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'Masri' and Open-market Manipulation Schemes

The Securities and Exchange Commission (SEC) recently obtained a mixed result when U.S. District Judge Richard J. Holwell of the Southern District of New York dismissed its "market manipulation" securities fraud complaint against a stockbroker, but allowed the action to proceed against the broker's client in *SEC v. Masri.*[1]

Judge Holwell's opinion in *Masri* grappled with the important and, in the U.S. Court of Appeals for the Second Circuit, unsettled issue of whether a series of otherwise legitimate "open market" stock transactions can be transformed into an illegal market manipulation scheme based solely on the trader's state of mind when the trades were executed.

The answer to this question could have serious ramifications for investment professionals, such as hedge fund advisers, who often pursue investment strategies that are likely to have an impact on a security's market price. The issue is also particularly timely in light of the growing wave of SEC enforcement cases and private lawsuits against hedge funds for employing perfectly legal trading strategies such as short selling for allegedly improper manipulative purposes.

Manipulation Schemes

Market manipulation schemes are typically prosecuted under §10(b) of the Securities Exchange Act of 1934 (the Exchange Act) and Rule 10b-5 thereunder.[2] It is well-settled that, in addition to prohibiting individuals from making false and misleading statements in connection with purchases or sales of securities, §10(b) and Rule 10b-5 prescribe trading-based market manipulation schemes involving so-called "wash sales" and "matched orders."[3]

Such transactions are essentially prearranged trades that result in no change in beneficial ownership and generally have no rational purpose other than to create the false impression of an active trading market at artificially inflated stock prices. Open-market transactions are in contrast "real" in that they involve the transacting party simply purchasing or selling securities in the open market without any prior arrangement with the counterparty.

Certain open-market transactions, such as aggressive short selling or a strategy that involves large purchases near the end of the trading day, will often move the price of a particular security. As a result, a "market manipulator" could arguably employ these strategies for the purpose of improperly influencing a company's stock price.

One could just as forcefully argue, however, that such transactions cannot amount to fraud because, unlike wash sales or matched orders, they simply do not inject false or misleading information into the marketplace.

SEC Position and Circuit Split

The SEC has long advocated the position that open-market transactions coupled with manipulative intent can give rise to liability under §10(b) and Rule 10b-5.[4] This position has not, however, been widely tested in the federal courts. The courts that have addressed the issue have adopted two competing approaches. In *GFL Advantage Fund, Ltd. v. Colkitt*,[5] the Third Circuit rejected the SEC's approach and held that manipulative intent alone is not enough to make open-market transactions amount to illegal market manipulation.

Rather, the court found that for an open-market manipulation claim to survive a motion to dismiss there must also be some specific allegation that the defendant "injected inaccurate information into the market or created a false impression of market activity." The court cited several examples of "deceptive practices" that would satisfy this requirement, including unauthorized placements or parking of stock, the existence of secret agreements designed to induce other parties to short stocks on the alleged manipulator's behalf, the existence of wash sales or matched orders, or the making of actual false statements to investors.

The District of Columbia Circuit, in contrast, embraced the SEC's position in *Markowski v. SEC.*[6] There, the court upheld an SEC administrative order sustaining disciplinary action in an open-market manipulation case based on what it characterized as "Congress' determination that 'manipulation' can be illegal solely because of the actor's purpose." The court came to this conclusion, without citing any portion of the legislative record, despite its recognition of the practical problems that such a rule could cause. As the court in *Markowski* succinctly put it, without fictitious transactions such as wash sales and matched orders, "[i]t may be hard to separate a 'manipulative' investor from one who is simply over-enthusiastic, a true believer [or disbeliever] in the object of the investment."

The Second Circuit has yet to define the elements of an open-market manipulation

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scheme. The Second Circuit has nonetheless expressed "misgivings" about the view that open-market transactions can run afoul of the antifraud provisions simply because the trades were executed with "the sole intent to affect the price of [a] security."[7]

The 'Masri' Decision

In *Masri,* the SEC brought an enforcement action under §10(b) and Rule 10b-5 against a trader and his broker based on allegations they executed a series of open-market stock purchases near the end of the trading day for the purpose of driving up a security's closing price. The SEC argued that trading activity such as this, which is often referred to as "marking the close," has "long been actionable as market manipulation and that Congress 'clearly intended' such conduct to fall within the ambit of Section 10(b)." The court rejected this argument, noting that "studies have shown that trading in organized securities is heaviest just before the market closes, as traders monitor activity and their positions throughout the day before conducting their trades."[8]

The court in *Masri* then framed the primary issue before it as follows: "[W]hether manipulative intent alone is enough to make open-market transactions manipulative and in violation of the securities laws[?]" After engaging in a lengthy analysis of the existing open-market manipulation case law, the *Masri* court answered the question affirmatively. The court was, however, careful to note that open-market transactions can only amount to illegal market manipulation if they were executed with the sole intent to affect the price of securities and not for some investment purpose. The court went to great lengths to emphasize the "sole intent" standard, stating that "in order to impose liability for an open market transaction, the SEC must prove that but for the manipulative intent, the defendant would not have conducted the transaction."

