Markets Disciplinary Panel

2 September 2016 **MDP CIRCULAR 2016–05**

DISCIPLINARY MATTER – Commonwealth Securities Limited

Commonwealth Securities Limited ("CommSec") has paid a total penalty of **$400,000** to comply with an infringement notice given to it by the Markets Disciplinary Panel ("MDP"). The penalty was for CommSec:

- failing to issue confirmations to Clients which included the necessary Principal disclosure, on three separate occasions; and
- failing to issue confirmations to Clients which included the necessary Crossing disclosure, on five separate occasions.

Background and circumstances

CommSec was alleged to have contravened subsection 798H(1) of the *Corporations Act 2001* ("Corporations Act") on eight separate occasions by reason of contravening Rules 3.2.3 and 3.4.1(3)(f) of the ASIC Market Integrity Rules (ASX Market) 2010 ("ASX MIR 3.2.3" and "ASX MIR 3.4.1(3)(f)"), and Rule 3.4.1(3)(f) of the ASIC Market Integrity Rules (Chi-X Australia Market) 2011 ("Chi-X MIR 3.4.1(3)(f)")..

ASX MIR 3.2.3 provides:

> "*When a Market Participant enters into a Market Transaction with a person (the "Client") as Principal, the confirmation issued by the Market Participant to the Client under Rule 3.4.1 in respect of that Market Transaction must state that the Market Participant entered into the transaction as Principal and not as agent.*"

ASX MIR 3.4.1(3)(f) and Chi-X MIR 3.4.1(3)(f) provide:

> "*(1) Subject to Rule 3.4.3, a Market Participant must give a confirmation to a person (the "Client") in respect of each Market Transaction entered into on the Client's instructions or on the Client's Managed Discretionary Account.*
>
> …
>
> *(3) The confirmation must meet the following requirements:*
>
> > *...*
> >
> > *(f) where the Market Transaction involved a Crossing, the confirmation must include a statement to that effect;*"

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

ASX MIR 3.4.1(3)(f): Reporting to Clients - Confirmations - Form and Timing

1) Between 1 August 2010 and 13 February 2014 inclusive, CommSec entered into Market Transactions on the ASX Market on behalf of retail clients, including persons who were retail clients of a New Zealand-based financial services company ("NZ Intermediary")

("Retail Clients"). CommSec subsequently issued 111,100 confirmations to Retail Clients, whose Orders were executed as Crossings, which did not include a statement that the Market Transactions had involved a Crossing ("Crossing Disclosure"), as described further below.

Contravention 1 – NZ Intermediary Crossing Issue

2) Between 1 August 2010 and 13 February 2014, CommSec issued 6,579 confirmations to the Retail Clients which failed to contain Crossing Disclosure.

3) CommSec became aware of its failure to include such disclosure on 14 February 2013 during a scheduled compliance review and notified ASIC on 12 June 2013. The cause of the confirmations not containing Crossing Disclosure and Principal Disclosure was different fields being used by CommSec's systems and the NZ Intermediary's systems to identify Crossings and Principal transactions for the purposes of marking confirmations. Initial fixes implemented by CommSec to address the issue were not effective. The issue was resolved by CommSec implementing changes to its system on 13 February 2014.

4) By reason of CommSec's failure to issue 6,579 confirmations to Retail Clients between 1 August 2010 and 13 February 2014 which included the necessary Crossing Disclosure, the MDP had reasonable grounds to believe that CommSec had contravened ASX MIR 3.4.1(3)(f) and thereby contravened subsection 798H(1) of the Corporations Act.

Contravention 2 – Condition Code Crossing Issue

5) Between 1 August 2011 and 9 October 2012, CommSec issued 56,522 confirmations to its Retail Clients which failed to contain Crossing Disclosure.

