SAMPLE ANSWER
2002 EXAM PART B

[Note: This is a complete and detailed answer that identifies all of the issues I intended to raise in the problem question in the 2002 exam paper. I would not have expected any student to have spotted all of these issues or to have written as detailed an answer as this under the constraints of exam conditions (if they did, they would have received a mark of 100% for the paper).

You do NOT have to follow this style in answering the problem question in the exam. The point of the problem question is for you to demonstrate that you can spot the compliance issues and express them in a way that shows that you understand them. You can do that in whatever style suits you.

You may not necessarily agree with all of the conclusions expressed in the sample answer below. Again, the point of the problem question is for you to demonstrate that you can spot the compliance issues and express them in a way that shows that you understand them. You won't be penalised for reaching a different conclusion on any particular issue if your position is reasonably argued.

Please note that since the 2002 exam, the Anti-Money Laundering and Counter-Terrorism Financing Act 2006 has been enacted and the ASX Business Rules were repealed and replaced by the ASX Market Rules in 2004 and then by the ASIC Market Integrity Rules (ASX Market) 2010 and the ASX Operating Rules in 2010. A different answer to this question would therefore be required today to that written in 2002.]

The facts presented raise the following legal and regulatory compliance issues:

Possible market manipulation

The timing and pattern of trading in EZ Feez Limited ("EZF") shares – small orders in a thinly traded stock executed at incremental prices which just so happen to materially increase the price of those shares just before EZF announces a scrip bid for ABC Limited ("ABC") – raises a strong suspicion that someone connected with EZF may have been trying to manipulate the market price of EZF shares upwards to make the bid for ABC look more attractive (as happened in *North v Marra Developments Ltd*). If so, this would be a clear case of market manipulation in breach of ss1041A and 1041B(1)(b) of the Corporations Act ("CA").

The "someone connected with EZF" in this case is Bill Bloggs ("BB"), the company secretary of EZF and the person who placed the orders with Peter Piper ("PP") to buy EZF shares on behalf of 123 Pty Limited ("123").

It is not absolutely clear whether PP was knowingly involved in what appears to be a scheme by BB to manipulate the price of EZF shares but there are some facts present in this case which suggest that he could have been:

- the fact that BB/123 was introduced to PP by Richie Rich ("RR"), who is known to have a close connection with the directors and senior managers of EZF and who appears to have been privy to the scheme to manipulate the price of EZF shares (see below); and

- the fact that PP is a close friend of RR and so the two are likely to have spoken about the matter.

Certainly, if PP intended to create, or was aware that BB was intending to create, a false or misleading appearance with respect to the market price of EZF shares, then McWorry

Stockbroking Limited ("MS") would have breached ASX Business Rule ("BR") 2.2.4(1)(b)(i) or (ii) respectively by executing BB's orders to buy EZF shares.[1]

Even if PP did not have, and was not aware of BB having, any manipulative intent, under BR 2.2.4(2),[2] PP was required to take into account the circumstances of BB's orders before executing them. Those circumstances would have included:

- the fact that EZF shares are thinly traded and therefore susceptible to manipulation;
- the fact that putting in intermittent bids to purchase a relatively small number of shares in a thinly traded stock at progressively higher prices will almost inevitably push the market price of those shares upwards;
- the fact that the 90 cent price limit on BB/123's orders was well above the 70-75 cents band in which EZF shares had consistently traded for some time; and
- assuming PP was aware of this, the fact that BB is the company secretary of EZF and, in that capacity, could well have a motive to manipulate the market price of EZF shares.

If PP had taken account of these circumstances, he ought reasonably to have suspected that BB might be placing the orders with the intention of manipulating the market price of EZF shares. As such, it was incumbent on PP under BR 2.2.4(1)(b)(iii)[3] and ASX BR Guidance Note 8/00 to make further enquiries, before he executed those orders, to satisfy himself that BB had a legitimate reason for trading. He failed to do so and, consequently, MS has breached BR 2.2.4(1)(b)(iii) by executing BB's instructions to buy EZF shares.

There is also evidence to suggest that RR was knowingly involved in a scheme to manipulate the price of EZF shares though his sale of EZF shares from the MS house account at progressively higher prices:

- the fact that RR is known to have a close connection with the directors and senior managers of EZF, dating back to the initial float of EZF;
- the fact that RR introduced BB/123 to PP, a close friend of his, to place orders to buy EZF shares; and
- the timing of RR's purchase and sale of EZF shares for Josie Rich ("JR") – buying 10,000 shares at 75 cents on 18/11/02 before the manipulation had begun and selling those shares at a profit at 90 cents on 22/11/02 after the manipulation had finished – which strongly suggests that RR was privy to BB's scheme to manipulate the price of EZF shares and has effectively "front run" that scheme.

