The Regulation of Capital Markets

Market Manipulation and Insider Trading

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Overview to Securities Regulation

Throughout the twentieth century, the capital markets have played an increasingly important role in the development of market economies. As we reach the start of the next century, governments around the world are recognizing that efficient securities regulation is critical to the development of any market based economy. While fostering the development of the entire economy, the capital markets also play an important equalizing role. They permit a much wider participation in the economy by greater numbers of people who share in investment opportunities, as well as business and market risks.

For a market to foster business development it must be attractive to prospective investors looking for investment opportunities. In order for a market to be attractive to potential investors, it must have earned investor confidence, which in turn is achieved through the imposition and effective enforcement of rules which ensure the market is operated efficiently and fairly.

Principles of Regulation in Canada

Key to a successful securities trading system is that all investors share equally in the risks and opportunities of investment. A number of principles have been developed in securities regulation to ensure fairness in the market. In Canada, the fundamental principle which ensures equal opportunity is that all trading in securities must take place in an environment where there has been full, true and plain disclosure of all material facts. This is brought about through a set of rules which impose significant disclosure requirements upon businesses, which seek to raise finances from the public through the capital market, as well as their controllers and insiders, and rules which ensure fair trading practices among all those who trade in the market.

While it is never possible for there to be perfect information available to investors, it is the objective of securities regulation to ensure that sufficient information is always available to permit buyers and sellers of securities to make informed decisions. Issuers are faced with obligations for full and timely disclosure of any information about the issuer, as well as its key shareholders, where the timing of access to such information can have a significant impact on investors.

The regulation of securities in Canada has also been designed to ensure that trading is conducted fairly, and that issuers and those that deal in securities on their behalf, provide fair treatment to investors. While disclosure rules are essential to investor protection, they are not sufficient to protect against such activities as insider trading and market manipulation. Accordingly, regulation has developed in an effort to curtail these types of trading activities. The specific problems of insider trading and market manipulation will be discussed later in this paper.

Regulation has also been developed with a view to establishing standards of competence and conduct for those persons who are in positions of fiduciary responsibility. These are primarily persons who have custody or control over investors' money, and those who provide advice or service to investors in complex matters. Rules have been established which attempt to exclude dishonest and incompetent people, and to ensure investors receive advice from those qualified to give it. People fulfilling such functions within the securities industry are required to be registered with a securities commission, and in most cases, also with a Self Regulating Organization. They are subject to rules regarding educational standards, record keeping, reporting to clients and conflicts of interest. Other rules relating to the directors and officers of issuers have been developed in an effort to establish duties to their investors and to ensure they fulfil those duties.

Ultimately, regulation of the Canadian markets has been designed primarily to give a basis for all participants in the markets to have confidence in its integrity. The integrity of the market is supported by rules which impose capital requirements, through the provision of investor insurance, and by ensuring there is a process available for resolution when the market appears to have been abused by participants. It is not the purpose of regulation to impose the judgment of regulators in substitution for the business judgment of market participants, but to make the market more credible and efficient by establishing and enforcing principles which ensure fairness, and which prevent activities which damage investor confidence. Confidence is critical to an effective market. Without it the economic benefits which it provides both to participants as well as to the general public will be lost.

Regulatory Authority

In Canada, securities markets are regulated by the joint efforts of provincial securities regulators, in the form of securities commissions, and self regulating organizations (SROs) which are comprised of industry participants. Provincial securities regulators obtain their authority from provincial legislation. SROs exercise authority obtained from a combination of sources including provincial legislation, delegation of authority from the securities commissions, and agreement by their members to follow rules established by the SRO. In British Columbia there are currently two SROs which operate under the supervision of the B.C. Securities Commission. These are the Investment Dealers Association and the Vancouver Stock Exchange (VSE). The B.C. Securities Commission and the SROs regulate the securities industry jointly in British Columbia through regulatory requirements and standards which are set out in provincial legislation, in policy statements, notices and decisions of the commission, and in bylaws, rules and policies of the SROs.

