

SESSION V: PROTECTING THE INTEGRITY OF THE MARKET

Presentation on
**PRICE MANIPULATION PRACTICES ON THE RUSSIAN SECURITIES MARKET AND RUSSIAN LAW
TO PREVENT SUCH MANIPULATIONS**

by

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1. ¹The Federal Law “On the Russian Securities Market” says that “a fact of price manipulation on the securities market is adjudicated **in court**” (paragraph 2, Article 51). To date we do not know what Russian court practice is with respect to cases brought on charges of price manipulation on the securities market. This does not mean of course that price manipulation is non-existent in Russia.

2. Instances that can be described as price manipulation are reported by the media, by witnesses who have seen such practices take place on stock exchanges, and from other hearsay sources.

3. Below are two accounts of manipulative practices on the stock market. The first one took place in May of 1996 and was described in the May 12, 1996, issue of the newspaper Segodnya and the May 15, 1996, issue of the newspaper Kommersant-Daily. Monday, May 6, was the last day of trading in futures contracts for the weighted average secondary-market price index of the 24th tranche of government zero-coupon bonds (Russian acronym: GKO) on the Moscow Central Stock Exchange. At the close of the trading session when the market was on the rise, one of the major market operators began to place numerous sell orders for futures contracts at prices equal to 61.2 percent to 63.5 percent of the nominal price. Most traders reasonably believed that the price was very low, and the major operator managed to sell around 30,000 futures contracts worth a total of 25 billion rubles. According to the rules governing futures trading on the Moscow Central Stock Exchange, the variation margin for positions remaining open on the last day of trading in this kind of contracts is tied to the weighted average price in secondary trading on another exchange (the Moscow Interbank Currency Exchange) on the following day, i.e., May 7. This participant in futures trading on the Moscow Central Stock Exchange is also a GKO dealer that trades on the other exchange (i.e., the Moscow Interbank Currency Exchange – MICEX) where it has a package consisting of approximately 200,000 such contracts. Several minutes before closing on the Moscow Interbank Currency Exchange when there were relatively few buy orders for the 24th GKO tranche, our dealer placed buy orders for around 50,000 contracts at 18 percent of the nominal price and an opposite sell order (the nominal closing prices was equal to 66 percent). The number of “outside” buy orders being negligible, the dealer concluded the majority of trades at this low price with itself (which is quite possible especially as 2 friendly banks are involved in the transaction). This manipulative operation was drove down the average weighted price of the 24th GKO tranche to around 10 points below the real-trade prices. This operation resulted in a favorable Moscow Central Stock Exchange futures market variation margin for this player of around 2.8 billion rubles, or 5 times higher than this player’s losses from previous trading on the Moscow International Currency Exchange. A check of clearing reports for the two days discovered that a clearing firm on the Moscow Central Stock Exchange had made a gain equal to nearly 95 percent of the variation margin.

¹ The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its member countries. This paper is subject to further revisions.

4. As a result, very many participants in trading and their customers incurred losses; and most clearing firms on the Moscow Central Stock Exchange found themselves in jeopardy. Though from the ethical perspective such speculative operations were quite questionable, according to some of the players, the operation was quite legitimate because it did not consist in a simple “footling” of a large number of contracts between two brokers; rather, it was a massive sale of contracts at the close of a trading session when the other players could not do anything to save the situation. But most directors of clearing firms were of the opinion that these secondary-market 24th tranche GKO operations on the Moscow International Currency Exchange could be defined as force-majeure under the Rules of Trading in Futures Contracts on the Moscow Central Stock Exchange and that these trades could be cancelled.

5. A second instance of price manipulation took place on June 30, 1998, and was described in the newspaper Kommersant-daily on October 29, 1998. At a large exchanges one of the participants in the Federal Loan Bonds (Russian acronym: OFZ) market violated an agreement under which it was to operate as a primary dealer. With an interval of 1 second two trades were made at 90 percent of the instrument’s market price at the time, which was quite in conflict with the exchange rules. No investigation followed because the exchange itself objected to such investigation: it claimed that this information was confidential and that the Bank of Russia had placed a ban on its disclosure.

