10 June 2014 **MDP CIRCULAR 2014–07**

DISCIPLINARY MATTER – Merrill Lynch Equities (Australia) Limited

Merrill Lynch Equities (Australia) Limited ('Merrill Lynch') has paid a penalty of **$65,000** to comply with an infringement notice given to it by the Markets Disciplinary Panel ('MDP'). The penalty was for failing to prevent the entry into the ASX Trading Platform of an erroneous Order which resulted in a market for RIO Tinto Limited ordinary shares not being both fair and orderly.

Background and circumstances

Merrill Lynch is alleged to have contravened section 798H(1) of the *Corporations Act 2001* ('Corporations Act') by reason of contravening Rule 5.9.1 of the ASIC Market Integrity Rules (ASX Market) 2010 ('MIR 5.9.1').

MIR 5.9.1 provides:

> '*A Market Participant must not do anything which results in a market for a Product not being both fair and orderly, or fail to do anything where that failure has that effect.*'

On the evidence before it, the MDP was satisfied that:

1) On 8 August 2011, at approximately 11:24am, a Merrill Lynch Designated Trading Representative or DTR ('Merrill Lynch DTR') entered an Order into the ASX Trading Platform for the sale of 6,985 of a Tailor-Made Combination ('RIO TMC'), at a net price of one cent each ('Relevant Order'). The Relevant Order, in effect, comprised an instruction to:

    (a) sell 6,985 units being 698,500 ordinary shares in RIO Tinto Limited ACN 004 458 404 ('RIO'); and

    (b) buy 6,985 RIO $77.00 call option contracts that expired on 27 October 2011 ('RIOWV7').

2) The Relevant Order was erroneous in that the Merrill Lynch DTR had intended to enter an Order to sell one RIO TMC, comprising an instruction to sell one unit (comprising a sell of 100 RIO) and to buy one RIOWV7, at a net price of $69.85.

3) Immediately prior to the entry of the Relevant Order into the ASX Trading Platform, the market for RIO was as follows:

    (a) the Bid/ask/last traded price – $71.40/$71.41/$71.42; and

    (b) the Bid schedule for RIO contained Bids for a total of about 211,400 RIO at prices between $71.40 and $50.00.

4) The net price at which the Relevant Order was entered did not accurately reflect material information relevant to and genuine supply for, the relevant component product, RIO.

5) The Relevant Order resulted in the generation of derived Orders (‘RIO Sell Orders’) which were entered into the market for RIO at prices down to $1.43.

6) The Relevant Order executed on the ASX Trading Platform between approximately 11:24am and 11:26am as follows:

   (a) against opposing Orders for the RIO TMC in the Tailor-Made Combination (‘TMC’) market; and

   (b) by the matching of derived Orders, against opposing Orders in the markets for the components, RIO and RIOWV7.

7) The ASX trade matching engine (the algorithm used for the purpose of TMC Orders) facilitated the execution process by allowing for the entry of the Relevant Order, the creation of derived Orders and the subsequent matching events.

8) The execution of the Relevant Order resulted in 337 Market Transactions for the sale of a total of 561,700 RIO at prices from $71.40 to $1.43. The 337 Market Transactions comprised:

   (a) ten Market Transactions which executed in the TMC market for the sale of 150,000 RIO at prices from $36.44 to $26.63;

   (b) one hundred and sixty five Market Transactions for the sale of 141,000 RIO which executed in the market for RIO at prices from $71.40 to $70.20; and

   (c) one hundred and sixty two Market Transactions for the sale of 270,600 RIO which executed at prices from $1.91 to $1.43 through trading with Bids in the market for RIO, although not necessarily in price/time priority (‘Relevant Transactions’).

9) The contravention relates only to the Relevant Transactions (as defined in paragraph 8(c) above).

10) But for the entry of the Relevant Order, the RIO Sell Orders would not have been generated and would not have been able to trade in the market for RIO at prices between $1.91 and $1.43, as described above.

11) The execution of the Relevant Order resulted in a significant decrease in the price of RIO which did not accurately reflect material information relevant to the price of RIO in that:

   (a) the price of RIO decreased by $69.99 or 98 percent below the last price at which RIO had traded immediately prior to the entry of the Relevant Order; and

   (b) the market for RIO varied significantly having regard to the market for RIO which existed immediately before and after the Relevant Order.

12) The error was identified by Merrill Lynch’s trading desk and Merrill Lynch compliance monitoring. At approximately 11:36am, Merrill Lynch contacted ASX, advised that the Relevant Order had been entered in error and requested that the error be referred to the ASX Dispute Governors Committee (‘DGC’). The DGC subsequently convened and recommended that all Market Transactions in RIO at $64.35 or below be cancelled.

13) ASX directed the cancellation of all Market Transactions in RIO which had been executed between 11:24am and 11:27am, at or below $64.35. One hundred and seventy two of the 337 Market Transactions, including the 10 Market Transactions

executed against opposing Orders for RIO TMC and each of the 162 Relevant Transactions, were cancelled pursuant to ASX's direction. A further 28 Market Transactions for RIO, which executed at prices above $64.35, were cancelled with counterparty agreement.

By reason of Merrill Lynch's entry of the Relevant Order into the ASX Trading Platform on 8 August 2011, the MDP had reasonable grounds to believe that Merrill Lynch contravened MIR 5.9.1 and thereby contravened section 798H(1) of the Corporations Act which requires compliance with the market integrity rules.