Exchanges on which securities trade are responsible for the surveillance of trading activity to ensure it reflects real trades taking place at a value determined by the market based on full, true and plain disclosure. Full, true and plain disclosure is achieved through a combination of ongoing filing obligations with securities regulators and public disclosure of material changes. It is the policy of the B.C. Securities Commission that any issuer of securities wishing to access the capital market in British Columbia through the public distribution of securities must have its securities listed on a stock exchange recognized by the commission. The commission believes that this level of regulation of securities transactions, which is only possible through an exchange, is essential to ensure that the principles of fair trading are followed.

Approval for distribution in British Columbia must be obtained through the acceptance by commission staff of a prospectus, which is the initial disclosure document for the distribution. B.C. Securities Commission staff have refused to issue prospectus receipts where, for example, the issuing business proposed to have its securities traded solely on the Canadian Dealer Network in Ontario or the NASDAQ Bulletin Board in the United States. While these trading systems may provide access to finances for the issuers, it is the view of commission staff that they do not provide adequate regulatory oversight to ensure that investors are sufficiently protected.

The value of a security is often very difficult to determine. Determination of both the value of a security and its associated risks depends entirely on information that may be difficult or even impossible for an individual investor to obtain and verify. For most investors, once a security has been purchased, they have little or no control over business decisions which may directly affect the value of the investment. Securities regulation has been developed to provide some measure of protection from unprincipled or incompetent issuers. In British Columbia, the Securities Commission places great reliance on the VSE to maintain a mechanism for the oversight of trading activity on the Exchange to ensure that the regulatory system is enforced.

Regulating on an Exchange

In 1990 the VSE became the first fully automated stock exchange in North America. It is now one of the most technologically sophisticated exchanges in the world. The VSE has made as its primary objective in attracting issuers and investors, the provision of a system which warrants confidence in trading on the Exchange. It has sought to achieve this by an assertive surveillance program, and by taking a position as the most aggressive exchange in the use of its regulatory oversight authority, through halts, suspensions and delisting of listed issuers, to enforce listing requirements and to respond to abusive conduct.

There are three primary means used to promote public confidence in securities traded on exchanges. These are; a) full disclosure at the time of the initial offering, b) continuous disclosure requirements and c) surveillance of trading activity.

Prospectus Disclosure

Before an issuer is permitted to distribute its securities through an exchange, there are substantial disclosure requirements that must be fulfilled. Although each jurisdiction in Canada is responsible for establishing its own disclosure criteria, the prescribed level of disclosure is consistent among the provinces. The levels of disclosure required to make an informed investment decision are, of course, substantially different as between an established business with a well known history, and a new venture capital enterprise. Accordingly, the required levels of disclosure differ.

A business listing for the first time on an exchange is subject to substantial disclosure requirements. Disclosure on the following major topics is required in the prospectus which is filed with the securities commission as the initiation of the application process:

- description and general development of the business
- summary and analysis of the financial objectives
- business objectives
- milestones (i.e. significant events required to meet the stated business objectives)
- material acquisitions and dispositions
- management experience and expertise
- organizational structure
- products developed or to be developed with the proceeds of the distribution
- proprietary protection
- operation (i.e. method of production)
- market by segment and specific geographic location
- marketing plans and strategies
- administration costs

While full and true disclosure of all these matters in a plain manner is a necessity of the prospectus filing, there are other rules which are equally important to ensure that the prospectus provides *nothing more* than full, true and plain disclosure. For example, the purpose of the prospectus is disclosure, so rules have been developed to ensure that it does not become a promotional document rather than a disclosure document.

Extensive rules have been developed regarding the disclosure of payments made, or to be made, particularly in relation to obtaining rights or services by the issuer. Such disclosure must be made in all cases where the payment was made or is to be made to an insider. This disclosure requirement applies to payments which have been or which will be made within a year.