6) CommSec became aware of its failure to include such disclosures on 26 September 2012 during the course of completing a compliance review of confirmations, and notified ASIC on 20 March 2013. The failure to include Crossing Disclosure on 56,522 of the 102,753 confirmations was due to the CommSec system used to produce confirmations not being able to interpret all of the different condition codes relating to Crossings. On 10 October 2012, CommSec implemented a code change to correctly interpret all relevant condition codes and rectify its error and CommSec notified ASIC on 20 March 2013.

7) By reason of CommSec's failure to issue 56,522 confirmations to Retail Clients between 1 August 2011 and 9 October 2012, which included the necessary Crossing Disclosure, the MDP had reasonable grounds to believe that CommSec had contravened ASX MIR 3.4.1(3)(f) and thereby contravened subsection 798H(1) of the Corporations Act.

Contravention 3 - Configurations Flag Crossing Issue

8) Between 15 August 2011 and 9 October 2012, CommSec issued 46,231 confirmations to its Retail Clients, which failed to contain Crossing Disclosure.

9) CommSec became aware of its failure to include such disclosures on 10 October 2012. The failure to include the Crossing Disclosure on 46,231 confirmations was caused by a configuration flag within CommSec's settlement system not being turned on. These issues were resolved by CommSec implementing a code change and turning on the configuration flag on 10 October 2012.

10) By reason of CommSec's failure to issue 46,231 confirmations to Retail Clients between 15 August 2011 and 9 October 2012, which included the necessary Crossing Disclosure, the MDP had reasonable grounds to believe that CommSec had contravened ASX MIR 3.4.1(3)(f) and thereby contravened subsection 798H(1) of the Corporations Act.

Contravention 4 - System Change Crossing Issue

11) Between 17 October 2011 and 18 December 2013, CommSec issued 1,768 confirmations to its Retail Clients in relation to Market Transactions in Option Market Contracts which failed to contain Crossing Disclosure.

12) CommSec became aware of its failure to include the disclosure on 16 December 2013 after conducting a check of confirmations involving Option Market Contracts and notified ASIC on 10 January 2014. The cause of the confirmations not containing Crossing Disclosure was a system platform change for the settlement of Options Market Contracts implemented by CommSec on 17 October 2011. The new system contained an incorrect data field, as a result of which it was unable to correctly identify that a Crossing had taken place. The issue was resolved by CommSec implementing a fix on 18 January 2014 to the system coding.

13) By reason of CommSec's failure to issue 1,768 confirmations to Retail Clients between 17 October 2011 and 18 December 2013, which included the necessary Crossing Disclosure, the MDP had reasonable grounds to believe that CommSec had contravened ASX MIR 3.4.1(3)(f) and thereby contravened subsection 798H(1) of the Corporations Act.

ASX MIR 3.2.3: Trading as Principal - Confirmation must include disclosure

14) In addition, in the period between 16 May 2011 to 13 February 2014, CommSec issued 50,484 confirmations to Retail Clients for transactions where CommSec had entered into the Market Transaction as Principal, which did not contain a statement disclosing this ("Principal Disclosure"), as described further below.

Contravention 5 – NZ Intermediary Principal Issue

15) Between 16 May 2011 and 13 February 2014, CommSec issued 3,949 confirmations to its Retail Clients, which failed to contain Principal Disclosure.

16) CommSec became aware of its failure to include the disclosure on 14 February 2013 during analysis conducted for a Compliance review. Between 1 August 2010 and 27 May 2013, CommSec's system was not compatible with the NZ Intermediary's system, which used different fields to identify Principal transactions for the purposes of marking confirmations. This issue affected the 3,949 confirmations between 16 May 2011 and 27 May 2013.

17) By reason of CommSec's failure to issue 3,949 confirmations to Retail Clients between 16 May 2011 and 13 February 2014 which included the necessary Principal Disclosure, the MDP had reasonable grounds to believe that CommSec had contravened ASX MIR 3.2.3 and thereby contravened subsection 798H(1) of the Corporations Act.

Contravention 6 – Configurations Flag Principal Issue

18) Between 15 August 2011 and 9 October 2012, CommSec issued 46,231 confirmations to its Retail Clients, which failed to contain Principal Disclosure.

