Explaining illegal market manipulation

On Monday, Burford Capital Limited (LON:BUR) said that last week's plunge in its share price was down to "illegal market manipulation".

Put simply, market manipulation (or abuse) is the act of intentionally trying to increase or decrease the value of a stock or influencing the behaviour of the market to do so.

This can take many forms, almost all of which are illegal and can result in hefty fines and criminal prosecution if discovered.

Spoofing and Layering

Spoofing is a type of market manipulation that involves a trader placing a large sell order just below the current offer price of the stock and then cancelling the order before it executes.

This process is then repeated over and over, driving down the price of the shares without any being sold.

A similar tactic is layering, which is when the sell order is placed just above the offer price. While these orders are almost certain not to execute, as it would involve buyers acquiring shares at more than the going rate, they can still affect the stock price at it suggests there are lots of shares for sale.

READ: Burford Capital adamant last week's share price plunge was down to 'illegal market manipulation'

It was these practices that Burford blamed for its woes last week, estimating that around £90mln in sell orders were placed and cancelled on 6 August, the day US hedge fund Muddy Waters criticised the firm in a tweet.

But while spoofing and layering are currently in the spotlight, they are merely two among multiple techniques used by unscrupulous traders to influence the price of a stock.

Washing and Churning

Two other methods of manipulation are the somewhat 'laundry-themed' practices of churning and wash trading.

Churning is when a trader will place both buy and sell orders for a stock at the same price in an attempt to increase (or 'churn') the trading volume, thereby making the stock more interesting to other investors.

Wash trading is also an attempt to create a façade of demand for a stock, although it involves selling and re-purchasing the security to generate activity without any shares changing hands.

An example of wash trading occurred in 2014, when the owner of US equity research firm Montgomery Street, Paul Pollack, was charged with using 'wash' trades to manipulate the price of a stock for which he was trying to solicit investors.
Cornering and raiding

Bear raiding and cornering the market are also somewhat similar examples of manipulation, although they approach from different ends of the buying and selling spectrum.

In a bear raid, traders will attempt to push down the price of a stock either through shorting or heavy selling.

Shorting, or short selling, is a legal technique where traders 'borrow' a stock and then sell it in the hopes that they can buy it back at a lower price and pocket the difference.

By contrast, cornering the market involves buying up enough of a stock to gain effective control of the supply, and thus being able to set the price.

'Painting the tape'

A slightly less direct form of manipulation, 'painting the tape', is when a group of traders create rumours or activities to drive up the price of a stock.

This involves trading the stock between themselves to create the impression of activity, similar to that of churning, in an attempt to lure in unsuspecting investors who may then boost the price higher.

'Painting the tape' usually occurs near the end of the trading day, as closing stock prices are widely reported in the press and watched by lots of investors, which can then lift the overall value of the company's shares and, by extension, the holdings of the manipulators.

The term harks back to the early 20th century when stock prices would be sent across telegraph lines and printed out on ticker tape.

Short & distort

A similar tactic to 'painting the tape', short & distort (S&D) is a type of illegal short selling when a trader will short a stock and then deliberately attempt to smear the target company in the hopes that other investors will sell their shares en masse, allowing the trader to make a profit on the short position.

The twin sister of S&D is 'pump and dump', a similar tactic which instead of attempting to drive down the price of a stock instead uses misleading information to inflate the price - pumping - before selling out - dumping.

Front-running

Front-running is a type of manipulation that involves a broker or other entity trading a stock with foreknowledge of a large, non-publicised transaction will take place and influence the price of the shares.

The practice also covers brokers executing trades before the public release of company news which could affect the share price or ahead of the broker themselves issuing a recommendation on the stock.

Front-running can also be considered a form of insider trading (see below) as it involves profiting off of information before it becomes public knowledge.

Insider trading

Perhaps the best-known form of market abuse, insider trading is when individuals trade stocks using confidential information about a company that is not available to the wider market.

For example, the chief executive of a firm will know the company's financial results before investors and could potentially buy or sell shares to benefit from the stock's price movement when the numbers are released.
Insider trading is not just limited to company executives or employees; friends, relatives or anyone else who could have access to the confidential information is liable if they are caught.

One of the most famous examples of insider trading is celebrity housewife Martha Stewart, who in 2004 was sentenced to five months in prison and fined US$30,000 after netting around US$250,000 from the sale of shares in biopharma firm ImClone shortly before the US Food and Drug Administration's rejection of one of its cancer drugs sent the stock price plunging from more than US$50 to US$10 in a matter of months.

Ironically, had Stewart held onto her shares for another four years, she would have earned US$60,000 more when ImClone was acquired by pharma giant Eli Lilly and Company (NYSE:LLY) for US$6.5bn.
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