Considerable problems have been caused by the use of "future oriented financial information". While legitimate predictions of the financial potential of the venture may be of considerable benefit to a potential investor, experience has demonstrated that the inclusion of such information may give the issuer an opportunity for a statement of considerably unjustified optimism. As a result, rules have been developed which place significant limitations on the use of such information. Where a prospectus includes future oriented financial information, it must be presented in accordance with the handbook of the Canadian Institute of Chartered Accountants, it must be presented as a projection or a forecast, it must be audited, and it must be periodically reconciled and updated.

Underwriters of the distribution for a venture capital corporation also are subject to obligations which are designed to enhance the credibility of the information contained in the prospectus. The underwriter is required to prepare a "due diligence report". This report must describe the process undertaken by the underwriter in determining that the distribution is worthy of the underwriter's support. The report must identify the individuals who participated in the process. It must contain a description of the reasons the underwriter believes it to be appropriate to proceed with the distribution.

The prospectus rules provide significant limitations on the inclusion of matters which have not been established as fact. Specifically, statements, beliefs or views must not be made unless the statements are made on the authority of an expert and consents are obtained from those whose opinion is proffered, and filed with the commission.

Where the prospective issuer is a junior speculative company, the underwriter is also required to obtain an assessment report. The report, which is in essence an assessment of the business plan of the issuer, is a review by a qualified consultant of the issuer's management, product or service or technology operations, market, marketing plan and financial plan. Where the subject of the assessment report has an unproved or unique technology that is the basis of, or is otherwise critical to the company's business, if the consultant preparing the assessment report does not have the specific expertise necessary to assess the technology, then the underwriter must also retain a specialist report which is an assessment of the feasibility of the company's technology.

It should be noted that it is the underwriter, not the issuer, who must obtain both the assessment report and the specialist's report. This is consistent with the theory that the underwriter has an independent interest (and duty) in assessing the merits of the issuer's proposed distribution. While the issuer would have an interest in obtaining a report which is as favourable to the issuer as possible, the underwriter's long term interests in maintaining its ability to perform the underwriting function should result in an interest in obtaining reports which are as fair and frank as possible.

While the prospectus which is filed with the commission is a public document, and while the issuer is obliged to ensure every potential investor has access to a copy of the prospectus if the investor so wishes, assessment reports and specialists' reports are not public documents. While mandating the preparation of these documents serves the function of ensuring that underwriters have fulfilled their due diligence obligations, requiring that these reports be made public may unreasonably intrude upon the interests of the issuer in maintaining the confidentiality of proprietary information. While it is important that investors have disclosure of information necessary to make an informed investment decision, disclosure should not come at the cost of providing business competitors of the issuer with access to the legitimate business secrets of the issuer.

Continuous Disclosure

While the disclosure of an issuer through the prospectus filed in support of its initial public offering provides investors with access to important information to determine whether they will buy securities of the issuer off the prospectus distribution, put in context, the financial implications of purchasing off the security are, in the broad Canadian context, relatively minor compared to the trading in securities subsequent to initial distribution, i.e. in the secondary market. In 1996, for example, while $23 billion were raised in the capital markets through the distribution of shares by issuers, post initial distribution trading in the secondary market reached approximately $369 billion in Canada.

As time passes from the prospectus distribution, the disclosure contained in the prospectus becomes of decreasing relevance to the investor. If investors are to have access to information sufficient to allow informed investment decisions past the initial distribution, clearly issuers must continue to provide relevant information accessible to investors as long as the securities of the issuer continue to be available for trade in the public market. To this end, securities regulators have imposed significant ongoing reporting rules for issuers as well as their insiders. Fulfilment of these obligations is foremost among the ongoing regulatory responsibility of issuers. Securities regulation in Canada is not based upon the regulators passing judgment upon the merits of an investment. Rather, it is based upon the belief that investors who are in possession of complete and timely information regarding the investment are in the best position to determine the merits of that investment for themselves. Compliance with these obligations by issuers is therefor essential to the proper functioning of the capital market.