6. Both examples cited above are classic cases of manipulation that are described by western practitioners of the market as a pool and a matched order.

7. However, neither case had widespread repercussions or led to a court trial.

8. Law and judicial practice in many western countries such as the USA, Great Britain, etc., provides a fairly detailed regulation of the forms and methods that can be used to influence prices. Thus, the book Stock Market (Richard J. Tewless, Edward S. Bradley, Ted M. Tewless, Stock Market, 6th Edition. New-York: John Wiley&Sons, Inc., 1992) views manipulation as an artificial control of prices; manipulation consists in an attempt to make investors buy securities at a price higher or lower than the price would be if it were formed by market demand and supply. A manipulator hopes to make a profit or avoid losses by forming artificial prices that would put rank-and-file investors at a disadvantage. While in western countries legislation enumerates the actions of professional participants in the stock market that can be described as price manipulation and that constitute *a corpus delicti*, Russian law does nothing of the kind.

9. But in Russia most varieties of manipulation are quite widespread, and they are not restricted either by laws or by rules of stock exchanges and other trading outlets.

10. All that Article 51 of the Federal Law “On Securities Market” does it place a general ban on price manipulation by professional participants in the securities market, but it does not spell out specific methods of manipulation. The Trading Rules of the Yekaterinburg Stock Exchange are more specific about manipulation. For example, paragraph 6.23 of the Rules says that “the Yekaterinburg Stock Exchange takes measures to prevent price manipulation, including even a possible suspension of trading, if the actions of the participants [in trading] clearly shows their being bound by an agreement aimed at having prices maintained, inflated or depressed artificially.”

11. One of the few documents that lays down fairly detailed rules that relate to the banned practice of price manipulation and that define the concept itself of “manipulation” is Directive No.603-Y, dated July 7, 1999, of the Central Bank of Russia “On the Procedure for Implementation at Lending Institutions of Internal Control of Compliance of Operations on the Financial Markets with Legislation on Financial Markets ” and the Rules of Trading in Securities on the Moscow Interbank Currency Exchange as

approved on January 26, 1999. It is of note that both documents were issued after the above situations had taken place.

12. Article 4 of Directive No.603-Y of the Central Bank of Russia defines price manipulation on the securities market as actions undertaken by any participant in the securities market or a group of such participants which are aimed at changing the price of a financial instrument, with a possible destabilizing effect on the securities market. Further on Article 4 discloses the specific forms in which price manipulation may take place, viz.:

- « - placing simultaneous orders to buy and sell securities on an organized market at prices markedly different from the market prices, seeking to change market prices in one's favor or to make other gain;
- collusion between two or more participants in trading or their employees with respect to buying/selling securities on the organized market at prices that are markedly different from their market prices;
- buying/selling large blocks of securities on the organized market without agreeing, prior to the operation, with the agent responsible for this financial instrument, of such a plan for the performance of the planned operation (transaction) that would prevent a possible destabilization of the market, and without reception of an appropriate permission;
- other cases of exerting a deliberate influence on the price of a stock instrument seeking to change market prices for own benefit or derive other gain.

13. A lending institution may not manipulate prices on the securities market or to force other parties to buy or sell securities by supplying to them deliberately misleading information concerning securities, issuers of securities, prices of securities, including advertising materials.”

14. Chapter 21 of the Rules of Trading on the MICEX (Moscow International Currency Exchange) that refers to price manipulation defines manipulation as actions undertaken by a Member or Members of a MICEX Division which are aimed at creating false price targets, by placing orders and concluding large transactions, or on price terms that are markedly different from objective market conditions in order to mislead the customers or any professional participants in the securities market.

15. The following may be described as price manipulation practices:

- actions aimed at causing the average weighted price of a security, opening price, closing price, MICEX Consolidated Stock Exchange Indices to deviate from its objective price trend;
- making cross-transactions, which are understood as making a transaction for own account in which one and the same Division Member acts both as a seller and a buyer;
- making a transaction that is subsequently cancelled due to non-performance of obligations between the two parties to the transaction.