If RR intended to create a false or misleading appearance with respect to the market price of EZF shares through his sales of EZF shares from the MS house account, then McWorry Stockbroking Limited ("MS") will also have breached ASX Business Rule ("BR") 2.2.4(1)(a)(i) because of those sales.[4]

As state in ASX BR Guidance Note 8/00, BR 2.2.4 is regarded by ASX as a "cornerstone of fair and orderly markets" and a breach of that rule is treated by ASX as a very serious matter.

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[1] On 11 March 2004, ASX Business Rule 2.2.4(1) was replaced by ASX Market Rule 13.4.1 on substantially the same terms. On 1 August 2010, this rule in turn was replaced by Rule 5.7.1 of the ASIC Market Integrity Rules (ASX Market) 2010, again on substantially the same terms.

[2] On 11 March 2004, ASX Business Rule 2.2.4(2) was replaced by ASX Market Rule 13.4.2 on substantially the same terms. On 1 August 2010, this rule in turn was replaced by Rule 5.7.2 of the ASIC Market Integrity Rules (ASX Market) 2010, again on substantially the same terms.

[3] From 11 March 2004 to 31 July 2010, ASX Market Rule 13.4.1(b)(iii) and, from 1 August 2010, Rule 5.7.1(b)(iii) of the ASIC Market Integrity Rules (ASX Market) 2010 (see note 1 above).

[4] From 11 March 2004 to 31 July 2010, ASX Market Rule 13.4.1(a)(i) and, from 1 August 2010, Rule 5.7.1(a)(i) of the ASIC Market Integrity Rules (ASX Market) 2010 (see note 1 above).

Possible insider trading by RR

As mentioned previously, the timing of RR's purchase and sale of EZF shares for JR strongly suggests that he was privy to BB's scheme to manipulate the price of EZF shares and has effectively "front run" that scheme. If so, this would be a clear case of insider trading in breach of CA s1043A. Information about the scheme to manipulate the price of EZF shares would have been price sensitive (the scheme in fact increased the market price of EZF share by 20% from 75 cents to 90 cents). That information was also not generally available. Accordingly, RR would have been precluded from buying or selling EZF shares while he was in possession of that information, whether as principal or as agent for JR.

The following facts raise a suspicion that the client account allegedly opened by RR for JR is in fact RR's personal account and that he has opened the account in his grand aunt's name in an attempt to avoid MS's staff trading rules and to cloak his insider trading:

- the fact that Rich lives in Maroubra and that his commission is paid by electronic funds transfer to an account at the Maroubra branch of the Commonwealth Bank;
- the fact that the account opening form for JR's account gives her mailing address as a PO Box in Maroubra and nominates an account at the Maroubra branch of the Commonwealth Bank as her account for settlement purposes, even though she lives in Melbourne;
- the fact that the account opening form has an illegible signature; and
- the fact that no client identification documentation was obtained to open the account.

Enquiries should be made to identify the source of funds that were used to pay for the initial purchase of 10,000 EZF shares that RR allegedly made for JR on 18/11/02. It would not be surprising if in fact it was a cheque drawn on, or an electronic transfer from, an RR account rather than a JR account.

Issues with MS's account opening procedures

There appears to be substantial weaknesses in MS's account opening procedures.

A trading account has been opened for 123, a two dollar company, without any identification or credit checks being undertaken and without any analysis of whether 123 is a retail or wholesale client.

Prudent business practice[5] (as outlined in ASX BR Guidance Note 13/97[6]) would dictate that MS should have obtained a company search of 123 to confirm that the company in fact exists and that the persons named in the account opening form as its directors and secretary in fact hold those offices. MS should also have obtained a copy of 123's most recent accounts and subjected them to a credit analysis so as to set appropriate exposure limits on its trading. This would apply whether 123 is a wholesale client or a retail client.

Proper enquiries should also have been made by MS to determine whether 123 is in fact a wholesale client or a retail client. Under CA ss761G(8) and (9), a client should be presumed to be

[5] Note that this exam question preceded the introduction of the *Anti-Money Laundering and Counter-Terrorism Financing Act 2006* ("AMLCTFA"). At the time, KYC identification checks were only legally required for the opening of "cash accounts" by "cash dealers" under the Financial Transactions Reports Act ("FTRA"). Hence, for most broking firms, KYC identification checks were a matter of "prudent business practice" rather than legal obligation. Now, of course, under s32 of the AMLCTFA, a broking firm would be expected to carry out a procedure to verify a customer's identity before providing a designated service to them. It would also be expected to have in Part B of its AML/CTF program appropriate risk-based systems and controls to determine what KYC information should be collected and verified for the different types of customers it deals with.