The primary continuous reporting obligation of issuers is the requirement that issuers provide timely disclosure of relevant financial information. This obligation is fulfilled through the filing of financial statements. The term “financial” has a broad meaning in this context, as these reports reflect the significant results of the issuer’s operations as well as its financial situation as at the date of the preparation of the financial statement. At the very least, they enable investors to review the management of the issuer’s resources in the past as a basis for making assessments of future performance.

Issuers are required to file with the commission audited financial statements annually, within 140 days of the financial year end. Audited financial statements include an income statement (statement of operations/loss), a balance sheet, a statement of retained earnings (or deficit), a statement of changes in financial position, and notes to the financial statement (which contain irregularities and explanations).

In addition, unaudited financial statements must be filed quarterly, within 60 days of the end of the reporting period. These will include an income statement and a statement of changes in financial position.

In order to demonstrate the relative significance of information contained within the financial statement, financial statements must be prepared on a comparative basis, which is the corresponding period for the immediately proceeding financial year.

A significant requirement for inclusion in the financial statement is the management discussion. This portion provides a narrative review of the operations in the quarter under review. Generally speaking it includes a summary of any significant event or transaction which occurred during the reporting period. Specifically:

- the issuer is required to reconcile previously disclosed “intended use of proceeds” with actual use
- details of significant transactions, including consideration received or paid, with related parties must be disclosed
- details of investor relations activity undertaken by the issuer during the reporting period must be disclosed
- the report must include details of other significant events or transactions
- discussion of details relating to the acquisition or disposition of any material capital asset must be included
- material expenditures, including discussion of their nature, must be included
- details of significant events or transactions previously disseminated through material change reports during the reporting period should also be included
- where the has been a breach of any corporate, securities or other laws, or of the issuers listing agreement with an exchange, disclosure is required
- where there has been a change in any of the material assumptions used in the preparation of future oriented financial information, that information must be updated in accordance with the change

These financial statements must be filed with the commission by all reporting issuers. In addition, the audited annual financial statement must be provided directly to each holder of the securities of the issuer.

Aside from the mandated filing requirements of disclosure information, there are ongoing public disclosure requirements. In Canada, securities acts, commission policies and exchange policies all set out continuous disclosure obligations. Generally speaking, issuers are required to file and publicly disseminate "material change reports". The general rule is that if it could reasonably be expected that a change in a reporting issuer's business operations, assets, or ownership would result in a significant upward or downward movement in the price or value of a security, then an announcement should be made by way of a press release and the filing of a material change report.

A number of specific examples of material changes requiring public dissemination have been recognized by regulators. These include:

- entering into or loss of significant contracts, including major corporate acquisitions or dispositions
- significant changes in management
- changes in capital or corporate structure (reorganizations, amalgamations etc.)
- development of new products, and developments affecting the company's resources, technology, products or markets
- firm evidence of significant increases or decreases in near term earning prospects
- changes in capital investment plans or corporate objectives
- events of default under financing or other agreements
- significant litigation
- major labour disputes, or disputes with other contractors or suppliers
- reverse take-overs and changes of business
- results of an asset pr property development or exploration, whether positive or negative
- any agreement to issue shares or other securities
- granting of any stock option, share purchase warrant or stock purchase plan
- any change in the board of directors or senior officers
- any agreement to enter into any management contract, investor relations agreement, service agreement not in the normal course of business, and any non-arm's length transaction
- any change of name, capital, reorganization, merger or amalgamation
- any acquisition or disposition of the company's own securities
- any changes in the beneficial ownership of the shares or other securities of the company which may affect the control of the company
- any loan or advance of funds to any person or company
- any change in the undertaking of the company
- any mortgaging, hypothecating or charging in any way of the company's assets
- any acquisition or disposition of assets involving, respectively, costs or proceeds exceeding the amounts from time-to-time prescribed

- the establishment of a special relationship with a registrant

Another of the ongoing disclosure requirements, designed to ensure that trading in securities takes place in a market where all investors have access to the same information at the same time, is the obligation of insiders to report to relevant commissions their trading activity. While there are many definitions of “insider”, the rule is designed to ensure that all those with a special relationship with the issuer, (such as directors and senior officers,) which relationship would normally give rise to an expectation that the person would have access, prior to its public dissemination, to information regarding significant activity affecting the issuer, publicly disclose their trading activity. Not only does this give regulators early access to information necessary to ensure that insiders have not traded on “insider information” (see below), but in addition it can provide investors with an indication of the view the insiders have of the longer term prospects of the issuer.