Maximum pecuniary penalty that a Court could order

The maximum pecuniary penalty that a Court could order Merrill Lynch to pay for contravening section 798H(1) of the Corporations Act by reason of contravening MIR 5.9.1, is $1,000,000.

Pursuant to section 798K(2) of the Corporations Act, the maximum pecuniary penalty that may be imposed by the MDP and payable by Merrill Lynch under an infringement notice given for contravening section 798H(1) of the Act by reason of allegedly contravening MIR 5.9.1, is $600,000.

Penalty under the Infringement Notice

The penalty payable under the infringement notice for the alleged contravention of section 798H(1) of the Act and therefore the total penalty that Merrill Lynch must pay to the Commonwealth, is **<u>$65,000</u>**.

Relevant factors

In determining this matter and the appropriate pecuniary penalty to be applied, the MDP took into account all relevant guidance and noted in particular the following:

- MIR 5.9.1 is aimed at promoting confidence in the integrity of the market. Imposing a strict obligation on Market Participants not to do anything which results in a market for a Product not being both fair and orderly, is critical in maintaining the integrity of the market;
- The misconduct had the potential to cause widespread detriment, impact public confidence, and damage the reputation and integrity of the market, as the entry of the Relevant Order into the ASX Trading Platform caused the price of RIO to decrease from the last traded price of $71.42 to $1.43, being a $69.99 or 98% decrease in the price of RIO. In this regard, the MDP noted the market prominence of RIO, not only within the ASX Market, but also other secondary markets;
- The misconduct was inadvertent on the part of Merrill Lynch as the Merrill Lynch DTR failed to properly exercise his functions to the requisite high standard when he incorrectly transposed price and volume, before submitting the Relevant Order into the ASX Trading Platform;
- In this matter the Merrill Lynch DTR, after keying the Relevant Order into an ASX Trader Workstation did not receive any price variation warning messages or alerts prior to the Relevant Order being submitted into the ASX Trading Platform. Notwithstanding this, the MDP reiterated that an important aspect of the role of the DTR is to pay proper attention and diligence to prevent the entry of Orders into the Trading Platform that could result in a market that is not both fair and orderly. This is a critical measure in maintaining the integrity of a market;

- Merrill Lynch did not derive any actual or potential benefit from the breach, although the breach had the potential to cause detriment to counterparties whose transactions were cancelled;
- The breach was isolated;
- Merrill Lynch promptly identified the error and took action to remedy the breach, including following ASX Operating Rules Procedures to cancel the Relevant Transactions. As a result, the 162 Relevant Transactions were cancelled pursuant to ASX direction;
- Merrill Lynch took the following remedial measures to prevent recurrence of the breach:
    - stopped trading in stock/option TMCs until a review of the controls in place was undertaken;
    - undertook a review of the controls available on the ASX Trading Platform and other possible controls in relation to TMCs;
    - following the above review, an enhanced procedure for the placement of stock/option TMCs was implemented, requiring an additional level of oversight and approval;
    - provided training on the general market integrity rule obligations and specifically on the newly implemented procedure to all staff involved in the placement of TMCs; and
    - actively engaged with ASX in relation to enhancements to filter capabilities in relation to the placement of TMCs.
- Merrill Lynch had one prior contravention found against it by the MDP for non-compliance with the market integrity rules;
- Merrill Lynch had 10 disciplinary sanctions recorded against it by the ASX Disciplinary Tribunal since 2005. This included Merrill Lynch having previously been sanctioned by the ASX Disciplinary Tribunal regarding the predecessor rule to MIR 5.9.1 in ASX Circulars 446/10 – dated 9 December 2010 and 117/10 – dated 6 April 2010;
- The MDP had regard to Merrill Lynch's compliance history and noted that notwithstanding the inadvertent human error in this matter, it could not overlook that this followed a series of compliance failures. The MDP also noted its previous comments in MDP Infringement Notice No. MDP07/13 – dated 22 October 2013, '... that, repeat contraventions in similar or comparable matters will not be viewed favourably';
- Merrill Lynch co-operated with ASIC throughout its investigation and did not dispute any material facts; and
- Merrill Lynch agreed not to contest the matter, thereby saving time and costs that would otherwise have been expended.

The Markets Disciplinary Panel

The MDP is a peer review body that exercises ASIC's power to issue infringement n**o**tices and accept enforceable undertakings in relation to alleged breaches of the market integrity rules. The market integrity rules are made by ASIC and apply to market operators, market participants and prescribed entities under the Corporations Regulations 2001 (‘Regulations’).

Additional regulatory information

Pursuant to subparagraphs 7.2A.15(4)(b)(i) and (ii) of the Regulations, Merrill Lynch has complied with the infringement notice, such compliance is not an admission of guilt or liability, and Merrill Lynch is not taken to have contravened section 798H(1) of the Corporations Act.

Further information on market integrity infringement notices, the market integrity rules or the MDP is available in ASIC Regulatory Guide 216–*Markets Disciplinary Panel* and ASIC Regulatory Guide 225–*Markets Disciplinary Panel practices and procedures* or at http://www.asic.gov.au under ‘markets–supervision’, ‘markets–market integrity rules’ and ‘Markets Disciplinary Panel’.