AFM Market Watch

Newsletter on MAR, MiFID II and transaction reporting topics

January 2021, Edition 2

Market manipulation

Editor's note
Dear reader, we are pleased to present the second edition of our recurring newsletter, the AFM Market Watch. It covers capital market related topics such as MAR, MiFID II and transaction reporting.

The newsletter consists of two parts: (i) a lead article tackling a current capital market related topic, supported by (data) analyses; and (ii) a recurring short facts and figures section tracking developments in the market. The AFM Market Watch will be published on a regular basis and will be sent to subscribers (click here to subscribe).

In this second edition the topic 'Market manipulation' will be discussed (pp.1-5), followed by the facts and figures section (p.6).

Introduction

According to the AFM Consumer Monitor, one in every six Dutch individuals is an investor. The low (and sometimes even negative) interest rates on savings most likely motivates to invest in financial instruments such as shares, derivatives, bonds and commodities. We have also seen that the number of investors has grown even further since the start of the COVID-19 pandemic.

Brexit has resulted in the AFM being responsible for a large part of the supervision of trading activity in the European Union. The AFM used to mainly focus on equity. With increased volumes traded within its supervisory jurisdiction in other asset classes, such as commodities, derivatives and fixed income, the AFM now has an increased focus regarding those asset classes. Efforts have been made to be able to intensify trust and integrity on the growing Dutch capital markets and ensuring the AFM's status as a multi asset class supervisor.

In all markets, *trust and integrity* are essential. Investors need to be confident that their transactions are established in a fair and transparent manner. Market abuse damages trust in the proper and orderly functioning of such markets.

Market confidence is damaged if the market is being manipulated. This is why market manipulation and attempted market manipulation are prohibited. This prohibition has been embedded in European legislation which applies in the Netherlands, as set out in Article 15 of the Market Abuse Regulation (MAR). The AFM is committed to promoting fair and transparent financial markets and monitors compliance with this prohibition.

In this edition of the AFM Market Watch, the AFM will elaborate on market manipulation, which is a specific aspect of market abuse, and in what ways detection and enforcement of market manipulation is organized at the AFM.

1. Market manipulation

Article 12 MAR contains a detailed description of market manipulation, and makes a distinction between market manipulation through trading practices and through the dissemination of false or misleading information. In brief:

Trading practices

With regard to financial instruments, the following activities are considered market manipulation:

Entering into a transaction, placing an order to trade or any other behaviour which:

i. gives, or is likely to give, false or misleading signals as to the supply, demand or price; or
ii. secures, or is likely to secure, the price at an abnormal or artificial level.

Dissemination of false or misleading information

In addition to trading practices, market manipulation may occur through the dissemination of information. This information may be false or misleading in respect of the price of, demand for, or supply of, one or more financial instruments. This information may also secure the price at an abnormal or artificial level.

2. Examples of market manipulation

Below are five situations involving manipulative practices.

i. *'Layering' or 'spoofing' – an investor is using orders to mislead the market as to his real intentions*

Many market participants that operate in the financial markets are highly automated and can react very quickly to market events and changes in the order book. This, for instance, enables them to always issue the best market price. In certain situations these participants may be turned into issuing higher or lower prices.

Figure 1: Layering/spoofing visualized in a spread graph. AFM Smarts

Figure 1 is a visualisation of such a situation of manipulation. In this scenario, an investor presents itself as a ***buyer*** in the market by entering buy orders at increasing prices (the incremental upward steps in the green section of Figure 1). Eventually, however, this investor ***sells*** at a relatively high price – the red dot is the transaction – to the (automated) participant that reacted automatically to the manipulative buy orders that drove up the price. Thereupon the manipulator cancels its previous buy orders.

The same method can (subsequently) be used in the opposite direction. In that case, the investor presents itself as a ***seller*** in the market by entering sell orders at decreasing prices (the incremental downward steps in the red section of Figure 1). Eventually, however, this investor ***buys*** at a relatively low price – the green dot is the transaction – from the (automated) participant that reacted automatically to the manipulative sell orders that drove down the price. Here too, the manipulator subsequently cancels its previous sell orders that directed the price downwards in the first place.

The difference between the higher sell price (red dot) and the lower buy price (green dot) constitutes the profit for the investor, which is the result of market manipulation.

ii. *'Pump & dump' and 'trash & cash' – using transactions to mislead the market*

Similar to the previous example, in this scenario market participants are turned to submit orders at more favourable prices. Contrary to the previous example, here the manipulation takes place with (small) transactions. Figure 2 helps to demonstrate the practice.