The court then turned to the question of whether the SEC had proffered sufficient evidence of each of the defendants' manipulative intent to avoid summary judgment. The court allowed the case to proceed against the trader, relying primarily on his failure to offer an economically feasible explanation for the transactions in question. With respect to the broker, on the other hand, the court dismissed the SEC's complaint, noting that there was no evidence that the broker was explicitly instructed to drive up the relevant security's market price and that the trades themselves were not sufficiently suspicious to put the broker on notice that he was participating in a market manipulation scheme.

The court in 'Masri' framed the primary issue as: "[W]hether manipulative intent alone is enough to make open market transactions manipulative and in violation of the securities laws[?]" The court answered in the affirmative.

Conclusion

Masri could embolden private litigants, the SEC, and perhaps even the criminal authorities to pursue market manipulation investigations and litigations against professional investors simply because those investors have pursued trading strategies that have impacted the market price of a particular security. Even before *Masri* was decided, several companies had recently sued hedge funds based on allegations of illegal short-selling schemes designed to put downward pressure on the companies' stock prices. These cases have drawn media attention, which inevitably invites additional scrutiny from the SEC and white-collar prosecutors. The relaxed standard advocated by the SEC will also likely encourage certain members of the plaintiffs bar to file spurious lawsuits for the purpose of extracting "nuisance value" settlements because it will be significantly easier for such cases to survive pretrial motions.

'Masri' Lessons

Masri also provides a number of lessons on the best way to defend against open-market manipulation allegations.

- First, the issue of the appropriate standard in these types of cases is still an open question in the Second Circuit. Defense counsel should start by advocating the position that open-market transactions can never provide the basis for a market manipulation charge, even if there are allegations of manipulative intent.
- Second, even if other courts were to choose to follow the approach set forth in *Masri,* the "sole intent" standard can be an exacting one.

Counsel should explore with their clients whether there was any legitimate investment purpose behind the allegedly manipulative trades. Under the "sole intent" standard, proof of a legitimate investment purpose should go a long way towards defeating an open-market manipulation claim even if there is other evidence that suggests the trades were partially motivated by a desire to impact a security's market price. For the same reason, clients should be advised to document legitimate investment strategies whenever possible and to avoid overly colorful or inflammatory words or phrases when using mediums such as e-mail or instant messaging that might later be viewed as evidence of so-called "manipulative intent."

1. 523 F.Supp.2d 361 (SDNY 2007).
2. Market manipulation is also prohibited by §9 of the Exchange Act, but the SEC and private plaintiffs have historically relied upon this provision less frequently than §10(b) and Rule 10b-5 because, among other things, §9 is limited to schemes to manipulate securities that are listed on a national securities exchange such as the New York Stock Exchange. See 15 U.S.C. §78i(a). While §9(a)(1) prohibits certain specific types of manipulative transactions, such as wash sales and matched orders, §9(a)(2) contains more general language that arguably applies to a broader range of conduct. The elements of a §9(a)(2) manipulation claim have been described as requiring the plaintiff to prove the following: "(1) a series of transactions in a security creating actual or apparent trading in that security or raising or depressing the price of that security, (2) carried out with scienter and (3) for the purpose of inducing the security's purchase or sale by others." *SEC v. Malenfant,* 784 F.Supp. 141, 144 (SDNY 1992) (internal quotations and citations omitted). In private actions, §9 also requires the plaintiff to prove reliance. See *Ray v. Lehman Brothers Kuhn Loeb Inc.,* 624 F.Supp. 16, 19 (N.D. Ga. 1984). Section 9 is beyond the scope of this article.
3. See, e.g., *Santa Fe Indus. Inc. v. Green,* 430 U.S. 462, 476 (1977) (Market manipulation "refers generally to practices, such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."). A matched order is an "order to buy and sell the same security, at about the same time, in about the same quantity, and at about the same price" and a wash sale is a "sale of securities made at about the same time as a purchase of the same securities…resulting in no change of beneficial ownership." Black's Law Dictionary, 1124, 1339 (7th ed. 1999).
4. For example, the SEC has a long history of bringing enforcement actions involving allegations of "marking the close" or "repeatedly executing the last transaction of the day in a security in order to affect its closing price." *SEC v. Schiffer,* 1998 WL 226101, at *1 (SDNY May 5, 1998); See also *Masri,* 523 F.Supp.2d at 371 (discussing history of SEC administrative settlement orders involving allegations of marking the close).
5. 272 F.3d 189, 205 (3rd Cir. 2001).
6. 274 F.3d 525 (D.C. Cir. 2001).
7. *United States v. Mulheren,* 938 F.3d 364, 368 (2d Cir. 1991).
8. *Masri*, 523 F.Supp.2d at 370.

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