In Canada the current standard for reporting ranges between a requirement to report within 10 days of the trade, to reporting within10 days after the end of the month in which the trade took place. With the increasing reliance on technology for the transfer of information within the securities industry, it is likely that in the foreseeable future all insider trading activity will be required to be reported virtually concurrently with the transaction.

Because of the paramount role of disclosure obligations in securities regulation, a breach of those obligations is treated very seriously.

Issuers who are in default of their continuous disclosure filing obligations with a commission will be listed in a published “issuers in default” list. At any time after the failure to file as required has occurred, the issuer may be subject to the issuance of a “cease trade order” by the relevant commissions. This order will prevent the trading of securities of the issuer by any people (investors or registrants) within the jurisdiction of the commission, and precludes trading of the issuer’s securities on any exchange within the jurisdiction of the commission. In addition, a prolonged failure to file, or a failure which has resulted from other misdeeds, may result in longer term, or even permanent enforcement action against the issuer and/or its officers and directors.

Similarly, a failure of insiders to comply with their disclosure obligations may lead to temporary or permanent sanctions being against the insider. A permanent order could, among other things, prohibit the insider from trading in any securities within the jurisdiction.

Surveillance

The automation of stock exchanges has provided a vehicle which greatly enhances the ability of regulators, in Canada primarily the SRO exchanges, to regulate trading activity which takes place through the facility of those exchanges to a level far exceeding non-automated systems. Canadian trading these systems are programmed with pre-trade parameters regarding the securities which trade through the facility of the exchange. If these parameters are exceeded, some of these systems, such as the VSE's "Vancouver Computerized Trading" (VCT) system, are capable of automatically identifying trading activity which exceeds the parameters, as determined by price or volume, and which are set through the automated system.

Such trades, once identified, will not take place without the consideration of specially trained staff. Exceeding the normal trading parameters would, in normal circumstances, be caused by the disclosure of activity relating specifically to the issuer, or sometimes to the broad industry in which the issuer is involved. Trading activity which exceeds the pre-established parameters may be evidence of unlawful insider trading, (where there are significant increases or decreases in the trading price of the stock without any disclosure of information which would explain the change,) or market manipulation (usually where there is an increase of trading volume and/or price without any disclosure of information which would explain the change).

On the other hand, there may be a reasonable explanation for the changes. Usually, exchange staff will start the investigation by contacting the issuer to determine whether there is any reasonable explanation for the change in trading activity. Where the issuer reveals undisclosed material information, the exchange may halt trading and require immediate public dissemination of the information. If there is no explanation, the trading activity may be based on rumour, and the issuer may be required to issue a news release indicating that there have been no material changes to the issuer's circumstances which would warrant the change indicated by the trading activity. Often the exchange may halt trading in the issuer's shares until there has been sufficient time for the mandated news release to reach the investing public. In extreme cases the exchange may halt trading even before any contact has been made with the issuer.

One tool which was introduced to the VSE shortly after the inception of the VCT provides for the determination of who was on the buy side and the sell side of the market. This facilitates the earlier detection and subsequent prosecution of cases involving unlawful trading activity. The VSE is currently involved in an initiative, with the Royal Canadian Mounted Police and securities regulators across Canada, to allow for a standardization of information formats so that evidence obtained through such systems will be admissible across Canada.

Another automated system allows regulatory staff to detect instances and patterns of “high closing”. “High closing” involves the execution of end of day trades at a level higher than most or all of the day’s trading activity. Most market news disseminators focus reporting on trading activity on the opening and closing price of the shares traded. A high closing often gives to investors who rely on such information the impression of gains to, or values of, the stock which is not supported by the overall trading activity.