PP's blind acceptance that 123 as a professional share trader and him not knowing anything at all about its portfolio apart from the holding it has in EZF resulting from the purchases he made on its behalf would certainly not pass muster under the KYC obligations in the AMLCTFA.

[6] Now ASX Market Rule Guidance Note 4.

a retail client unless there is clear evidence to the contrary. On the evidence available, as a two dollar company and nothing to suggest that it is a related body corporate of or controlled by a wholesale client, 123 should have been treated as a retail client and MS's account opening procedures for retail clients complied with. As a retail client, at a minimum, 123 should have received an FSG before any financial services were provided to it. Failure to provide an FSG would be a beach of CA s941A.

RR has also been able to open an account for his grand aunt JR without performing MS's usual identification checks. Front office staff members should not be able to open client accounts without appropriate back office checks. It opens up avenues for abuse of the type that is likely to have occurred here – namely, RR having opened up an account in JR's name which he in fact controls and which he has used to try to get around MS's staff trading rules and to cloak his insider trading.

Notwithstanding his relationship with JR, RR (or better still, someone else at MS) should have undertaken MS's usual "100 point" check[7] to verify the identity of JR. He/they should also have obtained evidence of JR's financial resources (such as a recent accountant's certificate, bank statement, tax return or the like) to inform the setting of appropriate exposure limits on her trading. In addition, he/they should have obtained evidence to confirm that JR is a wholesale client rather a retail client.

Again, under CA ss761G(8) and (9), a client should be presumed to be a retail client unless there is clear evidence to the contrary. In the absence of an accountant's certificate verifying that JR has net assets of at least $2.5 million or that her gross income for each of the last 2 financial years was at least $250,000 or more, or that she has or controls gross assets of at least $10 million, JR should have been treated as a retail client and MS's account opening procedures for retail clients complied with. As a retail client, at a minimum, JR should have received an FSG before any financial services were provided to her. Failure to provide an FSG would be a beach of CA s941A.

House traders placing client orders

I note the comment by RR that it is not uncommon for the house traders at MS to execute small client orders for friends and colleagues.

This is poor business and compliance practice. House traders should not be dealing for clients, particularly retail clients. They are unlikely to have access to, or training on, the systems needed to deal with retail clients – eg the systems required under Corporations Regulation ("CR") 7.8.19 or ASX BR 7.3.2[8] to keep proper client order records, under CR 7.7.09 to keep records of execution-related telephone advice[9] or under the CA s946A to provide SOAs for other personal advice. Dealing for clients and for the house also potentially exposes them to temptation and conflict. For example, if they happen to do a particularly good or bad trade, do they allocate it to the client or to the house?

Charging of commission on principal trades

I note that RR has not charged commission on the trades he effected for JR but that PP has charged standard commission for all of the purchases he effected for 123. For some of those purchases, the client on the other side of the transaction was the MS house account operated by RR and therefore these were principal trades, even though they were effected on market.

[7] The "100 point" check was one of the mandated processes under the FTRA by which a cash dealer could verify the identity of someone seeking to open a cash account.

[8] From 11 March 2004 to 31 July 2010, ASX Market Rule 4.10.1 and, from 1 August 2010, Rule 4.1.1(2) of the ASIC Market Integrity Rules (ASX Market) 2010.

[9] Since 2002, CR r7.7.9 has been amended to remove the notion of "executed-related telephone advice" and replace it with the notion of "further advice".

Under ASX BR 3.5,[10] MS can only charge a client commission on a principal trade if the client is a wholesale client and it has consented to that occurring. On the evidence, 123 does not appear to be a wholesale client. Even if it was, query whether the required consent was obtained to charge commission on a principal trade (the client file only includes an account opening form and so unless the consent is built into the account opening form, it would appear that a consent has not been obtained). The charging of commission on those trades may therefore constitute a breach of ASX BR 3.5 and CA s991E(3).

Disclosure of underwriting shortfall

MS's contract notes include a pro forma disclaimer that "some or all of this order may have been crossed as principal or as agent for another client". Nowhere on the contract notes does it mention, however, that the shares purchased by 123 from MS as principal included shares that MS held (in RR's house account) because of an underwriting shortfall.

Under ASX BR 3.13[11] (sale of an underwriting or sub-underwriting shortfall), a market participant is not permitted to offer shares received as a result of an underwriting shortfall for sale to a client within 90 days of the closing date of the underwriting unless they first inform the client of the closing date and the reason for the acquisition.