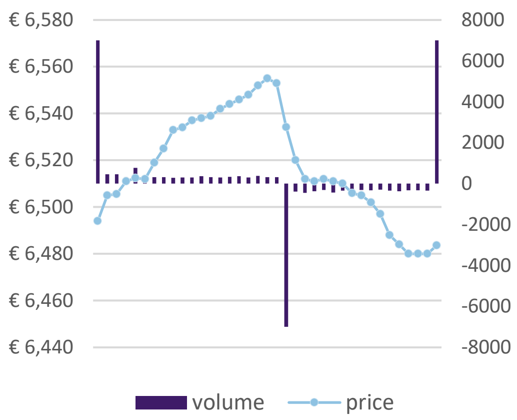

Figure 2: Pump & dump – Trash & cash

Here, an investor *buys* a relatively large number of shares at a relatively low price (the large upward bar at the left) and then *buys,* in addition, at consecutive moments, small quantities of the same shares at increasingly higher prices (*pump*, the small upward bars starting on the left). Other market participants are misled by these higher prices; they enter buy orders for a larger number of shares with a price around these higher transaction prices. At this point, the investor is able to *sell* a relatively large number of shares at the higher price (*dump*, the large downward bar in the middle) to the manipulated market participants. The reverse is also possible, by first *selling* a relatively large number of shares at a relatively high price and subsequently *selling* consecutive small quantities of the same shares at increasingly lower prices (*trash*, the small downward bars on the right). Thereafter a relatively large number of shares is *bought* back at that lower price level (*cash*, the large upward bar on the right) by the manipulating investor from the market participants that reacted to these lower prices by entering sell orders with a price around these lower transaction prices.

iii. 'Wash trades' – *transferring shares back and forth over and over*

A situation may occur at which an investor holds a position in a particular share and repeatedly transfers those shares back and forth, via transactions on a trading venue, between himself and affiliated parties (such as his own company or third parties with which he colludes). By doing so, the shares effectively remain under his control. However, these repeated transactions create the impression of (lively) trading in the share, whereas this is not the case in reality and the beneficial ownership effectively does not change. Such transactions are referred to as 'wash trades'. Sometimes these 'wash trades' are effected at pre-arranged, and thus artificial, prices. The AFM emphasises that unusual transactions that point to money laundering can be reported to the Financial Intelligence Unit (FIU).

iv. *Using tricks to trade more favourably against an at-market order*

Figure 3 (encircled section) presents a situation where there is an unusual increase in the price of a bond.

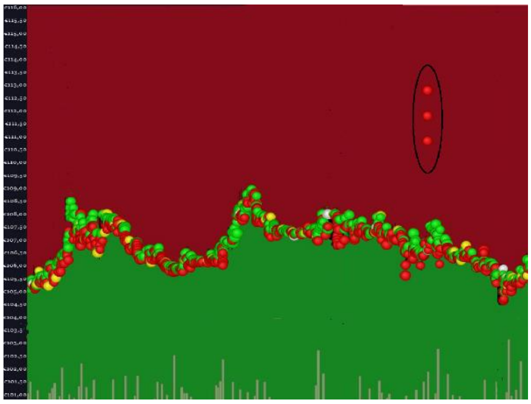

Figure 3: Price chart of a bond. AFM Smarts

In this situation, an at-market buy order for the purchase of a bond has been entered in the order book. An at-market buy order is an order to buy the bond at any price the market wants to sell for at this moment. An at-market buy order carries a certain risk, because the purchase price may be higher than expected.

A trading venue (therefore) has a safety mechanism designed to prevent extreme price changes by keeping prices between predetermined limits (usually a percentage of a reference price; also called thresholds). This safety mechanism prevents immediate trading at any price. However, if a transaction in a particular financial instrument is only possible at a price outside the top (or bottom) limit, the reference price is adjusted upwards (or downwards) by the trading venue, thus moving the thresholds up (or down).

A market participant who has spotted the at-market buy order and notices that few or no sellers are active, can respond by repeatedly entering *buy orders* that are not executed but do ensure that the upper price limit (upper threshold) is adjusted upwards by the trading venue. These actions enables him to *sell* bonds at higher than normal prices (in this example in three instances) to the participant who entered the at-market buy order.

v. *Disseminating false or misleading information*

In addition to trading practices, market manipulation or attempted market manipulation may also take the form of disseminating false or misleading information. Such information may have a significant impact on the prices of financial instruments. This kind of market manipulation could include disseminating false information, the wilful omission of material facts, as well as the knowingly inaccurate reporting of information.

