

**IN NZ MARKETS DISCIPLINARY TRIBUNAL  
SUMMARY HEARING PROCEDURE**

**NZMDT 3/12**

**UNDER** the NZ Markets Disciplinary Tribunal Rules

**IN THE MATTER OF** alleged breaches of the NZX Participant Rules

**BETWEEN** **NZX LIMITED**

**AND** **CRAIGS INVESTMENT PARTNERS  
LIMITED**

Respondent

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**DETERMINATION OF NZ MARKETS DISCIPLINARY TRIBUNAL  
9 JULY 2012**

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**Rachel Batters  
Executive Counsel  
NZ Markets Disciplinary Tribunal  
P O BOX 105269  
Auckland 1143  
Telephone + 64 21 201 4361  
Email: [rachel.batters@nzmdt.com](mailto:rachel.batters@nzmdt.com)**

1. This is a determination of a division of the New Zealand Markets Disciplinary Tribunal (*the Tribunal*) comprising David Boldt (division chairman), Trevor Janes and Campbell Stuart.
2. Capitalised terms that are not defined in this determination have the meanings given to them in the NZX Participant Rules (*the Rules*).

### **Procedural Background**

3. NZX Limited (*NZX*) served a statement of case on Craigs Investment Partners Ltd (*the respondent*), on 17 May 2012. The respondent is a Trading Participant. The statement of case alleged the respondent breached Rules 4.5.2, 8.8, 10.2.2 and 10.8.1 as a result of two separate orders which were directly entered into the NZX Trading System by a DMA authorised client of the respondent (*the client*). Each of these created considerable market disruption.
4. On 23 May 2012, the respondent requested a three week extension (to 21 June 2012) for the submission of its statement of response. NZX indicated that it supported the extension. The Tribunal granted an extension to 15 June 2012.
5. On 12 June 2012, the respondent requested a further one week extension, again with the support of NZX. The Tribunal granted an extension of three business days, until 20 June 2012.
6. The Tribunal noted in its minute that second or subsequent extensions, whether to facilitate settlement discussions or otherwise, are granted only in exceptional circumstances. The Tribunal is particularly strict where cases are brought under the summary hearing procedure, as the procedure is designed to place a premium on speed and certainty.
7. On 20 June 2012, the respondent filed a statement of response, which included a request for an oral hearing on the basis that a hearing would be essential to establish the facts relevant to the case.
8. On 25 June 2012, NZX filed a rejoinder, which noted that from its perspective, the material facts were not in dispute.
9. The Tribunal invited the respondent to reconsider its request for an oral hearing in light of this advice. The Tribunal noted that an oral hearing may only be convened to establish relevant facts, and will be of no value if the underlying facts are agreed.
10. On 2 July 2012, the respondent filed a short reply to NZX's rejoinder. The respondent advised that if the Tribunal considered the reply in its deliberations, there would be no need to hold an oral hearing. The Tribunal agreed the underlying facts were not in dispute, and agreed that the proposed oral hearing was no longer necessary.

## **Factual Background**

11. Under the Rules, a Trading Participant may provide Direct Market Access (*DMA*) to a client who is designated as a DMA Authorised Person. This status allows authorised clients to submit orders directly into the NZX Trading System without first passing them through the Participant's trading desk.
12. The respondent provides DMA to its client pursuant to an access agreement. Under that agreement, authorised clients are allowed access to the respondent's own proprietary system to submit trading messages to NZX through a process known as Direct Client Order Processing. The respondent's trading system is provided by IRESS (NZ) Limited (*IRESS*). IRESS describes itself as the principal supplier of share market systems in New Zealand.

## **The TEL Breach**

13. On 2 August 2011, using the respondent's trading system, the client entered a market order into the NZX Trading System to buy 640,000 Telecom Corporation of New Zealand Limited (*TEL*) shares (*the TEL order*). No price was specified for the TEL order.
14. The TEL order was immediately matched against more than 17 sell orders and resulted in a change to the traded price of TEL shares from \$2.68 to \$3.31, a 23.5% increase.
15. NZX Market Supervision (*NZXMS*) initiated an investigation and contacted the respondent. The respondent advised NZXMS that the client had entered the TEL order in error. The client had intended to place an order for execution by the respondent's trading desk and had not intended that the order be entered directly into the NZX Trading System.
16. NZXMS put TEL into a trading halt and cancelled the trades directly arising from the TEL order, along with all the trades in TEL that occurred between the TEL order and the trading halt. This resulted in 52 trades being cancelled.
17. The respondent accepts it failed to ensure that appropriate filters were set in its trading system at the time the TEL order was entered. As is discussed more fully below, it was the respondent's responsibility to ensure that proper filters were in place for its DMA clients. Appropriate filters would have rejected an order of this kind before it was routed to the NZX Trading System.

