Market manipulation using pump-and-dump strategy

By CFA Society Singapore Advocacy Team

CONSIDER this hypothetical scenario: In an effort to pump up the price of his holdings in a loss-making distributor of electronic games, Steve Wong logs on to several investor chat rooms on the Internet to start rumours that the company is about to expand its distribution network to untapped overseas markets, in anticipation of tie-ups with big local champions in their respective domestic markets.

Wong also uses several accounts and supposedly sound analysis of the company to reinforce his messaging. Should the price of the securities rise, Wong would dump his holdings in hopes of earning a tidy sum.

This is often labelled a pump-and-dump strategy, which allegedly may have been employed on the stock of GameStop, a US-based consumer electronics and gaming merchandise retailer.

Market manipulation

As a global body for investment professionals, CFA Institute deems the above pump-and-dump strategy as an attempt to manipulate the market. It is a violation of one of its Standard of Professional Conduct – Market Manipulation.

Wong disseminated false information about the distributor of electronic games with the intent of misleading market participants. According to the standard, one must not engage in practices that distort prices or artificially inflate trading volume with the intent to mislead market participants.

Consequences

Market manipulation damages the interests of all investors by disrupting the smooth functioning of financial markets and lowering investor confidence. Market manipulation may also lead to a lack of trust in the fairness of the capital markets, resulting in higher risk premiums and reduced investor participation.

A reduction in the efficiency of a local capital market may negatively affect the growth and economic health of the country and may also influence the operations of the globally interconnected capital markets.

Law on false or misleading statements

Local regulations also prohibit making misleading statements. Section 199 of the Securities and Futures Act states: No person shall make a statement, or disseminate information, that is false or misleading in a material particular and is likely –

(a) to induce other persons to subscribe for securities, securities-based derivatives contracts or units in a collective investment scheme;

(b) to induce the sale or purchase of securities, securities-based derivatives contracts or units in a collective investment scheme, by other persons; or

(c) to have the effect (whether significant or otherwise) of raising, lowering, maintaining or stabilising the market price of securities, securities-based derivatives contracts or units in a collective investment scheme,

if, when he makes the statement or disseminates the information –

I. he does not care whether the statement or information is true or false; or

II. he knows or ought reasonably to have known that the statement or information is false or misleading in a material particular.

Wong violated item (a) and (b) as he induced other investors to purchase the securities of the electronic games retailer. He also violated item (c) as he knew the information he put out was false and has the effect of raising the price of the securities.

Information-based market manipulation includes, but is not limited to, spreading false rumours to induce trading by others. IMAGE: PIXABAY

SGX listing rules

Practice Note 13.8.1 on market manipulation and a false market also prohibits market manipulation. It reads:

A Trading Member or a Trading Representative must not engage in, or knowingly act with any other person in, any act or practice that will or is likely to:

(1) create a false or misleading appearance of active trading in any securities or futures contracts; or

(2) lead to a false market in respect of any securities or futures contracts. For avoidance of doubt, a false market includes a market in which:

(a) information is false, exaggerated or tendentious;

(b) contrived factors are in evidence, such as buyers and sellers acting in collaboration to bring about artificial market prices; or

(c) manipulative or fictitious orders, transactions or other devices have been employed.

Types of market manipulation

Information-based manipulation includes, but is not limited to, spreading false rumours to induce trading by others. For example, one must refrain from "pumping up" the price of an investment by issuing misleading positive information or overly optimistic projections of a security's worth, only to later "dump" the investment (that is, sell it) once the price, fuelled by the misleading information's effect on other market participants, reaches an artificially high level.

Another example information-based strategy is "trash and cash" which involves circulating damaging information on securities with the intention of purchasing the securities at a lower price.

Transaction-based manipulation involves instances where one should have known that one's actions could affect the pricing of a security. This type of manipulation includes, but is not limited to, the following:

- Transactions that artificially affect prices or volume to give the impression of activity or price movement in a financial instrument, which represent a diversion from the expectations of a fair and efficient market, and
- Securing a controlling, dominant position in a financial instrument to exploit and manipulate the price of a related derivative and/or the underlying asset.

The CFA Institute market manipulation standard is not intended to preclude transactions undertaken on legitimate trading strategies based on perceived market inefficiencies. The intent of the action is critical to determining whether it is a violation of this standard.

Another example of transaction-based strategy is "wash trading" where buying and selling transactions give the impression of higher interest in the stock, but do not result in actual change in beneficial owners.

Ethics in action

Here is a case to illustrate how the Market Manipulation Standard works. The case is adapted from material developed by CFA Institute.

As a guide, the desired ethical behaviour required is based on the CFA Institute Code of Ethics and Standards of Professional Conduct (Code and Standards).

Hypothetical case: Saravanan is a private investor who bought a large position several years ago in Fame Pharmaceuticals, a small-cap security with limited average trading volume. He has now decided to significantly reduce his holdings owing to the poor price performance. Saravanan is worried that the low trading volume for the stock may cause the price to decline further as he attempts to sell his large position.

Saravanan devises a plan to divide his holdings into multiple accounts in different brokerage firms and private banks in the names of family members, friends, and even a private religious institution. He then creates a rumour campaign on various blogs and social media outlets promoting the company.

Saravanan begins to buy and sell the stock using the accounts in hopes of raising the trading volume and the price. He conducts the trades through multiple brokers, selling slightly larger positions than he bought on a tactical schedule. Over time, he is able to reduce his holding as desired without negatively affecting the sale price.

Saravanan violated the Market Manipulation Standard by fraudulently creating the appearance that there was a greater investor interest in the stock through the online rumours.

Through his trading strategy, he also created the appearance that there was greater liquidity in the stock than actually existed. He was able to manipulate the price through both misinformation and trading practices.

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