19) CommSec became aware of its failure to include such disclosures on 10 October 2012. The failure to include the Principal Disclosure on 46,231 confirmations was caused by a configuration flag within CommSec's settlement system not being turned on. These issues were resolved by CommSec implementing a code change and turning on the configuration flag on 10 October 2012.

20) By reason of CommSec's failure to issue 46,231 confirmations to Retail Clients between 15 August 2011 and 9 October 2012, which included the necessary Principal Disclosure, the MDP had reasonable grounds to believe that CommSec had contravened ASX MIR 3.2.3 and thereby contravened subsection 798H(1) of the Corporations Act.

Contravention 7 – Operator Reference Principal Issue

21) Between 26 February 2013 and 6 March 2013, CommSec issued 304 confirmations to its Retail Clients which failed to contain Principal Disclosure.

22) CommSec became aware of its failure to include the disclosure on 5 March 2013. The cause of the confirmations not containing Principal Disclosure was commencement of the use of five new operator references in CommSec's booking system which did not contain the phrase "CST", being the phrase typically used by CommSec to indicate when a related entity was the originator of any Orders. Following the close of trading on 6 March 2013, CommSec made sure that the five new operator references could no longer be entered for Market Transactions where Retail Clients were on the opposite side of the transaction. Further, on 19 March 2013 the number of operator references recognisable as being Principal Orders by CommSec's settlements system was expanded. CommSec also strengthened the governance process around the creation of new operator references for Orders from its related entity. CommSec notified the matter to ASIC on 3 April 2013.

23) By reason of CommSec's failure to issue 304 confirmations to Retail Clients between 26 February 2013 and 6 March 2013 which included the necessary Principal Disclosure, the MDP had reasonable grounds to believe that CommSec had contravened ASX MIR 3.2.3 and thereby contravened subsection 798H(1) of the Corporations Act.

Chi-X MIR 3.4.1(3)(f): Reporting to Clients - Confirmations - Form and Timing

Contravention 8 – Participant Identifier Issue

24) Between 15 March 2012 and 26 April 2013 inclusive, CommSec executed Market Transactions on the Chi-X Market on behalf of Retail Clients. CommSec subsequently issued 3,741 confirmations to Retail Clients whose Orders were executed as Crossings during that period which did not contain a Crossing Disclosure.

25) CommSec became aware of this failure on 19 February 2013. The cause of the confirmations not containing Crossing Disclosure was that CommSec's retail and institutional participant identifier numbers, which are used in the process of settling Market Transactions, were treated as two separate participants by Chi-X Australia's systems. On 26 April 2013, Chi-X Australia implemented an automated fix to its system so that Crossings executed by CommSec between its retail and institutional businesses would be recognised as Crossings between a common Market Participant. CommSec notified the matter to ASIC on 12 June 2013.

26) By reason of CommSec's failure to issue 3,741 confirmations to Retail Clients between 15 March 2012 and 26 April 2013, which included the necessary Crossing Disclosure with respect to the relevant Market Transactions executed on the Chi-X Market, the MDP had reasonable grounds to believe that CommSec had contravened Chi-X MIR 3.4.1(3)(f) and thereby contravened subsection 798H(1) of the Corporations Act.

Maximum pecuniary penalty that a Court could order

The maximum pecuniary penalty that a Court could order CommSec to pay for contravening subsection 798H(1) of the Corporations Act:

- by reason of contravening ASX MIR 3.2.3 is $100,000;
- by reason of contravening ASX MIR 3.4.1(3)(f) is $100,000;
- by reason of contravening Chi-X MIR 3.4.1(3)(f) is $100,000.