16. If a Division Member is suspected of price manipulation, the Exchange may request the Member to explain his/her actions. Within one week of the receipt of such request from the Exchange, the Division Member must provide an explanation. If found guilty of price manipulation, a Division Member may be penalized with a fine of \$1000 for the first proven offense; the penalty is increased by 50 percent for each subsequent offense but not higher than \$10,000; the penalty is payable to the Exchange; a Member may be suspended from trading in the Division for a period of up to 1 year; or a Member may be expelled from the Division permanently.

17. Another document which the MICEX adopted on January 26, 1999, “List of Measures to Prevent Price Manipulation in Securities Trading on the Moscow Interbank Currency Exchange”, adds to the

earlier-passed provisions. This list contains a number of measures aimed at preventing of price manipulation. Specifically, such measures include the following: availability of a system to control making orders to buy/sell securities and the conclusion of transactions; an on-going monitoring in the real-time mode; aftertrading analysis of all orders and transactions registered in the Trading System; and authorized Exchange staff reporting any suspected cases of price manipulation to the Exchange Executive Board.

18. A system for control of placed orders introduces a ceiling limit of price fluctuations during a trading session, pre-trading and aftertrading periods, including control of trading large blocks of securities. For example, when a buy order is made in the Trading System for a price that is lower than the limit price, such order is automatically rejected; the same treatment is given to a sell order (i.e., prices may not be higher than a certain limit).

19. Some of the manipulative practices are not mentioned in the above quotations, such as *deriving profits from the knowledge of intentions of the customers regarding the purchase/sale of securities* (when a broker performs operations for own account if there are instructions from investors to buy/sell securities or opposite instructions. Specifically, when a broker buys securities from an investor or on the open market to resell them to another broker at a profit for himself) *and neglecting customer interests or misleading customers in performance of transactions* (making of orders and performance of transactions on a customer's account on terms disadvantageous to the customer, and an unauthorized use of a customer's account), but they are indirectly covered by other laws and regulations. For example, Article 992 of the Civil Code of the Russian Federation says that a commission agent must carry out customer instructions on terms that are as beneficial as possible for the principal and in accordance with the principal's directions; and if the agency agreement does not specify any such directions, in accordance with the customs of business usage or other usual and standard requirements. The Federal law "On Securities Market" in its Article 3 that governs brokerage operations lays down the following requirements relating to a broker's performance of his/her duties: "a broker should carry out his/her customers' instructions conscientiously and on a 'first-come-first-served' basis, unless a different procedure is prescribed in the broker-customer agreement or in the customer's instructions. In all cases transactions made at the customer's instructions have priority over the dealer operations of the broker himself/herself when such broker doubles as a dealer. If a broker has an interest that prevents him/her from carrying out a customer's instructions on terms of maximum benefit to the customer, the broker must notify the customer immediately that he/she has such an interest. If a conflict of interests between a broker and his/her customer, of which the customer is not notified prior to the reception by the broker of appropriate instructions, results in [the broker's] carrying out such instructions in a manner detrimental to the customer's interests, the broker must reimburse the [customer's] losses at own expense in a manner prescribed by the civil law of the Russian Federation."

20. It is noteworthy that it is extremely difficult to establish a fact of price manipulation on the securities market because it is difficult to identify and record such practices. This calls for a high-price software to monitor sharp price fluctuations in the real-time mode. For supervisory purposes western self-regulating organizations and exchanges set up specialized units with a staff equal to 5 percent to 7 percent of total staff, and with an annual budget of \$5 million to \$50 million. In Russia only the MICEX has an automated system of surveillance of the securities markets (SMARTS – Security Market Automated Research Training & Surveillance). This system carries out the following tasks: identifies unusual behavior patterns of participants in trading if their actions are suspect, monitor compliance by the participants with the Rules of Trading on the MICEX Stock Division and monitor principal indicators characterizing the situation on the securities markets.

