



11 September 2014

MDP CIRCULAR 2014-11

DISCIPLINARY MATTER – Merrill Lynch Equities (Australia) Limited

Merrill Lynch Equities (Australia) Limited ("Merrill Lynch") has paid a total penalty of **\$96,000** to comply with an infringement notice given to it by the Markets Disciplinary Panel ("MDP"). The penalty was for:

- failing to have in place an appropriate automated price filter in relation to Automated Order Processing for one client account, which interfered with the efficiency and integrity of the ASX market; and
- failing to prevent the entry into the ASX Trading Platform of an erroneous Order which resulted in a market for Class A non-voting common stock in News Corporation Inc., not being both fair and orderly.

Background and circumstances

Merrill Lynch is alleged to have contravened subsection 798H(1) of the *Corporations Act 2001* ("Corporations Act") by reason of contravening Rules 5.6.1 and 5.9.1 of the ASIC Market Integrity Rules (ASX Market) 2010 ("MIR 5.6.1" and "MIR 5.9.1").

MIR 5.6.1 provides:

"A Trading Participant which uses its system for Automated Order Processing must at all times:

- (a) have appropriate automated filters, in relation to Automated Order Processing; and*
- (b) ensure that such use does not interfere with:*
 - (i) the efficiency and integrity of the Market; or*
 - (ii) the proper functioning of any Trading Platform."*

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 28 February 2012 at about 15:40:11, a Direct Market Access ("DMA") client of Merrill Lynch ("Client") entered an Order into Merrill Lynch's Automated Order Processing ("AOP") system to sell 49,000 Class A non-voting common stock in News Corporation Inc., having ASX code 'NWSLV', at a price of \$0.43 ("Initial Order"). The Initial Order comprised in part, an Order to sell 35,334 NWSLV at a price of \$0.43 ("Relevant Order").

- 2) Immediately prior to the entry of the Initial Order by the Client into Merrill Lynch's AOP system and before submission of the Relevant Order into the ASX Trading Platform, the market for NWSLV was as follows:
 - a single Bid for 150 NWSLV at \$17.98; and
 - the last traded price for NWSLV was \$17.96.
- 3) At about 15:40:11.219, the Relevant Order was submitted through Merrill Lynch's AOP system into the ASX Trading Platform without triggering an AOP filter (or automated filter) and; no internal warning messages were received by Merrill Lynch despite the Relevant Order being about 97.6% lower in price than the last traded price of \$17.96.
- 4) The Relevant Order traded with Bids in the market for NWSLV, as follows:
 - immediately traded in one Market Transaction for 150 NWSLV at \$17.98, leaving Merrill Lynch with a residual Relevant Order for 35,184 NWSLV at \$0.43; and
 - between 15:40:11.260 and 15:40:19.598, other participants entered Bids for NWSLV at \$0.43 that then traded with the residual Relevant Order and resulted in 13 Market Transactions for a total of 14,486 NWSLV at \$0.43 ("Relevant Transactions").
- 5) The Relevant Transactions resulted in a 97.6% decrease in the traded price of NWSLV.
- 6) Each of the Relevant Transactions fell within the Extreme Cancellation Range ("ECR") under procedure 3200 of the ASX Operating Rules Procedures ("Procedure 3200").
- 7) Merrill Lynch within about eight seconds after submission of the Relevant Order into the ASX Trading Platform identified the error and cancelled the residual or unfilled part of the Relevant Order for 20,698 NWSLV at \$0.43.
- 8) Merrill Lynch then contacted the ASX to facilitate cancellation of the Relevant Transactions under the ECR in accordance with Procedure 3200.
- 9) Between about 15:52:50 and 15:55:20, each of the Relevant Transactions was cancelled.
- 10) The Relevant Order was submitted into the ASX Trading Platform without triggering an AOP filter because:
 - In October 2011, Merrill Lynch upgraded its AOP system (supplied by a third party software vendor) to accommodate the introduction of market competition. As part of the upgrade, a bridge was used to transfer the DMA Order flow received for the Client's account from Merrill Lynch's previous AOP system to its upgraded AOP system ("Bridge").
 - In November 2011, the Client's DMA account was migrated from Merrill Lynch's previous AOP system to its upgraded AOP system:
 - although Merrill Lynch's previous AOP system contained an Order Range Percentage ("ORP") automated filter applicable to Orders entered by or on behalf of the Client's account, this filter did not behave as expected;
 - the ORP automated filter within Merrill Lynch's previous AOP system had limits set for both aggressive and passive Orders;
 - unknown to Merrill Lynch, the ORP automated filter when applied in its upgraded AOP system via the Bridge, acted only as a passive filter; and
 - as a result, no internal warning messages were received by Merrill Lynch through its AOP system on receipt of the Initial Order and before the submission of the Relevant Order into the ASX Trading Platform.