In this case, it is likely to have been less than 90 days since the closing date of the underwriting (EZF only floated on 1/9/02 and RR sold the underwriting shortfall from 18/11/02 to 22/11/02).

Also, under ASX BR 3.8(3),[12] where securities are sold to a client pursuant to ASX BR 3.13, the confirmation is required to include a statement to that effect.

The construction and effect of ASX BR 3.13 is rather unclear. It could be argued to apply in this case. However, there is no evidence on the facts of any "offer" being made by MS to 123 to sell the particular shares held by MS as a result of the underwriting shortfall. The purchase of those shares by 123 took place on the market in the ordinary course. I therefore lean to the view that there has been no breach of ASX BR 3.13 or 3.8(3).

Requirement to lodge a suspect transaction report[13]

There is sufficient evidence for MS to suspect that EZF, BB, RR and/or PP may have breached a number of provisions in the Corporations Act. MS should file a suspect transaction report under s16 of the Financial Transactions Reports Act in relation to those breaches as soon as practicable after forming that suspicion.[14]

Phone taping

I note that MS does not tape the phone lines of either its house traders or client advisers because its senior management considers that the costs involved outweigh the putative benefits.

While the ASX does not require brokers to tape phone lines, it has made some public statements (for example in the joint Trading Best exercise it conducted with ASIC in 2001) that it considers telephone taping systems to be an integral part of a proper compliance regime and that tapes should be regularly reviewed on a sample basis.

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[10] From 11 March 2004 to 31 July 2010, ASX Market Rule 7.3.4 and, from 1 August 2010, Rule 3.2.4 of the ASIC Market Integrity Rules (ASX Market) 2010.

[11] From 11 March 2004 to 31 July 2010, ASX Market Rule 7.20 and, from 1 August 2010, Rule 5.10.5 of the ASIC Market Integrity Rules (ASX Market) 2010.

[12] ASX Business Rule 3.8(3) was effectively repealed on 11 March 2004. The provision was not carried across into the new ASX Market Rules adopted on that date and has no counterpart in the ASIC Market Integrity Rules (ASX Market) 2010 now in force.

[13] See note 14 below.

[14] Since the enactment of the AMLCTFA, MS would now be expected to file a suspicious matter report under s41 of that Act. The report would need to be filed within 3 business days after forming the relevant suspicion.

Other enquiries that could be made

I note that PP said that he had noticed that RR had appeared in the market selling parcels of shares and that, in accordance with his instructions from BB, he had purchased those shares as they became available. He also said that he had not spoken to RR about the transactions and simply assumed that RR was taking advantage of the improving market price to exit his long position in EZF shares in the MS House Account.

Given the known friendship between PP and RR, it would be surprising if they had not spoken about their transactions in 123 shares. How did PP know, for example, that RR had a long position in EZF shares? PP should be pressed on this point.

It would make sense to examine the email records on PP's and RR's computers and MS's back-up tapes to see if there were any email exchanges between the two of them or between them and BB, 123 or EZF at or around the time of the trading in question.

In terms of other enquiries that could be made, given MS's involvement as corporate adviser on EZF's takeover bid for ABC, enquiries should be made of MS's corporate advisory division to determine whether it has had any involvement with the trading in EZF shares or has any connection to PP or RR. If it has, then that may suggest a worrying breakdown in MS's Chinese walls procedures.

I note that ABC shares closed on 22/11/02 at 36 cents, although they had recently traded as high as 40 cents. It would be wise to examine whether any trading has been undertaken by MS in ABC shares over the period in question to see if there is any evidence of an attempt to manipulate the market price of ABC's shares downwards, again to make EZF's scrip bid look more attractive.

I would also enquire whether MS has published any research on EZF or ABC in the period leading up to the takeover bid to see if there is any suggestion of the research department having been used to move the market price of either stock.

While not directly relevant to MS's position, the timing and pattern of selling of EZF shares by Hardly Pointless (HP) – in small increments and at prices that might have the effect of pushing up the closing price – is suspect and could suggest that HP too may have been party to manipulating the market price of EZF shares. As a professional courtesy, consideration could be given to contacting the compliance department at HP to alert them to the issue. If this is done, care would need to be taken not to breach the "tipping off" provisions in s16(5A) of the Financial Transactions Reports Act.[15] In particular, no mention should be made to the HP compliance department that MS intends filing a suspect transaction report in relation to suspected breaches of the Corporations Act.

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[15] Now s123 of the AMLCTFA.