Market surveillance is critical to the integrity of the capital market. Insider trading and market manipulation have done more to cause investors to lose confidence in capital markets than all other forms of abuse of the market. Surveillance is essential to deter or halt these abuses whenever possible before they harm investors.

Insider Trading

Trading on insider information (that is information which is not disclosed to the public) violates the principle of full, true and plain disclosure, as well as the principle that all investors must share equally in the risk and opportunity. “Insider trading” generally refers to the purchase or sale of securities while in possession of material non-public information concerning such securities, or “tipping” such information (providing the information to a third party to their trading benefit, or so they can trade on behalf of the insider,) where the trader or tipper breaches a fiduciary duty or a duty arising out of trust or confidence. Those who trade on insider information have a clear opportunity to obtain an economic advantage over other investors who do not have access to the same information. Legitimate investors will likely be unwilling to trade in a market where they perceive that other investors may have an advantage over them.

The investigation of insider trading activity normally follows a public announcement of information which materially affects the price of the issuer's security. Large trades beyond the parameters of normal trading activity should usually be viewed as suspicious. Similarly, any trade which immediately precedes the disclosure of material information warrants examination. Significant unexplained trading by insiders often provides evidence that the trading was based on insider information.

After potential insider trading has been identified, the first step in the investigation normally involves a review of the information publicly disclosed before and after the trading occurred. Then next step may involve the gathering of information of all insiders and their trading activity during the relevant period. Insiders and traders are identified, and the trading records of the traders involved are obtained.

Telephone records, particularly where the trading may involve "tipping", often provide a valuable source of information relating to the relationships between traders, insiders, and others with whom the insiders may have shared information. Careful analysis of telephone records may, for example, reveal previously unknown connections between third parties who have common contact with an insider.

Early contact with the principals of an insider trading investigation is often valuable for in establishing the positions of the parties before they have organized a common defensive strategy. Needless to say, detailed analysis of the trading records of all brokerage firms involved in trading of the stock proximate to the time of the insider trading, will be essential to the proof of insider trading. A review of records such as opening account documents of third parties who have traded heavily before the disclosure of material facts may provide information which is valuable in the identification of nominees who trade on behalf of and to the benefit of insiders.

The evolution of sophisticated investigation techniques has produced the unfortunate result that many insiders now seek to utilize the trading facility of so-called "secrecy jurisdictions" in an effort to avoid regulatory scrutiny. Accounts opened in the names of third parties, but to the benefit of insiders, have provided a shield for insiders who have sought to conduct trading while avoiding examination of their activities by Canadian regulators.

Recent international pressure on these secrecy jurisdictions has led many of them to realize that the short term benefits of providing this kind of protection to those who seek to violate international standards for the transfer of money may be outweighed by the long term detriments they bring upon themselves. As a result, there has been an increasing level of cooperation by many these jurisdictions in providing information to regulators.

Market Manipulation

Market manipulation, which also violates the principles of full, true and plain disclosure, as well as the principle that all investors must share equally in the risk and the opportunity, occurs when traders intentionally cause the trading price of shares to take place at a price which is not reflective of fair market value. In a market manipulation, investors are deceived or defrauded by those who artificially affect the price of a security. It is usually brought about by a combination of false information and deceptive trading activity.

Market manipulation generally refers to such practices as wash trading, matched orders or rigged prices. These practices are all ultimately intended to produce a market for the securities which has little or no bearing on the true value of the securities based on the real business of the issuer and its true prospects.

Because price and volume should be set by the justified judgment of buyers and sellers, market manipulation violates the integrity of the market because it alters the independent trading and pricing mechanisms of the market. Because manipulation can be a victimless offence in some circumstances, or at the very least can have victims who are invisible to the offender, in some quarters market manipulation has been viewed as an acceptable means of trading. Because of the harm it does to the integrity of the market, as well as in most cases to investors, there is no requirement that investors lose money for a manipulation to have occurred. In most cases, however, the collapse of the market at the cessation of the manipulative conduct is not only the best indicia of manipulative behaviour, but also results in substantial losses to investors who are left holding what has become worthless stock.

