders inform the co-head of European bond trading of the "Dr. Evil" strategy; the traders then make an aborted attempt on July 30, which they repeat more successfully on August 2.[70] However, we must remember that, even though there is every reason to believe the account published by the highly reputable *Journal*, the facts as recounted are presented *ex parte* without Citicorp exercising its right to impeach, object to or qualify their content. They could look substantially different in the bank's defensive pleadings and during oral argument. Moreover, the requirement that the courts of EU Member States interpret national law in conformity with existing European law should not have much impact in this case because the trades were made before the deadline for implementation of

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[65] Joachim Vogel, *Überwachung des Verbots der Kurs- und Marktpreismanipulation, in* WERTPAPIERHANDELSGESETZ 375, 640, marginal note 98 (Heinz-Dieter Assmann & Uwe H. Schneider, eds., 3rd ed. 2003). *But see* Andreas Möller, *Die Neuregelung des Verbots der Kurs- und Marktpreismanipulation im Vierten Finanzmarktförderungsgesetz,* 7 WM 309 (2002).

[66] *See* Bryan v. United States, 524 U.S. 184, 191, 118 S.Ct. 1939, 1944-1945 (1998).

[67] Vogel, *supra* note 65, at 640, marginal note 98. For a discussion of the "knowingly" standards, *see* United States v. Bailey, 444 U.S. 394, 404, 100 S.Ct. 624, 632 (1980).

[68] Vogel, *supra* note 65, at 642, marginal note 104.

[69] Vogel, *supra* note 65, at 640, marginal note 98.

[70] *See* Ascarelli, *supra* note 1, at box on A1.

2003/6/EC into national law.[71] Thus, any attempt to use that interpretive canon to pull the subjective intent-oriented version of § 20a in the direction of the objective test required by 2003/6/EU would likely fail.

If the trades constituting "Dr. Evil" and "Mini Mi" are found in violation of § 20a German Securities Trading Act, the result could be a revocation of the market participant's license,[72] fines of up to €500,000[73] and a prison sentence of up to five years for the individuals involved.[74] As discussed above, however, the hurdles that the older form of the law places in front of the Frankfurt district attorney's office[75] remain much higher than they will be under the new law. It will be interesting to see how the "objective" test used in the new law will fair. As Vogel points out, the test of willing falsification of the market price was from the outset contradicted by the many types of willing acts – such as stabilization and share repurchase programs – that were and still are explicitly permitted by law.[76] Now, the law internalizes its custom-based exceptions within its primary test: transactions that are likely to give false or misleading signals to the market are actionable unless they conform to accepted market practices and the market participant proves a legitimate reason for their execution.

D. Some Concluding Remarks on Significance and Manipulation

As a concluding thought, it appears to the author that market manipulation can really only be *information-based.* Trade-based manipulation arises only to the extent that a trade *becomes a signal* (EU and German law), or communicates an inducement to act (U.S. law). It also appears that a willingness to focus on such "signaling" might well increase. In the idealized "efficient market" that seems to be passing into history under the revelations of empirical research and work on behavioral biases, "asset prices were a function only of systematic risk; capital structure did not affect firm value; and informationally efficient markets policed these

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[71] *See* Vogel, *supra* note 65, at 585, marginal note 9, and GERT NICOLAYSEN, EUROPARECHT I: DIE EUROPÄISCHE INTEGRATIONSVERFASSUNG 339 (2002).

[72] § 37k Securities Trading Act.

[73] § 39(1) no. 2 and (4) Securities Trading Act.

[74] § 38(1) no. 4 in connection with § 39(1) no. 2 Securities Trading Act.

[75] There is no direct action, or "private right of action" for an investor or other market participant under § 20a. The Federal Agency has an duty under § 20b(6) to refer cases of manipulation to the relevant district attorney for prosecution. *See* Vogel, *supra* note 65, 580, marginal note 2; KNUT SAUER, HAFTUNG FÜR FALSCHINFORMATION DES SEKUNDÄRMARKTES 44 (2004).

[76] Vogel, *supra* note 65, at 648, marginal notes 116 *et. seq.*

relationships through arbitrage."[77] In such a system, ambiguous or obscure signals are either cancelled out or quickly clarified, and manipulative "signaling" might well not be read.

If we are leaving a relatively positivistic period and entering one focusing on the critical analysis of motives and structural bias, much as we did in other branches of legal theory during the twentieth century, it would follow that market activity will more often be scrutinized for secondary meanings. As Brav & Heaton point out: "Efficient market prices are 'right' in a normative sense. Inefficient market prices are 'wrong' prices, implying the possibility of social gains if wrong prices are correctable. Inefficiency seems to invite regulation."[78] In an environment thought to be naturally characterized by indeterminacy, the kind of trades that bring market efficiency, leading to the "right" prices, could be sorted out in advance only by their conformity to a posited norm. This process of sorting out trades could lead to an increase in the prosecution of market manipulation to enforce the norm.

If all trades are regarded as containing one bias or another, we will need a model to sort out the biases and project a positive norm. However, theories that focus on uncovering and unbundling motivations rarely serve as bases for the postulation of positive norms. Absent what Kelsen called a "transcendental" concept of efficiency, regulators would perhaps turn to a "socially imminent" one,[79] such as we find in Article 1(2)(a) of 2003/6/EC, where transactions that "signal" are manipulative unless they "conform to accepted market practices on the regulated market concerned." Trades that stand out beg for clarification. Indeed, as Mahoney notes, block traders already have to submit to a sort of 'pat down' to prove that they are not manipulative and allow them to avoid paying a penalty in the form of a higher bid-ask spread.[80] Such forced detours of the immediate market to guarantee "efficient" pricing (i.e., pricing that accurately reflects information regarding fundamentals) are certainly "inefficient" in a business sense, and should be limited in scope if possible. The increased perception of indeterminate "signaling" that could arise if the general acceptance of the EMH further erodes should thus be countered with safe harbors or similar measures capable of filtering out suspicious connotations from legitimate trades so that important market participants will not be forced to use manual procedures for transactions the market infrastructure was designed to facilitate. Carving up the market into good

[77] Gilson & Kraakman, *supra* note 54, at 743.

[78] Alon Brav & J. B. Heaton, *Market Indeterminacy*, 28 J. Corp. L. 517, 537 (2003).

[79] HANS KELSEN, PURE THEORY OF LAW 28 (Max Knight, trans. 1967).

[80] Mahoney, *supra* note 61, at 548.

and bad transactions has obvious disadvantages, but in an uncertain environment it would reduce both transactions costs and the costs of obtaining information necessary to dispel signals of manipulation.

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