By reason of Merrill Lynch's entry of the Relevant Order into the ASX Trading Platform on 28 February 2012, the MDP had reasonable grounds to believe that Merrill Lynch contravened MIR 5.6.1 and MIR 5.9.1 and thereby contravened subsection 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 subsection 798H(1) of the Corporations Act:

- by reason of contravening MIR 5.6.1, is \$1,000,000;
- by reason of contravening MIR 5.9.1, is \$1,000,000;

Pursuant to subsection 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 subsection 798H(1) of the Corporations Act:

- by reason of allegedly contravening MIR 5.6.1, is \$600,000;
- by reason of allegedly contravening MIR 5.9.1, is \$600,000.

Penalty under the Infringement Notice

The penalties imposed by the MDP for each of the alleged contraventions of subsection 798H(1) of the Corporations Act were as follows:

- MIR 5.6.1 – \$70,000;
- MIR 5.9.1 – \$50,000.

However the MDP considered it appropriate in this matter to adjust the total sum of the separate penalties, as set out above, to ensure that the final penalty payable was just, and appropriate and not excessive, having regard to the totality of the conduct, and other relevant factors. In doing so, the MDP had regard to paragraphs RG 216.125 and RG 216.126 of ASIC Regulatory Guide 216–*Markets Disciplinary Panel* ("RG 216") and applied the 'totality principle' in arriving at the appropriate pecuniary penalty to apply in this matter.

On this basis, and in accordance with subparagraphs 7.2A.06(g)(i) and (ii), and subregulation 7.2A.07(2), of the Regulations, for the alleged contraventions of subsection 798H(1) of the Corporations Act, the MDP imposed a total pecuniary penalty of \$96,000.00, as follows:

- MIR 5.6.1 – \$56,000;
- MIR 5.9.1 – \$40,000.

Therefore, the total penalty that Merrill Lynch must pay to the Commonwealth is **\$96,000**, being the penalty payable under the infringement notice for the alleged contraventions of subsection 798H(1) of the Corporations Act.

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 5.6.1 is aimed at promoting confidence in the integrity of the market. Imposing a strict obligation on Trading Participants which use their systems for AOP to at all times have appropriate automated filters and ensure that such use does not interfere with the efficiency and integrity of the Market or the proper functioning of the Trading Platform, is critical in maintaining the integrity of the market;

- Appropriate automated filters are essential components of AOP systems used by DMA clients of Trading Participants. Appropriate automated filters are in place to ensure Orders are submitted into the Trading Platform without interfering with the efficiency and integrity of the Market or the proper functioning of the Trading Platform;
- Merrill Lynch failed to ensure that at all times its AOP system had in place an appropriate automated price filter, and failed to ensure that the automated price filter functioned as expected for the Client's account. These failures had the potential to undermine public confidence in the integrity of the market;
- MIR 5.9.1 is similarly 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 also critical in maintaining the integrity of the market;
- The misconduct had the potential to damage the reputation and integrity of the market, as the submission of the Relevant Order into the ASX Trading Platform caused the price of NWSLV to decrease from the last traded price of \$17.96 to \$0.43, being a decrease of about 97.6%;
- The breaches were of a serious nature and had the potential to undermine confidence in the market;
- While there were two breaches of the market integrity rules, being one breach of MIR 5.6.1 and one breach of MIR 5.9.1, both breaches arose from a single source of conduct;
- The misconduct was negligent as Merrill Lynch failed to ensure that at all times its AOP system had in place an appropriate automated price filter in relation to the Client's account;
- Merrill Lynch had a significant history of non-compliance with both the ASX Market Rules and the market integrity rules. Merrill Lynch had previously been sanctioned by the ASX Disciplinary Tribunal on 10 occasions since 2005. Two of these previous matters involved five comparative MIR 5.9.1 contraventions. Merrill Lynch had one prior AOP contravention found against it by the MDP in Infringement Notice - MDP 02/13 dated 31 May 2013, relating to Rule 5.6.3(a) of the ASIC Market Integrity Rules (ASX Market) 2010. The MDP reiterated that any future, repeat contraventions in similar or comparable matters would not be viewed favourably;
- Merrill Lynch took action as soon as the breach was detected in accordance with relevant ASX Operating Rules Procedures to facilitate cancellation of the Relevant Transactions by the ASX;
- Merrill Lynch took the following steps to prevent recurrence of the breaches:
 - conducted a manual review of automated filters across its AOP system;
 - established an enhanced process for limit changes to automated filters, including a 'four-eyes' principle and a requirement for all changes to be approved by the Global Markets Chief Operating Officer;
 - developed an extensive automated formal 'user acceptance testing' protocol that applies to AOP system changes, including the upgraded AOP system in question;
 - implemented an automated daily review comparing filter settings on trade day ("T") with those on T+1, with discrepancies and exceptions escalated to Merrill Lynch management and compliance; and

- introduced 'rule-based' verification with exceptions escalated to Merrill Lynch management and compliance;
- 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 notices 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 subsection 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".