## The RBC Breach

18. On 15 November 2011, again using the respondent's trading system, the (same) client entered a market order into the NZX Trading System to buy 30,000 Rubicon Limited (RBC) shares (*the RBC order*). The RBC order immediately matched against three sell orders, resulting in a change to the traded price of RBC from \$0.39 to \$0.58, a 48% spike.
19. On becoming aware of the RBC order, NZXMS halted trading in RBC and contacted the respondent. The respondent advised NZXMS that the RBC order had been entered in error. Once again, the client had intended to place an order for execution by the respondent's trading desk and had not intended that order be entered directly into the NZX Trading System. NZXMS cancelled the relevant trades resulting from the RBC order.

## The Rules

20. NZX alleges that the respondent breached Rules 4.5.2, 8.8, 10.2.2 and 10.8.1 as a result of the TEL order and the RBC order being entered into the NZX Trading System in error by the client.

21. The relevant part of Rule 4.5.2 provides that:

*... For the avoidance of doubt, a Trading Participant allowing access to its trading system via DMA must ensure that it has the appropriate filters, screens and security measures in place to achieve the objectives of this Rule 4.5.*

22. The relevant parts of Rule 8.8 provide that:

*Each Market Participant...must ensure their conduct promotes and helps maintain an orderly market. For the purposes of this Rule, each Market Participant...must ensure that their actions comply with:*

- (a) *the obligations of Market Participants...as set out in these Rules; and*
- (b) *any directions given from time to time by NZX and at all times observe Good Broking Practice.*

23. Rule 10.2.2 provides:

*When accepting an Order each Trading Participant, NZX Advising Firm and NZX Advisor, must consider the following:*

- (a) *whether that Order, or the execution of that Order, is consistent with recent trading in that Security, taking into account current market conditions;*

- (b) *whether that Order, or the execution of that Order, will materially affect the market for, or price/yield of, any Security;...*

24. Rule 10.2.3 provides that:

*For the avoidance of doubt, the obligations placed on each Trading Participant...in relation to the requirement not to create a false or misleading market for, or price/yield of, any Securities also applies in respect of Orders the subject of Direct Market Access.*

25. Rule 10.8.1 provides:

*Each Trading Participant that provides Direct Market Access to its DMA Authorised Persons must at all times ensure that:*

- (a) *It, any DMA Authorised Person and any DMA Dealer, complies with all applicable Rules, any directions issued from time to time by NZX and at all times observes Good Broking Practice, including ensuring that the appropriate filters screens and security measures are established and maintained by that Trading Participant;*
- (b) *Its use and access, and the use and access by each DMA Authorised Person and DMA Dealer, to Direct Market Access does not interfere with:*
  - (i) *the efficiency and integrity of the markets operated by NZX; and*
  - (ii) *the proper functioning of the Trading System.*

26. Rule 10.8.2 provides:

*Each Trading Participant acknowledges that it is responsible and liable for Orders entered/submitted into the Trading System via Direct Client Order Processing or Direct Principal Order Processing.*

### **The TEL order**

27. The respondent admits that it failed to have appropriate – or indeed any – filters in place at the time of the TEL order, and that the market disruption which followed was a consequence of this. It is unclear how this error occurred, however the respondent appropriately accepts that each of the four breaches arising from the TEL order is established.