Pursuant to subsection 798K(2) of the Corporations Act, the maximum pecuniary penalty that may be imposed by the MDP and payable by CommSec under an infringement notice given for contravening subsection 798H(1) of the Corporations Act:

- by reason of allegedly contravening ASX MIR 3.2.3 is $60,000;
- by reason of allegedly contravening ASX MIR 3.4.1(3)(f) is $60,000;
- by reason of allegedly contravening Chi-X MIR 3.4.1(3)(f) is $60,000.

Penalty under the Infringement Notice

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

- Contravention 1 – ASX MIR 3.4.1(3)(f) – $55,000;
- Contravention 2 – ASX MIR 3.1.4(3)(f) – $55,000;
- Contravention 3 – ASX MIR 3.1.4(3)(f) – $55,000;
- Contravention 4 – ASX MIR 3.1.4(3)(f) – $55,000;
- Contravention 5 – ASX MIR 3.2.3 – $55,000;
- Contravention 6 – ASX MIR 3.2.3 – $55,000;
- Contravention 7 – ASX MIR 3.2.3 – $55,000;
- Contravention 8 – Chi-X MIR 3.4.1(3)(f) – $60,000.

However, the MDP considered it appropriate in this matter, to make an adjustment to the total sum of the separate penalties 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 paragraph 7.2A.07(2) of the Regulations, for the eight alleged contraventions of subsection 798H(1) of the Corporations Act, the MDP imposed a total pecuniary penalty of $400,000 comprised as follows:

- Contravention 1 – ASX MIR 3.4.1(3)(f) – $49,375;
- Contravention 2 – ASX MIR 3.1.4(3)(f) – $49,375;
- Contravention 3 – ASX MIR 3.1.4(3)(f) – $49,375;
- Contravention 4 – ASX MIR 3.1.4(3)(f) – $49,375;
- Contravention 5 – ASX MIR 3.2.3 – $49,375;
- Contravention 6 – ASX MIR 3.2.3 – $49,375;
- Contravention 7 – ASX MIR 3.2.3 – $49,375;
- Contravention 8 – Chi-X MIR 3.4.1(3)(f) – $54,375.

The total penalty payable under the infringement notice for the eight alleged contraventions of subsection 798H(1) of the Corporations Act and therefore the penalty that CommSec paid to the Commonwealth, was **$400,000**.

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:

27) That the remedies applied should:

- promote market integrity and the confident and informed participant of investors in financial markets; and
- act as a deterrent to any future misconduct by the subject person; and
- also act as a general deterrent to others from engaging in the same or similar conduct.

28) Transparency through disclosure is a fundamental aspect of ensuring the fair and efficient functioning of Australia's financial markets. Proper disclosure is essential to empowering investors to make confident, informed investment decisions which are themselves a necessary contributing factor to maintaining fair and efficient markets;

29) Any failure to comply with the standard of disclosure is serious and causes, or at least gives rise to the potential for, the interests of clients and the integrity of, and public confidence in, the market to be adversely affected;

30) Each of the contraventions of ASX MIR 3.4.1, ASX MIR 3.2.3 and Chi-X MIR 3.4.1 constituted negligent misconduct on the part of CommSec, in the MDP's view, due to its failure to ensure that confirmations had the appropriate disclosures;

31) It is a Market Participant's responsibility to ensure that its confirmations have the appropriate disclosures, and to that end that its systems are able to correctly identify transactions for the purpose of marking confirmations with the requisite disclosures under the market integrity rules;

32) ASX MIR 3.4.1, ASX MIR 3.2.3 and Chi-X MIR 3.4.1 are directed at the timely sending of confirmations with all mandatory disclosure to retail clients to ensure client protection and also in order to protect the integrity of the market. The rules also provide safeguards against possible unauthorised trading activity (including potential fraudulent activity). Without such safeguards, clients are unable to identify, for example, unauthorised transactions in a timely manner. For these reasons, the disclosure requirements are accepted as essential, standard practice by the market, in the MDP's view;

33) The disclosure requirements apply to every Market Transaction that is entered into on behalf of a retail client. A retail client cannot opt out of receiving such disclosure nor can a Market Participant elect to not provide all relevant disclosure;