21. Nor is it less difficult to investigate instances of price manipulation because neither the self-regulating organizations nor the Federal Commission for Securities Market has powers to make such investigations, and the information an investigator needs is not made available to the regulators as there

are many possibilities to avoid making it available (i.e., it is defined as confidential, or bans are cited of the Central Bank on the disclosure of certain kinds of information). It is of note that the Criminal Code of the Russian Federation and the Administrative Code of the Russian Federation contains no rules allowing to define such practices as unlawful.

II. Use of Restricted Company Information on the Securities Market. Making Insider Transactions as a Method of Influencing the Price of a Financial Instrument

22. Much in conflict with the legislation of western countries Russian legislation does not go beyond a declaration that it is inadmissible to use insider information in trading in the Federal Law “On the Securities Market” (further, the Law on the Securities Market). As of now Government authorities have issued several regulations that lay down requirements aimed at preventing an unauthorized access to restricted company information, and specifies penalties against offenders. Yet Russian Law still does not provide an efficient mechanism for control of insider transactions.

23. It is no exaggeration that a large number of stock transactions that are made on the Russian market are in some manner based on the use of insider information.

24. Primarily, liability for an illegal use of company information is recorded in the Civil Code of the Russian Federation. For example, Article 139 provides a definition of a business secret: “information constitutes a business or commercial secret if this information has an actual or potential commercial value by virtue of this information not being accessible to a third person; it is not freely and legally available to the public and the owner of this information takes measures to keep it confidential. Information that can not constitute a business or commercial secret is defined by Law or other legal acts. “Therefore, restricted company information is information that is characterized by three aspects: this information is not available to third persons, it is not legally and freely accessible to the public, and its owner has taken measures to keep it confidential, i.e., to protect it.

25. Article 31 of the Federal Law “On Securities Market” (further on, Law on the Securities Market) describes as restricted company information “any information that is not commonly accessible, about an issuer and its securities that places persons who have such information by virtue of their post or position, work responsibilities or an agreement entered into with an issuer at an advantage as compared with other players in the securities market.” That is, this information shares all requisite features characterizing confidential information constituting a business secret.

26. The Law on Securities Market describes the following persons as insiders (persons having access to restricted company information):

- 1) members of the management bodies of an issuer or of a professional participant in the securities market that is under an agreement with the issuer;
- 2) individuals who are professional participants in the securities market;
- 3) auditors of a issuer or of a professional participant in the securities market that is under an agreement with the issuer;
- 4) government officers who have access to such information due to their supervisory or administrative duties and also those that perform such duties by special authority.

27. Instructions number 1, dated 01.10.97, of the Central Bank of the Russian Federation “On Procedure for Regulation of Banking Operations” also says that the following individuals are defined as insiders in accordance with international practice:

- 1) shareholders having more than 5 % of shares;
- 2) directors (presidents, chairpersons and their deputies);
- 3) Council members, members of the Credit Council (committee);

- 4) directors of subsidiaries and parent structures;
- 5) other persons who can influence a decision regarding making a loan and insiders' relatives, former insiders and other persons who participate in outside organizations in the form of limited liability companies in which insiders also participate.

28. Also, Russian Law has a concept of affiliated persons who can also be referred as persons having some access to restricted company information.

29. Thus, the list of persons having an access to restricted company information, is varied and quite broad, and it is fairly well determined in Russian Law.

30. This list is, on the whole, quite traditional: in most countries law defines the same persons as insiders. However, in other countries legislation also describes as insiders major shareholders who own 10% or more of the issuer's shares (USA, Japan); management members of a company in the process of its takeover of another company (Japan); close relatives of all abovementioned persons (Great Britain); company officers who have access to restricted company information; persons who receive information from any of the above persons.

