



Participant Circular

Date: 16 December 2002

Key topics

1. AOT Securities Pty Limited

Reading List

Compliance Managers
Client Advisers (Brokers)
DTR Operators.
Managing Directors.
Office Managers
Operations Managers (back office)

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DISCIPLINARY MATTERS

Following the conclusion of an appeal to the Australian Stock Exchange Limited's Appeal Tribunal ("Appeal Tribunal") from a determination of the National Adjudicatory Tribunal ("NAT"), AOT Securities Pty Limited ("AOT Securities") has been fined a total of \$100,000 (plus GST) in relation to breaches of ASX Business Rules 2.2.2(1)(a), 2.2.2(1)(b) and 2.2.2(5) on 29 June 2001.

Background:

1. SEATS (Stock Exchange Automated Trading System) is used to trade shares, warrants and other securities. Each trading day, the market goes through a number of different phases. At 16:00.00 SEATS enters the Pre-Open phase. During this phase Trading Participants may enter orders on SEATS, however these orders do not trade and are instead queued according to price-time priority for execution during the Closing Single Price Auction (CSPA), which ordinarily takes place between 16:05.00 and 16:06.00.
2. The SPI 200 futures contract, which is traded on the Sydney Futures Exchange, is an index futures contract which tracks the movement of the S&P/ASX 200 index. Until 29 June 2001, the SPI 200 futures contract expired on the last business day of the quarter and was settled at the official closing price of the S&P/ASX 200 Index (which was established by the CSPA).
3. Stock index arbitrage is a legitimate commercial activity. It is a form of trading by which a trader seeks to profit from pricing differences between an index futures contract and the underlying equities index by either buying or selling the securities making up the index and simultaneously taking the opposite position in the futures market. Depending on movements in the difference between the futures contract price and the underlying index price, an Index Arbitrageur will seek to secure an arbitrage profit by closing out its futures and securities positions at the same time. In order to achieve volume and price convergence an arbitrageur closing out a futures position on expiry will often buy or sell large volumes of stock on or about the close of trading on the day of expiry. In these circumstances stocks may be bought or sold in configurations of stocks (bid baskets or ask baskets) which the arbitrageur has calculated to replicate the behaviour of the futures contract which the stocks are intended to replace. As a consequence and prior to 29 June 2001, higher volumes of securities may have been traded on ASX on the expiry dates of the SPI 200 futures contract.

4. The June 2001 SPI 200 futures contracts were due to expire on 29 June 2001. On this day, ASX extended the period of the Pre-Open phase by 10 minutes to accommodate the impact on trading expected as a result of the June SPI 200 contract expiry and consequently the CSPA would occur at a random time between 16:15.00 and 16:16.00 on that day. All Trading Participants were also required, for the first time, to disclose the volume of all Bids and Asks entered into SEATS during the Pre-Open phase.

Circumstances of the Breaches:

5. AOT Securities undertakes Automated Order Processing in accordance with ASX Business Rule 2.2.2(1). AOT Securities uses a range of filters which include a price steps filter to prevent, without further manual intervention, orders received via its Automated Order Processing system reaching SEATS where they are entered more than a certain number of steps above or below the best opposing Bid or Ask for a particular security.
6. At 11:14 on 29 June 2001, AOT Securities sent an e-mail to a client ("the Client") informing it that AOT Securities would disable its price steps filter for the Client before 16:00.00 that day. AOT Securities contended that it proposed this action because the price steps filter was not appropriate during the Pre-Open phase when there was often a large Bid/Ask overlap. AOT Securities did not inform ASX of its intention to disable its price steps filter. Before the NAT, AOT Securities asserted that the disabling of that price steps filter in the circumstances was not a material change to its Automated Processing arrangements. The Client was the main client of AOT Securities, accounting for, at that time, around 98 % of AOT Securities' trading (by value) on a historical basis and close to 100% of its trading on 29 June 2001.
7. At, or very shortly before, 16:00.00 on 29 June 2001, AOT Securities disabled its price steps filter for the Client and put in place what it called "manual override" arrangements (including having 5 Designated Trading Representatives on hand) to manually monitor the orders placed by the Client after they entered SEATS but before they were executed in the CSPA. The price steps filter remained disabled in respect of all orders placed by the Client during the Pre-Open phase in SEATS, prior to the CSPA. AOT Securities did not have any prior notice of the particular orders placed by the Client on 29 June 2001. However, it suspected that the Client would place large orders on that date in connection with the unwind of a large index arbitrage position.
8. Between 15:59:25 to 15:59:37, the Client used AOT Securities' Automated Order Processing system to enter Bids into SEATS for 122 securities with a total value of \$470,469,848.87 ("the First Bid Basket"). 14 of these Bids were executed by 16.00.00.
9. Between 16:14.24 and 16:14.31, during the Pre-Open phase, the Client used AOT Securities' Automated Order Processing system to enter Bids into SEATS for 123 securities with a total value of \$468,321,401.23 ("the Second Bid Basket").
10. On 29 June 2001, the actual time of commencement for the CSPA was 16:15.00. This occurred only 29 seconds after the last of the Bids in the Second Bid Basket was placed by the Client directly into SEATS. By 16:15.01, 98% of the Bids in the Second Bid Basket had been executed on SEATS, in addition to 3 orders placed in the First Bid Basket, resulting in individual stock orders being executed by AOT Securities during the CSPA on that day, at a value of \$447,966,109.34
11. AOT Securities disabled its price steps filter to advance the commercial interests of its Client. The Bids in the Second Bid Basket were entered by the Client at prices between 2% and 21% above the last sale price for each security. This was a result of the large Bid/Ask overlaps which arose during the Pre-Open phase in almost all of the stocks in the second Bid Basket.
12. AOT Securities did not review all of the orders in the Second Bid Basket before they were entered in the Pre-Open phase and executed during the CSPA. AOT Securities only checked between 20 and 30 securities in the time before the CSPA commenced. Based on its understanding as to how arbitrage baskets were constructed by the computer systems used by the Client, AOT Securities formed the view that it was not necessary for AOT Securities to review all of the orders in the Second Bid Basket to conclude that the