34) Generally, a confirmation will be timely where despatched to a client on the day on which the Market Transaction is executed;

35) Furthermore, the rules are intended to ensure that a client is notified in a timely manner of a potential conflict of interest where a Market Participant is executing trades in a Crossing on both sides for its respective clients or when trading as Principal, because this allows clients to make an informed decision about how the potential conflict may affect their financial interests;

36) Market Participants need to manage conflicts between the interests of clients as well as conflict between the licensee's own interests and those of their clients. ASIC Regulatory Guide 181–*Licensing: Managing conflicts of interest* ("RG 181") sets out at RG 181.27 that "…the conflicts management obligation requires that all conflicts of interests be adequately managed. Many conflicts of interest can be managed by a combination of (a) internal controls and (b) disclosures." RG 181.34 then states that for conflicts management arrangements to be adequate, they must be "…regularly reviewed (internally or by a third party such as an auditor, where appropriate) and, where necessary, updated to ensure that the arrangements are adequate to identify, assess, and evaluate and successfully control conflicts of interest…";

37) The non-disclosures affected large numbers of confirmations and Retail Clients and occurred for a period of approximately:

- three and a half years for Contravention 1;
- one year for Contravention 2;
- one year for Contravention 3;
- two years for Contravention 4;
- three years for Contravention 5;
- one year for Contravention 6;
- one week for Contravention 7; and
- one year for Contravention 8.

38) This is despite the requirement that Market Participants must send a client a confirmation as soon as practicable after the Market Participant enters into the Market Transaction. The MDP viewed these periods of time in which the contraventions occurred and the time taken for detection of the contraventions to be significant and completely unacceptable. Upon detection of one contravention, CommSec should have undertaken an extensive system review that may have alerted them to the presence of other contraventions;

39) The contraventions resulted from multiple, overlapping, systemic issues and poor internal procedures within CommSec for ensuring compliance with the relevant market integrity rules and to detect any breaches and remedy them promptly, which was of considerable concern to the MDP;

40) While the MDP had regard to CommSec's determination that the breach was not significant such as to require notification to ASIC pursuant to section 912D of the Act, it also noted that CommSec's Auditors considered the breach to be significant and reported it to ASIC pursuant to section 311 of the Act;

41) This is the fifth occasion on which the MDP has found that CommSec has not complied with the market integrity rules. Since 2008, CommSec has also been sanctioned on three occasions by the ASX Disciplinary Tribunal for non-compliance with the ASX Market Rules and on one occasion before ASX Compliance for non-compliance with the ASX Settlement Operating Rules;

42) ASIC also accepted an enforceable undertaking from CommSec on 17 December 2013 which related to concerns that ASIC held that CommSec may not have complied with its obligations in relation to the handling of client money under the Act. This enforceable undertaking was varied on 2 February 2015, to require CommSec to engage an independent expert to undertake ongoing reviews and provide monthly reports on the progress on a remediation plan developed under the original undertaking;

43) CommSec has undertaken significant remediation, including the implementation of improved governance processes, increased monitoring, and additional process controls in relation to confirmations;

44) Following discussions with ASIC in November 2014, CommSec agreed to voluntarily refund the portion of brokerage charged where CommSec was buying or selling for a related entity and the confirmation did not contain Principal Disclosure. Between 16 December 2014 and 10 March 2015, CommSec voluntarily refunded approximately $1.1 million in brokerage to over 25,000 customers;

45) CommSec also agreed to voluntarily notify all clients about the lack of disclosure on the affected confirmations. Between 17 November 2014 and 10 March 2015, CommSec

contacted 48,205 affected customers to notify them of the lack of disclosure and to provide corrective disclosure;

46) CommSec did not gain any benefit as a result of the contraventions;

47) CommSec co-operated with ASIC throughout its investigation and did not dispute any material facts; and

48) CommSec 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, CommSec has complied with the infringement notice, such compliance is not an admission of guilt or liability, and CommSec 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".