Manipulation never occurs with large issuers with substantial capitilization, except to the extent, such as in the Bre-X case, where the entire captilization was the product of a market manipulation. It is, to the contrary, thinly capitalized issuers with unknown business prospects which are the favourite targets for fraud and manipulation. With such enterprises a relatively small amount of capital can be employed to gain control of a listed company, collapse its distribution, manipulate the price of its shares in an ever increasing manner, and ultimately to sell the shares to unsophisticated purchasers who accept as true, misrepresentations about the issuer's business prospects, or who all too often are simply seduced by nothing more than the strong upward trend of the share price.

The most common form of manipulation has been referred to as a "pump and dump" scheme. Typically, insiders purchase a dormant publicly owned company by acquiring the majority of its issued shares, and "vend in" an asset, (which could be a property, but may be something as insubstantial as an idea,) or merge the company with a privately held business.

Along with a promoter, the insiders locate a broker who is willing to assist in the creation of a market for the shares of the company. The promoter "pumps up" the value of the company by touting its dubious virtues, while the broker generates trading volume and advances the bid price. Often at the early stages of the manipulation, "circular trading", that is trading that involves a small group of traders deliberately recirculating the stock among themselves at increasingly higher values to create the appearance of both demand and value in the shares, is the only trading which occurs. Large blocks of stock are traded through nominee and other accounts controlled by the insiders, through match orders and wash sales. Often the purchased stock is "paid for" by the proceeds of the subsequent sale of the same stock, sometimes called free riding. Through this mechanism, manipulated stock can appear to have achieved a significantly high level of capitalization, without the injection of a significant amount of capital by the insiders.

Often such schemes are conducted through the facility of a "boiler room", which is nothing more than a group of people with telephones and call lists who find unwitting investors. When the market reaches a high level, the insiders sell their shares into the market, often generating enormous profits.

Some forms of manipulation, usually those of the less virulent sort, involve patterns of "high closing", where the insiders execute the last trade of the day at a price higher than previous trading values, in order to give the appearance there is a higher market value to the stock than really exists.

Unfortunately, most market manipulation investigations follow the collapse of the stock where unwary investors have been left holding a stock purchased at a high price, which subsequently becomes valueless. Investigations often start with the identification of the source of the stock used for the scheme, and the source of the activity and information which produced the increase in price and volume.

The identification and activity of the promoter will demonstrate much of the basis for the trading activity. An examination of the acquisition of the company may reveal that there never was any legitimate business interest in the company, and the intention had always been to manipulate the stock.

The telephone records of those trading in the stock will often demonstrate the collusion among the insiders. Establishing the relationships between the brokers, or between those on whose behalf trades are executed, will often provide evidence of the limited nature of the early part of the distribution.

Of late, tracking information disseminated on the Internet may explain some of the trading activity. While tracking the source of false information on the Internet may prove difficult, it will sometimes lead to the identification of those who have disseminated false information.

In any case, the means of the creation of the market for the stock will be critical to the investigation. Historical trading patterns should be analysed. Does there appear to be any logic to the trading patterns during the period of the alleged manipulation? Can the trading be explained by the activities of the promoter, brokers and insiders? What were the sources of information regarding the stock, and did it have a basis in reality? How did the stock perform in comparison to the stock of similar enterprises?

Ultimately, automated trading systems will prove invaluable in determining the existence of wash trading and matched sales, how often any individual broker or group of brokers were involved in raising the bid during the period of the alleged manipulation, and who was involved in the trading as the price increased.

Conclusion

The existence of a strong regulatory framework is essential to the creation of a credible capital market which is attractive to both investors seeking to find a legitimate place to invest their money, and issuers seeking to attract capital to support legitimate businesses. The existence of credible rules must be supported by a vigorous enforcement program which has the ability to respond to misconduct in the market, and sanctions which will ensure the credibility of the market is maintained and deter the unscrupulous from abusing the market in dishonest and fraudulent schemes.

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