IN THE HIGH COURT OF AUSTRALIA
MELBOURNE REGISTRY

No. M73 of 2012

BETWEEN:

DIRECTOR OF PUBLIC PROSECUTIONS (Cth) Applicant

- and -

JM Respondent

APPLICANT'S REPLY

Part I – Internet publication

1. These submissions are in a form suitable for publication on the internet.

Part II – Reply

2. The respondent argues that "the concept of 'artificial price' introduced and employed in s130 of the FIA[1] was directed towards prohibiting *manipulation of underlying market supply and demand* as understood and analysed in economic theory, rather than any lay notion of artificiality".[2] Provided that "economic theory" is limited to the understanding of the workings of supply and demand, the applicant takes no issue with this general statement. The respondent concedes that if the price of a share or commodity is higher or lower than it would have been, but for manipulative conduct, then the price is aptly described as 'artificial'.[3] Given the acceptance in Australian financial markets[4] and by Australian courts[5] that buyers and sellers whose transactions are undertaken for the sole or primary purpose of setting or maintaining the market price are not part of the forces of genuine supply and demand, the concession is significant. The *economic theory* underlying this position is that transactions undertaken with the purpose of setting the market price are a distortion of those forces: in the case of a buyer seeking to increase a price or maintain one that would otherwise

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1 *Futures Industry Act* 1986 (Cth)

2 RSA [25]

3 RSA [59]. The respondent also agrees, that "a price reflecting the basic forces of supply and demand working in an open, efficient and well informed market is to be contrasted with an artificial price resulting from manipulative conduct".

4 Market licensees are obliged to ensure that markets are fair, orderly and transparent (s792A *Corporations Act* 2001); ASX Business Rule 2.2.4 (2001) entitled *Prevention of Manipulative Trading* and the relevant Guidance Note which quotes A Black – *Regulating Market Manipulation* who describes market manipulation as "*the interference with supply and demand in the market for securities*".

5 *North v Marra* (1981) 148 CLR 42, 59; *Fame v Jeffries* (1998) 28 ACSR 58, 62.

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fall, by creating artificial demand; and in the case of a seller seeking to lower a price, or maintain one that would otherwise rise, by creating artificial supply.

3. The respondent contends that the concept of "artificial price" originated in legislation which regulated futures trading. He further contends that "in that context" it acquired a specialised meaning.[6] It is thus no coincidence that its earliest interpretations centred on abuse of market power, for the futures market was particularly susceptible to that type of manipulation. However, even in the context of the futures market, the interpretation given to the term focused on the deliberate distortion of the forces of supply and demand to create a price that, but for the distortion, would not have been achieved.

4. However, the respondent submits that the general proposition at RSA [22] should be further refined. The respondent asserts that an 'artificial price' for the purposes of s1041A (and previously s130 of the FIA) only occurs if the *manipulation of underlying market supply and demand* occurs through *exploitation of market power*[7]. Thus, the respondent argues that proof of 'artificial price' requires economic evidence analysing exploitation of market power.[8] It is posited that the foundation for this assertion is paragraph 285 of the Explanatory Memorandum for the Futures Industry Bill, which identifies the *main* forms of manipulation in the context of futures trading. The respondent argues that the clear meaning[9] divined from this paragraph is that the provision is to be directed to manipulation of supply and demand *by exploitation of market power*. However, whilst it is clear that the provision was intended to cover cornering and squeezing it is by no means clear that it was the intention of parliament to confine it to those concepts. For the reasons given by Chief Justice in the Court of Appeal,[10] it was not. Further, it is not apparent from the terms of s1041A (or s130 or even paragraph 285 of the EM) that artificial price requires economic evidence analysing exploitation of market power. Indeed, the respondent does not suggest what evidence would need to be adduced to prove misuse of market power leading to the creation of an artificial price for a security in an equities market.[11]

5. The respondent relies upon an industry opinion[12] contemporaneous to the enactment of the FIA which noted the particular susceptibility of the futures market to monopolistic behaviour, and thus the need for a provision that catered for such conduct, however, neither that author, nor others relied upon by the respondent, suggest that the futures manipulation provision ought be narrower than its securities counterpart.

6. At RSA [32], the respondent notes that a deliberate choice was made to employ the language of "artificial price" rather than the wording of s997. As much is obvious; however, that choice combined with the fact that the new provision was designed to

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6 RSA [22]
7 RSA [43]
8 RSA [33]
9 RSA [24]
10 Reasons of Chief Justice Warren below at [211] to [226].
11 Indeed, the respondent merely asserts that "there is nothing to prevent the Crown adducing economic evidence of the relevant kind" RSA [62].
12 Mr David Rutledge also noted: "*Manipulative activity is extraordinarily difficult to define.*" Rutledge, a former chief executive of the Sydney Futures Exchange, was speaking specifically about the then draft *Futures Industry Bill* 1985.