31. Besides, Federal Law number 117-FZ, dated 23.07.99, "On Protection of Competition on the Market of Financial Services" bans "unfair competition in the market of financial services between financial institutions, which unfair competition takes the form of actions seeking to gain advantages in business operations, conclusion of agreements or undertaking of concerted actions between themselves or with a third person that are in conflict with the legislation of the Russian Federation and customs of business usage and that may cause or have caused losses to other financial institutions/competitors in the market of financial services or have done damage to their business reputation including:

- obtaining, use and disclosure of **information**, constituting **a business ... secret**, without consent of its owner unless such actions are provided for in the legislation of the Russian Federation."

32. The rules of transfer and distribution of restricted company information by officers of a lending institution when they perform operations (transactions) on financial markets, as well as recommendations relating to the fulfillment of requirements restricting an authorized transfer of company information between company units are currently recorded in Directive number 603-u, dated 07.07.99, of the Central Bank of the Russian Federation "On Procedure for Internal Control at Lending Institutions of Compliance of Operations on the Financial Markets with Legislation Governing Financial Markets." According to the above Directive, the following is recommended:

- staffers of a lending organization are required to promise in writing that they will not disclose confidential information;
- units should have separate organizational and technology support facilities (specifically, access to computer networks must be off limits to other units);
- systems should be created to limit access to different levels of information for different staffer;
- separate premises should be provided for an organization's functional units (units performing operations (transactions) on financial markets and those that record and account for these operations (transactions)).

33. However, the Russian legislation prescribe a procedure for establishing a fact of misuse of restricted company information or a mechanism for the investigation of wrongdoings in insider transactions. On the other hand, Russian Law provides administrative, civil and criminal liability for such offenses.

34. Article 33 of the Law on the Securities Market bans persons having access to restricted company information from using this information for making transactions and from sharing restricted company information for a third person to make transactions.

35. The use of restricted company information is also described as a violation of the Securities Law in the Provisions on Procedure for Application to Lending Organizations of Penalties for Violation of Legislation on the Securities Market, approved by the Central Bank of the Russian Federation, number 49-p dated 19.08.98. According to these Provisions, a violation of the legislation on the securities market is a violation by the employee of a lending institution of the rules of legislation on the securities market that cover the use by these employees of restricted company information on the securities market. If an employee of a lending organization is not in compliance with requirements relating to the use of company information he/she may be liable to the following penalties:

- 1) censure;
- 2) order to remedy violation of the legislation on the securities market;
- 3) information concerning the offense is given to the prosecutor's office in a manner prescribed by law and other normative acts;
- 4) a complaint is filed with the Federal Securities and Exchange Commission of Russia when by virtue of the nature of violation or insufficient powers of the Bank of Russia, the Bank of Russia cannot apply one of the penalties on its own;
- 5) a court suit is filed in cases prescribed by Federal Law.

36. If a lending institution does not respect the law on the securities market that establishes binding requirements; or if it disregards a ban established by the law on the securities market, such violations make the institution liable to penalties (a revoked license or a fine).

37. Violations by employees of rules regarding the use of restricted company information are covered in the legislation on the securities market; they are defined in the Provisions that govern:

- professional activities on the securities market;
- operations of a lending institution that issued the securities;
- investors' activities on the securities market.

38. The use of restricted company information is supervised by the owner of such information, the lending institution's officers and the state authorities having control and supervisory powers.

39. Specifically, paragraph 9 of the Interim Provisions on Requirements for Organizations Trading on the Securities Market as approved by Regulation No.49, dated 16.11.98, of the Federal Securities and Exchange Commission of Russia, establishes requirements for the officers and employees of the organizer of trading, aimed at preventing an unlawful use of restricted company information. An organizer of trading must also approve a list of measures aimed at preventing an authorized access to and use of restricted company information. As of today, nearly all large exchanges have developed such internal documents. For example, on 28.03.98, the Russian Trading System adopted Provisions on the Auditing Commission of the "Non-Commercial Partnership 'RTS Trading System' that provides for an internal investigation of unauthorized use of restricted company information and names disciplinary measures the Partnerships' offending employees and partners may be liable to.

40. As a civil remedy Article 139 of the Civil Code of the Russian Federation names reimbursement of losses incurred. Losses may be tied both to actual damage and to lost profit. Other remedies are also possible.