Information manipulation is harmful to investors, because it makes them base their investment decisions on false or distorted – misleading - information. It is also harmful to the issuer concerned, because the manipulation detracts from the reliability of information available in the market in respect of that issuer. That impact on reliability may jeopardise an issuer's opportunities to issue new shares, for example. Information usually spreads fast among market participants. This also applies to false or misleading information. The adverse consequences for investors and issuers may last until it is apparent that the information is false or misleading and is rectified.

Disseminating information (including rumours) of which the disseminating party knows or should know to be false or misleading is prohibited. Dissemination of false or misleading information may occur, for example, in internet chat rooms or via (social) media. Users have to be careful not to post statements about certain issuers, or particular market activity, that are not true or that they do not have a reason to believe are true. The AFM actively monitors internet chatrooms and social media for false or misleading information.

3. Detection

Surveillance by the AFM

The AFM performs multi asset class surveillance on trading in commodities, derivatives, equities and fixed income. Both in real-time and on a daily basis. Real-time surveillance on the financial markets under AFM's supervision is performed by closely following market developments. We do this with a view to accomplish that all necessary information that should be public is published by listed companies.

The AFM has access to order and transaction data, both directly from trading venues, and regulatory data, in order to analyse market developments and trading behaviour. As a data-driven regulator, making use of algorithms, tailored detection and commercial surveillance tools, the AFM will track down suspicious trading. If suspicious trading is cross-market or cross-border, the AFM teams up with other (EU) supervisors in the detection, analysis and investigation phase.

Where attempted or actual market manipulation is observed, the AFM may and does contact involved parties directly -catching them in the act- to ensure a prompt intervention. Such intervention is in parallel to additional measures that are available to the AFM (read more in Section 4, 'Sanctions').

Market participants: Suspicious Transaction and Order Report

It is not just the AFM that monitor markets. Every bank, broker, proprietary trading firm or trading venue (anyone arranging or conducting transactions concerning financial instruments in a professional capacity) must have systems in place aimed at preventing and detecting actual or attempted market abuse. These market participants are obliged to notify the AFM immediately via a Suspicious Transaction and Order Report (STOR) of any reasonable suspicion of attempted or actual market abuse. This includes suspicions of (attempted) market manipulation.

The AFM is constantly supervising these participants in order to improve their level of surveillance and the quality of their STORs. For example by periodic market conduct meetings in which STORs and, so-called, near-misses are discussed, but also by showing them what the AFM detected in its own surveillance and what they should have detected themselves. If one is failing to report a reasonable suspicion of attempted or actual market abuse, the AFM could take formal measures towards it.

4. Sanctions

Where necessary, the AFM will intervene. If the AFM observes an infringement of the prohibition of market manipulation, it can take enforcement action. This is laid down in the AFM's enforcement policy.
Whether the AFM will act in a formal or informal capacity, and what measures or combination of measures will be taken on that occasion, always depends on the circumstances of the infringement and the weighting of the related factors involved. In

addition to the gravity and duration of the infringement, the AFM also considers factors such as the degree of culpability.

An infringement of the prohibition of market manipulation is serious and qualifies as a crime. The AFM may impose an administrative fine. The basic amount is €7.5 million. When determining a fine, the AFM takes the infringer's financial capacity into account. The AFM may also report the infringement to the public prosecutor. This will trigger an investigation of the infringement and prosecution under criminal law.

5. Concluding remarks

As described in this AFM Market Watch, the AFM is keen to continuously increase the overall level of surveillance for all asset classes under its supervision. This is realised by continuously improving AFM's data-driven surveillance as well as encouraging (and challenging) the financial industry to operate at a high level. This is a constant process, which develops over time. The AFM will do whatever it takes to make sure trading on the Dutch markets is fair and transparent, with the objective that true demand and supply can meet, and the financial system can support the sustainable growth and development of the economy.

Facts & Figures

STORs and other notifications on Market Abuse received by the AFM in 2020 versus 2019

2020	Insider trading	Market manipulation	2020 total	2019 total	% change 2020 vs 2019 totals
Domestic STORs	125	152	277	146	90%
Foreign STORs	216	27	243	329	-26%
Total number of STORs	341	179	520	475	9%
Other notifications	50	94	144	139	4%
Total STORs & other notifications	391	273	664	614	8%

Did you know:

- More information about the obligation to notify the AFM of any reasonable suspicion of market abuse can be found here.

- You can also notify the AFM voluntarily on market abuse issues. Contact with the AFM.

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Mission statement:
The AFM is committed to promoting fair and transparent financial markets.
As an independent market conduct authority, we contribute to a sustainable financial system and prosperity in the Netherlands.

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