cover both securities and futures markets and products, suggests that the wording intended to have broader coverage was utilised.[13] The respondent has pointed to no extraneous materials that suggest it was the intention of Parliament to narrow the ambit of the "market manipulation" provisions as they applied to securities and thus effectively exclude from the Act a provision that covered the ground of s997 (and its predecessors).[14] To the contrary, the commentary of Minister Hockey at 11.10[15] relied upon by the respondent at RSA [32(a)], strongly suggests that it was intended that s1041A would cover at least the same ground as s997, but whereas that provision required proof of specific intent to induce others to act, the new provision would not.[16]

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7. At RSA [32(d)], the respondent relies on a paper by Dr Vivienne Goldwasser in support of his argument. [17] That paper was written before the introduction of s1041A and contains the author's personal views about legislative control of market manipulation. It is suggested by the respondent that Dr Goldwasser had considered the proposed replacement of ss 997 and 1259 with a single provision. This is not correct; the proposal that she was considering was not a draft of s1041A, but her own suggested formula for a revised anti-manipulation provision.[18]

8. The underlying tenet of Dr Goldwasser's paper was, that the then existing anti-
20 manipulation provisions (ss997 and 998) were "*highly refined*" and had "*proved difficult to enforce*" such that the "*time has come to change the regulatory philosophy to one which recognises the importance of flexibility in such a volatile and delicate regulatory field as stock market regulation*".[19] It would seem therefore, Dr Goldwasser was content to rely on the notion of 'artificial price' as it applied to her broad based formula as covering all forms of manipulative conduct, including that described in *Marra*, *Fame* and *Soust*. Therefore, to the extent that she suggests that it is necessary in every case, in order to establish artificial price to have recourse to expert evidence, it does not follow that such evidence would be confined to market power analysis.[20]

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13 See Chief Justice Warren below at [213].

14 If the respondent (and the majority in the Court of Appeal at [338]) is correct it would be expected that the Explanatory Memorandum to the Act would have stated that s.997 is to be replaced by s.1041C.

15 11.10 states: "*Section 997 currently contains an 'intention' element. A civil contravention of the new provision will not require that element of intention to be established. Criminal prosecutions will flow from a contravention only of the requisite intention is proved*".

16 At 11.8 and 11.10 of the commentary, it was noted that the new provision would be a civil penalty provision, and in that context would not require the element of intention to be established, but criminal consequences would flow if the "requisite intention" is proved. All members of the Court of Appeal in *JM* were of the view that the fault element under s1041A was recklessness (which includes intention – *Criminal Code* s5.4(4)). Thus the Crown would need to prove the accused was (at the very least) reckless as to whether his conduct would create an artificial price. The clear link between fault and the creation of an artificial price was recognised by the Court of Appeal.

17 Goldwasser, *The Regulation of Stock Market Manipulation – A Blue Print For Reform*, 9 (1998) Australian Journal of Corporate Law, page 109.

18 Goldwasser, *ibid.* at page 140 Dr Goldwasser said at page 112 that "*The argument will be made that in the context of stockmarket manipulation, there is much to be said for repeal of ss. 997 and 998 and their replacement with a new generic anti-manipulation provision ... The suggested formula for the revised anti-manipulation provision is as follows: A person shall not in or connection with any dealings in securities, manipulate the market for or the price of, any securities.*" She said further at page 140 that "*in the context of this proposal, the term "manipulate" is taken to mean artificially inflating or depressing the market for, or the reported price of, any securities.*"

19 Goldwasser, *ibid.* at page 138-139.

20 Contrary academic views have been expressed. In a paper entitled "*Redefining Market Manipulation in Australia; The Role of an Implied Intent Element*", Dr Hui Huang opined – "*When deciding the*

9. The respondent relies upon United States jurisprudence in support of his proposition that 'artificial price' is a "technical concept requiring economic market analysis". [21] Although s997 (and earlier versions) was based upon equivalent United States provisions,[22] s1041A is not. Therefore, for the reasons stated in *Mansfield and Kizon*[23] the court derives little assistance in the resolution of the question of construction of 'artificial price' in the *Corporations Act*.

10. In any event, the position in the United States is not now, nor was it in 1986, that 'artificial price' was confined to prices resulting from conduct "typified by cornering and squeezing". The definitions suggested by various courts, despite frequently arising in futures cases involving corners and deliberate squeezes, are broad in application.[24] United States authorities prior to 1986 recognized that an artificial price in the context of futures trading was not solely established through market dominance or proved by "analysis of market and market power". *In re Henner*[25] involved the creation by the respondent of an artificial price for egg futures, not by misuse of market dominance, but by purposefully paying more than he needed to pay for November shell egg futures in order to cause the closing price on the Exchange to be two cents more than the previous days settlement price. Of note, the Judicial Officer of the Commodities Futures Trading Commission considered that the manipulation did not require market power analysis. [26] Johnson and Hazen referred to *In re Henner*, and pointed out that there were forms of manipulation other than intentional corners and squeezes. [27]