## The RBC order

28. The respondent denies it is responsible for the market disruption which followed the RBC order. While it admits that, once again, an order entered by its DMA client led to disorder in the market, it does not accept it was responsible for this.
29. The respondent, like most, if not all, major market participants, utilises a trading platform and Direct Market Access software supplied by a third party, IRESS. Though users place orders through the respondent's own DMA system, the respondent's DMA platform was supplied and maintained by IRESS. In practice, the respondent's ability to provide direct market access for its clients is dependent on IRESS's system being error-free. The respondent is also dependent on IRESS to ensure the DMA filters it specifies are effective.
30. As noted in paragraphs 21 and 26 above, participants are responsible for ensuring appropriate filters are in place for their DMA clients. After the TEL order mishap, the respondent took immediate steps to ensure the same thing did not happen again. It was therefore a matter of some surprise when, in November 2011, it did.
31. The respondent says that this time the failure was not its fault. On the very day of the TEL order error, the respondent sought confirmation that the new filters it requested for all its DMA clients would be sufficient to stop a repeat of the market disruption if the TEL order were placed again. It was advised by IRESS that the order would be "denied straight off".
32. The Tribunal is satisfied that the respondent acted properly and responsibly after the TEL order disruption.
33. In correspondence with NZX, IRESS accepted that the RBC error was a result of a software error on its part. In an email to NZX dated 12 June 2012, IRESS agreed there was a 'bug' in the IRESS Order System (IOS); the bug was ultimately traced to an incorrectly configured 'Market' order attribute on the IOS server, and remedied. In its statement of response, the respondent pleads that the latent software error was something it did not know about, and could not have known about.
34. As a result, the respondent seeks to assert it has established a defence of total absence of fault. An absence of fault defence is available for regulatory offences enforced in the criminal courts (see *Civil Aviation Department v MacKenzie* [1983] NZLR 78; *Millar v Ministry of Transport* [1986] 1 NZLR 660). The defence has been applied, by analogy, in a range of disciplinary contexts. In short, the defence will be made out if a defendant proves, despite the actus reus of the offence being established, that the defendant was not at fault; i.e. the prohibited outcome was not the result of any culpable act or omission on its part.

35. NZX submits the total absence of fault defence is not available for breaches of the Rules. It notes that the breaches with which the respondent is charged are not criminal offences, and that the respondent's liability here arises as a matter of contract between it and NZX. Rule 3.16 provides that:

*Upon NZX designating a company, firm, organisation or partnership as a Market Participant, these Rules shall form a binding contract between that Market Participant and NZX.*

36. It is not necessary for the Tribunal to determine whether, as a matter of general principle, a total absence of fault defence is available pursuant to the Rules, as the Tribunal is satisfied that, in any event, the defence cannot be established in the case of the RBC order. The nature and wording of the offence provisions are decisive. Critically, in agreeing to be bound by the Rules, the respondent agreed (Rule 4.5.2):

*"A Trading Participant is responsible for ensuring the accuracy of the details, the integrity and bona fides of all trading messages which are entered into the Trading System using that Trading Participant's identification code, regardless of whether the trading messages are entered into the Trading System via a Dealer, DMA Dealer or as a result of the Trading Participant allowing access to its trading systems via Direct Client Order Processing." (See also Rule 10.8.2, paragraph 26 above)*

37. The defence the respondent seeks to establish in this case would, if accepted, allow participants to circumvent this provision. In light of Rule 4.5.2, a participant cannot avoid responsibility for errors in its trades by pointing to the actions or inactions of a third party. Participants are responsible for their own trades; the Rules do not entitle them to point the finger at anyone else if things go wrong. The respondent was quite entitled to contract part of its order processing to an outside provider, but the effect of the relevant Rules is that each participant is responsible for errors associated with its trades. Because the respondent chose to use IRESS to complete a transaction which was the respondent's responsibility, the respondent must also accept responsibility for IRESS's error.
38. The fact the respondent was not directly involved in this breach, and took steps to ensure effective filters were in place after the TEL order, is relevant to penalty (and substantially mitigates its culpability) but it does not provide a defence.
39. Accordingly, the Tribunal finds all four breaches arising from the RBC order proved.

### **Approach to Penalty**

40. NZX sought penalties totalling \$95,000. The way it broke the penalties it seeks down has been the subject of argument. NZX has asked the Tribunal

to impose a single concurrent penalty for the two breaches of each provision, but submits that the four provision-specific penalties should then be accumulated.

