

SFC Takes Action Against Nomura International (Hong Kong) Limited

29 Dec 1998

The Securities and Futures Commission today announced the outcome of its inquiries into dealings through Nomura International (Hong Kong) Limited (NIHK) of Nomura International Plc (NIP), a UK company on the Australian Stock Exchange (ASX) and the Sydney Futures Exchange (SFE) on 29 March 1996.

The dealings were in reference to NIP's Australian Index arbitrage book. Most of the trading was undertaken on NIP's behalf by NIHK on the instructions of NIP. All relevant trades were executed on behalf of NIP on a proprietary basis. Responsibility for devising the overall strategy to be adopted on 29 March 1996 was in London.

On 29 March 1996, as part of its Australian index arbitrage operations, NIP went to an expiry in relation to its position in sold March 1996 SPI Contracts, and placed orders with ten Australian securities brokers to sell parcels of 345 individual securities worth approximately AUD\$600 million in the last 30 minutes of trading on the ASX. At the close of trading on 28 March 1996, NIP had a short futures position of 10,912 sold March 1996 SPI Contracts on the SFE, being approximately 14% of total open interest in those contracts. Those contracts were cash settled by reference to the closing price of the All Ordinaries Index (All Ords) on 29 March 1996.

In addition to giving instructions to sell AUD\$600 million worth of stocks, Nomura instructed one of the ten Australian securities brokers to input into the ASX Stock Exchange Automated Trading System (a computerised order-driven trading system) bid orders for the same stocks at between 5 and 20% discount to the closing price on 28 March 1996. The effect of this was that there would always be a bid order (on behalf of NIP) available to match the selling orders given by Nomura, so that the selling orders could be executed even if there were no third party buying orders, that is that in the event there were no third party buyers NIP would buy the stocks from itself at a discount. NIP's bid orders are also referred to as a "bid basket". The probability that NIP's bid basket would be traded was highest for the less liquid stocks. Had the selling orders been traded as anticipated by Nomura, Nomura would have purchased stock for itself at or near the close and as a consequence there would have been a greater impact on the All Ordinaries Index and in turn the settlement price of the March SPI contract.

Nomura also instructed two Australian futures brokers to sell March expiry SPI futures contracts during the course of the day on 29 March 1996, thus increasing Nomura short March SPI futures position by 2,607 contracts. This was a trade which would be profitable if the All Ords fell.

Nomura also instructed those brokers to sell June expiry SPI futures contracts during the course of the day on 29 March 1996. This was in order to hedge against the expected long position in stock which would arise from a failure to sell all of the position to third parties. NIP sold 1,040 June SPI futures contract during the day.

In the event, on 29 March 1996, the All Ords fell from a high of 2251.3 at 3:05 p.m. to 2225.6 at the close, a fall of 25.7 points. At 3:45 p.m., the All Ords stood at 2237.9 points. The index therefore fell 12.3 points in the last 15 minutes of trading during which time the NIP sale orders were being executed. Notwithstanding Nomura instructions, the ten Australian securities brokers managed to sell less than half of the AUD\$600 million worth of stocks on 29 March 1996 at the market close but further sales took place after the market closed, mostly at the closing price. As a result of NIP having given both buying and selling orders in those stocks two sales involving no change of beneficial ownership (wash trades) were executed on behalf of NIP, at a discount of 15% and 20% respectively on the closing price of 28 March 1996. In addition to the costs incurred of brokerage and stamp duty of AUD\$1.54 million, NIP made a loss of AUD\$900,000 arising from the failure to dispose of all of the stocks on 29 March 1996 and further losses from the consequently unbalanced nature of NIP's Australian index arbitrage book. NIP made a profit of AUD\$1.1 million on the expiry of the 2,607 sold March SPI futures contracts entered into on 29 March 1996.

This trading, to the extent conducted on behalf of NIP by NIHK, was of concern to the SFC because NIHK is registered by it. While the authorities in Australia, London and Hong Kong have each

conducted their own investigation under their respective legal powers, they have closely co-operated with each other and exchanged the information that they gathered and that had been voluntarily supplied by Nomura.

The Australian Securities and Investments Commission instituted civil legal proceedings in the Federal Court of Australia alleging that the conduct of NIP, but not NIHK or any individuals, had contravened Sections 995, 998 and 1260 of the Corporate Law, which deal with misleading and deceptive dealing in securities (S.995) and false or misleading appearance of active trading in securities (S.998) and in future contracts (S.1260). Judgment was delivered on 10 December 1998. The Federal Court found that: NIP's conduct in giving instructions to sell a large volume of stocks and the placement of bid basket at well below market levels meant that the sell order which hit the bids in the bid basket in respect of the 2 stocks were wash trades and contravened Section 998. The Court further found that the combined operation of the sell orders and the placing of the bid basket constituted conduct intended to create a false or misleading appearance of active trading in illiquid securities in contravention Section 998. NIP's measures were intended to determine the closing price of illiquid securities on the expiry date for future contracts and have influence the cash settlement price of futures contracts going to expiry and consequently created a false or misleading appearance with respect to the price for dealings in a futures contract on a futures market in contravention of Section 1260.

The SFC instituted disciplinary proceedings against NIHK and certain individuals for misconduct and on the basis that their fitness and propriety to be registered as securities and futures representatives had been impugned. Nomura challenged the timing of these disciplinary proceedings in the High Court of Hong Kong by way of judicial review. In December 1997, the High Court granted Nomura's application to stay the disciplinary proceeding thereby temporarily preventing the SFC from proceeding. In April 1998, the SFC successfully appealed to the Court of Appeal who unanimously allowed its appeal deciding that NIHK had not established sufficient evidence of a real risk of serious prejudice. NIHK sought leave to appeal this decision to the Court of Final Appeal. The Court, on 21 October 1998, dismissed the application and awarded costs to the SFC.

Whilst NIHK understands that NIP is giving consideration to the possibility of an appeal against the decision of the Federal Court in Australia against NIP, NIHK has taken account of this decision. NIHK acknowledges that the SFC had wholly legitimate concerns about the appropriateness of its conduct. NIHK has expressed deep regret that it did not more actively pursue an agreed outcome with the SFC. NIHK has confirmed that it has taken steps to ensure that it does not knowingly execute wash trades with the intention of depressing, raising or stabilizing the market price of any securities and does not knowingly allow its staff to engage in conduct in any market which would not meet Hong Kong standards of fitness and properness.

The SFC has severely publicly reprimanded NIHK for failing adequately to supervise the two employees who instructed the ten Australian securities brokers on 29 March 1996 and for allowing NIHK to be involved in conduct on behalf of NIP which it knew or should have known was likely to mislead or deceive participants in the Australian markets. The SFC has also suspended Mr. Duncan Moss, one of the employees concerned, for a period of 12 months for his misconduct. NIHK has agreed to pay the SFC's costs in full.