41. Article 183 of the Civil Code of the Russian Federation establishes criminal liability for the collection of information constituting a commercial or banking secret through theft, bribery or threats or by method other than the abovementioned, for the purpose of disclosure or illegal use of this information, and liability for their disclosure or illegal use provided the perpetrator acts from mercenary motives or other personal interest and does substantial damage to the rightful owner.

42. Though Russian law enumerates the persons who have an access to restricted company information; provides a definition of restricted company information; and establishes liability for an unauthorized use thereof, the mechanism for the supervision and monitoring of insider transactions has yet to be fine-tuned. For this and some other abovementioned reasons it is difficult to identify cases of unlawful use of restricted company information or to bring to account the guilty persons. At least we do not yet know of a single case of unauthorized use of inside information that reached a court of law. And yet, an attempt has been made to invoke the law that establishes liability for the use of insider information.

43. In late October of 1999 the mass media reported that the World Bank had begun an investigation of the role of the World Bank's Russian representatives in the transfer of official information to the former management of the Russian commercial bank Incombank. The story runs as follows: a Wall Street Journal article said that Russia's representative at the World Bank had provided official information and provided other unlawful assistance to Incombank. The investigation followed a check of documents which had uncovered that a high-level Russian official at the World Bank had disclosed to Incombank from 1992 through 1997 confidential information regarding the World Bank's investments in the debt market and who had also been Incombank's contact person in the USA. Today the ex-officer is in charge of a Moscow-based consultative firm, Economic Analysis Bureau, which is largely financed from the World Bank. This officer admitted that he had provided some assistance to the Russian bank during his work in Washington, but he did not admit he had supplied confidential information or had received regular payments. Nevertheless, the investigation materials gathered by the World Bank contain a "top secret" memorandum in the Russian language which, addressed to former Incombank director, had been signed by the officer and had been sent to Moscow in October of 1993. Based on confidential information from the World Bank and the International Monetary Fund, the memorandum recommended that Incombank urgently invest \$10 million in the former USSR's debt because such investment would yield a 40 percent profit. Two weeks after the memorandum had been written, the Russian bank negotiated a purchase of options on the Soviet debt papers (PRIN and IAN) worth around \$5 million.

44. The report emphasizes that the high-level officer was dismissed from the post of director of the Moscow Economic Analysis Bureau at the request of the Government of the Russian Federation. Also, the Russian leadership expressed willingness to provide assistance in the investigation of this conflict and in bringing the responsible persons to account.

45. Insider transactions on any stock market, including the Russian one, obviously detract from the attractiveness of this market to investors and slow down its development. Cases of unlawful use of confidential information take place on the securities market in nearly every country. The problem is how much attention is devoted to the resolution of this problem in this or that country. Citing the above example of the use of confidential information by a Russian World Bank officer, one can conclude that today Russian leaders are paying a close attention to the resolution of this problem despite (as has been mentioned) of a lack of a proper regulatory base.

46. Therefore, even though there is a certain legislative base providing liability for unlawful use of confidential information on the securities market, Russia does not have a proper body of judicial or administrative practice. But as the evolving Russian stock market has been approaching world standards, and the legislative base has been expanding, one can be reasonably sure that the number of court cases relating to liability for unauthorized access to confidential information will increase. We believe that the key to this is the adoption of laws that will create a control mechanism and elaborate a procedure for the

investigation of these transgressions. Of importance may certainly be the elaboration and adoption of internal documents by self-regulating organizations to remove gaps in appropriate Russian legislation.

Conclusions.

47. Russian legislation to prevent manipulation on the securities market should evolve in two directions.

48 First, civil liability for manipulative practices should be coupled with administrative and criminal; to this end, the Civil Code of the Russian Federation and the Administrative Code of the Russian Federation should be enlarged appropriately. *Corpus delicti* should be made as specific as possible.

49. Second, Government authorities regulating the securities market should be vested with a special procedural jurisdiction relating to the investigation of manipulative practices.