11. If "artificial price" is to carry the meaning suggested by the terms of paragraph 285 of the EM, it could have no applicability to securities trading, as there are no underlying physical commodities that are deliverable under a share transaction. However, stripped of its contextual application to the futures market, paragraph 285 suggests that the provision was directed to prohibiting *manipulation of underlying market supply and demand.*[28] That principle can be comfortably transposed to dealings in securities.[29] Thus a price that results from conduct of a participant in a transaction which is other than the natural conduct of a buyer wishing to buy at the lowest price

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artificiality of a price, it is necessary to look at the mental state of the trader. It can be said that "intent" is integral to the concept of "artificiality" and therefore the definition of market manipulation" - Company and Securities Law Journal, Vol. 27 (2009), page 8 at 11-12.

21 RSA [35] ff

22 Section 9(a)(2) of the *Securities Exchange Act* 1934 (US).

23 *Mansfield v The Queen; Kizon v The Queen* [2012] HCA 49 (14 November 2012), per Hayne, Crennan, Kiefel and Bell JJ at [50].

24 See paragraph 73 of the Applicant's primary submissions. See also *Volkart Brothers Inc. v Freeman*, 311, F.2d 52, 58 (1962).

25 *In re Henner*, 30 Agric. Dec. 1151 (1971).

26 *In re Henner* at page 44 (Lexis Nexis version, load date 19 August 2011, page 30).

27 *Commodities Regulation* 2nd Edition, Boston Little Brown 1989 at 5.35, pp 75-76. The pages were taken from a paper published in Volume 38 *Washington and Lee Law Review* 1981 at page 725, and also were published in Chapter 5 of Phillip Johnson's, *Commodities Regulation* (1st Ed.), Little Brown and Co 1981. In subsequent decisions, United States courts have confirmed this notion of artificial price – *Anderson v Dairy Farmers of America,* Inc., No. 08-4726, (D. Minn. Sept. 30, 2010); *DiPlacido, v Commodity Futures Trading Commission*, Unreported summary order of the United States Court of Appeals for the Second Circuit, (16 October 2009).

28 See RSA[25]

29 Cf RSA [42]

and a seller wishing to sell at the highest price and done with the intention of affecting the market price of the security is an artificial price.[30]

12. While there are some similarities in the economic characteristics and effect in short selling securities and futures, there are a number of significant differences, such as the relatively small "short" side, the absence of a great deal of leverage, the lack of an underlying commodity (all in equities) and the feature (in futures trading) of congestion which is the primary imperative for the need to regulate corners and squeezes.[31] There is no such imperative in securities markets. Thus the opportunity to use economic or market power to create a price, different from that which would be fixed by the undistorted operation of the forces of supply and demand, it greatly limited.[32]

13. At RSA [55], the respondent argues that s1041A has a narrower scope compared to its futures predecessors. For the reasons stated herein and in the applicant's primary submissions, it is apposite to consider the securities predecessors to s1041A as well as the futures predecessors.[33] It is of relevance that s997 contained a specific intent component, which was removed by the *Financial Services Reform Act*. However the proscribed intent was not to affect the price of the security, but rather to enter into transactions, that had or were likely to have that effect, with the intent to induce conduct on the part of others. Such intent, axiomatically, involved intent to create or maintain the price of the security, because the inducement of other persons was dependent upon that price effect. Commentators have noted that the intent to induce component of s997 (and earlier versions) made the prosecution of that offence difficult.[34] It is not surprising that the removal of this component was highlighted in the commentary referred to in paragraph 6 hereof. The result is that the provision is now broader than its predecessor – applying regardless of whether the manipulation occurred with the intent to induce others to trade. However that is not to say that a purpose to affect the price of the financial product is not relevant to the question of artificial price, both with respect to civil and criminal breaches.[35]

Dated: 8 March 2013

JEREMY W RAPKE QC **CHRIS WINNEKE** **GRAEME HILL**

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30 See *North, Fame and Marra.*

31 See for example the passages referred to by the respondent at RSA footnote 12, [28] and [29].

32 The respondent merely asserts (RSA [43]), without analysis or authority, that "market power in a securities market may be attained and manipulated even within the legislative restrictions relating to equity holdings".

33 All members of the Court of Appeal contrasted the position of s.1041A with s.997 concerning the question of intent: majority at [373], Chief Justice at [269].

34 Goldwasser, ibid, at page115, Hui Huang, *Redefining Market Manipulation in Australia: The role of an implied intent analysis* (2009) 27 Company and Securities Law Journal, Vol. 27, page 8 at page 22.

35 Of note, all members of the Court of Appeal (the majority at [350] and the Chief Justice at [228]) rejected the respondent's argument (relying upon analogy with s45A of the *Trade Practices Act*) that effect cannot be inferred from subjective intent.