basket as a whole was a legitimate and proper order to unwind an index arbitrage position. AOT Securities incorrectly believed it was open to it under the Business Rules to review the basket of orders as a single composite order in these circumstances.

13. The orders placed by AOT Securities on behalf of the Client contributed to an increase in the S&P/ASX 200 Index from 3444.6 to 3490.3, an increase of 45.7 points (or 1.3%) between 16:00 and 16:15 on 29 June 2001. There was no allegation of manipulative trading against AOT Securities.

Tribunal Findings:

1. That AOT Securities had breached:

(i) ASX Business Rule 2.2.2(1)(a) in that it failed to comply with the Operational Requirements, including having appropriate automated filters in relation to its Automated Order Processing.

NAT made the following findings:

- (a) AOT Securities disabled its price steps filter for the Client shortly before 16:00 on 29 June 2001;
- (b) AOT Securities could not and did not properly review the orders in the Second Bid Basket before these orders were executed on SEATS during the CSPA;
- (c) AOT Securities did not have in place, appropriate arrangements to adequately control the orders that the Client placed through its Automated Order Processing system on 29 June 2001.

AOT Securities did not contest this breach before NAT. NAT imposed a fine of \$ 20,000 (plus GST) with respect to this breach. AOT Securities appealed items (b) and (c) of Nat's findings but was not successful in that appeal (see (ii) below).

(ii) ASX Business Rule 2.2.2(1)(b) in that it failed to ensure that its Automated Order Processing did not interfere with the efficiency and integrity of the markets conducted by the Exchange.

NAT made the following findings:

- (a) All that is required to make out a breach of the Rule, is a failure to take reasonable steps to ensure that its Automated Order Processing does not interfere with the efficiency and integrity of the market;
- (b) In any event, the conduct of AOT Securities did cause actual interference with the market in relation to the closing prices of two securities on 29 June 2001;
- (c) By turning off the filter, AOT Securities permitted the Client to put through a basket of transactions in the CSPA, which might otherwise have been screened out or held up in the interests of the efficiency and integrity of the market;
- (d) If a Trading Participant, such as AOT, unilaterally decides to turn off its price steps filter, then it has the onus of establishing that it nonetheless ensured that its Automated Order Processing did not interfere with the efficiency and integrity of the market. The "manual override" arrangements used by AOT Securities were not sufficient to ensure that there was no interference with the efficiency and integrity of the market;
- (e) AOT Securities did not satisfy the Tribunal that it took reasonable steps to ensure that its Automated Order Processing did not interfere with the efficiency and integrity of the markets.

AOT Securities contested this breach before the NAT and appealed items (a)- (e) of the NAT's findings. AOT Securities was successful in its appeal in respect of item (b) but was not successful in that appeal in respect of items (a) and (c)-(e). The Appeal Tribunal made the following observations:

- (a) AOT Securities took its decision on 29 June (to disable its price steps filter) with knowledge of the ASX Business Rules and of the difficulties encountered in executing arbitrage strategies at the expiry of a futures contract period;
- (b) The phrase in Rule 2.2.2(1)(b) "*efficiency and integrity of the markets*" is used in a number of places in the Rules and should be given a broad meaning;
- (c) It is apparent from Rules 2.2.1(5), 2.2.2(4), 2.2.2(5), 2.2.2(7), 2.2.3 and 2.2.4 and the applicable Guidance Notes issued by ASX that Rule 2.2.2(1)(b) has an important preventive purpose to ensure that certain things do not happen. An obligation to "*at all times ...ensure*" is an obligation to take steps to achieve or prevent an occurrence. The steps must be sufficient to prevent the likelihood of the occurrence. That obligation will be breached if appropriate steps have not been taken. It is not necessary to wait until the occurrence has occurred, in this case interference with the efficiency and integrity of the markets conducted by the Exchange, before finding a breach of the obligation;
- (d) The focus of Rule 2.2.2(1)(b) is on the positive obligation to "*ensure*" rather than on the "*interference*" which the performance of the obligation is intended to prevent;
- (e) The concept of the "*integrity*" of the market includes the harmonious operation of the whole of the system for regulation of the market by supervision of the conduct of Trading Participants in the market. That system of regulation is constituted by the Rules. The conduct of AOT Securities in disabling its price steps filter and allowing its Automated Order Processing system to be utilized to execute 126 individual stock orders on SEATS at a value of \$447,996,109 without such a filter, interfered with the integrity of the market in this sense. It impaired and diminished the system of regulation of the conduct of Trading Participants in the market, at least as far as AOT Securities was itself concerned. That system involves a series of obligations in relation to Automated Order Processing designed to operate in a preventive fashion. Those obligations involve scrutiny and control over orders placed by clients before they are accepted for submission into SEATS by the Trading Participant.
- (f) AOT Securities could not and did not properly review the orders in the Second Bid Basket before they were executed on SEATS. It seemed to have recognized the seriousness of its decision to disable the price steps filter by its conduct in making arrangements for 5 of its Designated Trading Representatives to manually scrutinize the Client's orders. The manual review was manifestly inadequate.
- (g) AOT Securities allowed orders to be accepted for submission into SEATS without any automated price filter screening and without being in a position to comply with its obligations to prevent manipulative trading. AOT Securities put itself in a position where it was unable to make an informed decision on that question before making a Bid or Offer or dealing in securities on behalf of its Client. There is no suggestion of manipulative trading by AOT Securities. But AOT Securities put itself in a position where it was unable to prevent manipulative trading if it had occurred; and
- (h) The result was that the system of preventive measures set out in the Rules, an object of which was to enable the Exchange to do all things necessary to ensure that the market is fair and orderly, was thwarted.

The Appeal Tribunal determined not to vary the fine imposed by NAT of \$60,000 (plus GST) with respect to this breach.

(iii) ASX Business Rule 2.2.5 in that it proposed to make a material change to the organizational and technical resources it employed to comply with Rule 2.2.1(1) and did not immediately notify the Exchange of those changes prior to implementation.

NAT made the following findings:

- (a) Turning off its price steps filter constituted a "material" change for the purposes of this Business Rule;

(b) AOT Securities disabled its price steps filter shortly before 16:00 on 29 June 2001 and did not notify ASX prior to doing so.

AOT Securities did not contest this breach before the NAT. The Tribunal imposed a fine of \$ 20,000 (plus GST) with respect to this breach.

2. The NAT took into account the following matters in determining the appropriate penalty for the breaches:

- (i) The seriousness of the breaches and the need to deter AOT Securities and other Trading Participants from engaging in similar conduct;
- (ii) The impact that the trading had on the closing price of two stocks;
- (iii) The potential damage to which the market was exposed by AOT Securities turning off its price steps filter;
- (iv) The Client obtained a commercial advantage that it would not otherwise have had if the price steps filter had been operational;
- (v) AOT Securities agreed not to contest two of the breaches ((i) and (iii) above);
- (vi) There was no prior record of disciplinary action against AOT Securities;
- (vii) AOT Securities has been actively involved in the development of Automated Order Processing and had worked closely with ASX in this regard;
- (viii) AOT Securities has since ensured that its price steps filter remains active at all times and that it will not be disabled without the prior approval of ASX;
- (ix) Arbitrage is a legitimate form of economic activity that does not release a Trading Participant from its obligations under the Business Rules; and
- (x) Although the existence of market volatility in the CSPA on 29 June 2001 was not a major factor influencing the Tribunal's decision, the very late entry of the second bid basket in the CSPA may have limited the opportunity for more efficient price discovery in the market.

AOT Securities appealed items (ii)- (iv) and (x) on the basis that they should not have been taken into account by NAT in determining penalty. In relation to item (ii), the Appeal Tribunal found that NAT had erred in holding that the conduct of AOT Securities caused interference with the market in relation to the closing prices of two stocks. AOT Securities was not successful in its appeal in respect of items (iii)-(iv) and (x). The Appeal Tribunal was not satisfied that there was any error in the amount of the penalty imposed.