41. NZX seeks \$25,000 for the two breaches of Rule 4.5.2, \$15,000 for the two breaches of Rule 8.8, \$30,000 for the two breaches of Rule 10.2.1 and \$25,000 for the two breaches of Rule 10.8.1. NZX submits these penalties should be added together, giving a total penalty of \$95,000.
42. The Tribunal agrees with the respondent that this is an inappropriate way to construct the penalty. Indeed, the Tribunal has determined the penalty should be approached in the opposite way. All of the offences which were established as a result of the TEL order arose from the same acts and omissions. The respondent is no more culpable because its conduct happened to infringe four provisions than it would have been if it had breached only one. The correct focus is on the acts and omissions which led to the breach (together with the serious consequences which flowed), rather than the number of provisions which were violated. The Tribunal has determined it should assess the appropriate level of penalty for the most serious of the breaches, then apply it concurrently across all four.
43. On the other hand, the TEL breaches and the RBC breaches were separate events. They occurred several months apart in very different circumstances. The aggravating and mitigating factors are also different in each case. Once again it will be necessary to determine a (concurrent) penalty for the four RBC breaches, but this penalty will be cumulative on the penalty imposed as a result of the TEL order.
44. NZX submits that both breaches fall within Penalty Band 5 of the Tribunal's Procedures. Band 5 is designed for breaches of the Rules of a moderate nature, including provisions designed to ensure participants adhere to Good Broking Practice, and to ensure procedures are in place to prevent a breach of the Rules. Band 5 carries an indicative maximum penalty of \$50,000 in the case of a corporate respondent. Examples of Band 5 breaches include acting in a manner which is detrimental to NZX or brings NZX into disrepute. It encompasses conduct which affects the public's perception of NZX and market integrity.
45. The respondent argues that the breaches fall within Penalty Band 4, which applies to operational breaches of the Rules of a medium to moderate nature. This band is aimed at less serious conduct, for example failing to disclose a potential conflict.
46. The Tribunal is satisfied that the respondent's breaches fall squarely within Penalty Band 5. It failed to have procedures in place to avoid breaches of the Rules, and as a result caused detriment to the public's perception of the market. The need to unwind a substantial number of trades in the shares of a high profile company, and the attendant publicity, risked damaging the market's reputation, both with the wider public and with investors.



47. The Tribunal is satisfied that the TEL breach fell towards the top end of that band. There was a total failure to have appropriate filters in place. That failure has not been explained. But for the respondent's prompt acknowledgement of the breaches, and the immediate and responsible steps it took to prevent a recurrence, a penalty at the very top end of Band 5 would have been appropriate.
48. The Tribunal has determined that a penalty of \$35,000 is appropriate for the breaches arising from the TEL order, and imposes a penalty in that sum in respect of each breach. Those penalties are concurrent.
49. As already noted, the breach arising from the RBC order is in a different category. This breach was the result of a technical failure. The respondent has not taken responsibility for the breach as it did in the case of the TEL order. That said, there are also no aggravating features. The breach serves as a reminder of the need to ensure that critical systems, like DMA filters, are robust, and are properly tested and monitored. If participants choose to utilise third party providers, they must also insist that those providers are similarly vigilant to ensure errors of this kind do not occur.
50. The Tribunal is satisfied (and NZX accepts) that the respondent's culpability is lower in the case of the RBC order than for the TEL order. A penalty of \$10,000 is imposed on the respondent in respect of each breach arising from the RBC order. Once again, these penalties are concurrent. The effective \$10,000 penalty is cumulative on the \$35,000 penalty arising from the TEL order.

### **Summary of Orders**

51. It follows that the Tribunal imposes the following penalties:
  - (a) A **public censure** in the form of an announcement by the Tribunal to the market that the respondent has breached Rules 4.5.2, 8.8, 10.2.2 and 10.8.1 in respect of both the TEL order and the RBC order, and the respondent is censured accordingly.
  - (b) In respect of the TEL breaches, an order that the respondent pay to NZX, within 20 Business Days of the date of this decision, the **sum of \$35,000** by way of penalty.
  - (c) In respect of the RBC breaches, an order that the respondent pay to NZX, within 20 Business Days of the date of this decision, the **sum of \$10,000** by way of penalty.
  - (d) An **order** that the respondent, within 20 Business Days of the date of an invoice from NZX, pay the actual costs and expenses incurred by the Tribunal in considering this matter.

(e) An **order** that the respondent pay, within 20 Business Days of the date of an invoice from NZX, the actual costs and expenses incurred by NZX in relation to this matter.

52. The Tribunal recommends that this decision be released to the market in full under Tribunal Rule 6.6.

53. Under Rule 6.1.1 NZX has the discretion to refer a matter, which is not frivolous but is not sufficiently serious to require determination under the Full Hearing Procedure, to the Tribunal for hearing and determination by way of the Summary Hearing Procedure.

54. NZX's statement of case indicated it considered this matter appropriate for the Summary Hearing Procedure, and the Tribunal agrees.

**DATED** 9 JULY 2012

A handwritten signature in black ink, appearing to read 'D. Boldt', is written over the printed name of the Division Chairman.

David Boldt, Division Chairman, NZ Markets Disciplinary Tribunal