

SFC reprimands and fines Macquarie Equities (Asia) Ltd

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The Securities and Futures Commission (SFC) has issued a reprimand to Macquarie Equities (Asia) Ltd (Macquarie) (Note 1) and fined it HK\$4 million following an investigation into Macquarie's operation of a commission rebate scheme between January 2004 and January 2005 in relation to derivative warrants issued by Macquarie Bank Ltd (MB warrants).

An SFC investigation found that Macquarie operated the commission rebate scheme in breach of its obligation to act with due skill, care and diligence in the best interests of the integrity of the Hong Kong market (Note 2).

Macquarie used the commission rebate scheme to reduce transactions costs for investors and stimulate trading in selected MB warrants. Under the rebate arrangement, Macquarie agreed to reimburse investors, through their participating brokers, either in full or in part, the brokerage costs they were charged by their brokers for trading specified warrants.

In January 2002, the SFC warned Macquarie that they should ensure their commission rebate scheme did not facilitate trading of MB warrants that was not for any genuine economic or commercial purpose. The SFC was concerned that the commission rebate scheme could encourage improper trading and lead to a false market for the MB warrants.

The SFC identified heavy trading activities in MB warrants between two clients from two participating brokerages during the period from January 2004 to January 2005. The two clients repeatedly traded the MB warrants at or near the same prices within short time intervals and created substantial amounts of turnover (Note 3). While generating a significant amount of commission rebate from Macquarie, the two brokerages gave the clients discounts on brokerage costs for large volume trading. The two clients were then able to generate risk-free profit from the difference between the commission rebate and the discounted brokerage costs (Note 4).

Macquarie had put in place some controls to deal with the risk to market integrity and monitored the payment of commission rebate. However Macquarie failed to check whether the commission rebate scheme was providing clients with more money than was required to rebate actual brokerage costs. The volume and nature of the trading should have alerted Macquarie to make additional inquiries about the operation of the commission rebate scheme and to check whether it was distorting the market for these MB warrants.

The SFC considers that if Macquarie had realised the true nature of this trading activity, Macquarie would have been obliged to ban those brokers from further participation in the commission rebate scheme. Macquarie eventually did ban some commission rebate scheme participants, but this was too late (Note 5).

Macquarie's failure to properly monitor the operation of its commission rebate scheme contributed to conditions which created a distorted market for the relevant MB warrants for more than a year. The trading may have misled investors that certain MB warrants were more actively traded by a wider range of investors than was actually the case.

"Licensed intermediaries, especially those entrusted with the function of providing liquidity in a derivative warrant market, have an obligation to help protect market integrity," the SFC's Executive Director of Enforcement, Mr Mark Steward, said.

"Intermediaries should be alert to identify obviously suspicious trading especially when put on notice by the regulator and we will take action where intermediaries fail to maintain the standards of diligence expected in Hong Kong," he added.

In deciding on the public reprimand and a fine of HK\$4 million, the SFC has taken into account that Macquarie took some steps to supervise its commission rebate scheme, it was not itself a party effecting any abusive trading, it has co-operated with the SFC in the disciplinary proceedings and its clean disciplinary record.

End

Notes:

1. Macquarie Equities (Asia) Ltd is licensed under the Securities and Futures Ordinance (SFO) to carry on business in Type 1 (dealing in securities) regulated activities.
2. The SFC banned commission rebate schemes in March 2006.
3. For example, in one particular warrant, on one day, two clients of two participating brokers engaged in about 400 trades between themselves in just over 60 minutes of trading with a transaction around every 10 seconds (being responsible for 90% of turnover on that day). The trades were conducted at or near the same prices within short time intervals and with effective brokerage commission costs below the amount of commission rebate paid by Macquarie. It appears the trading turnover of the relevant MB warrants was inflated and may have misled investors into believing that certain MB warrants were more actively traded than was actually the case.
4. The SFC has commenced criminal proceedings against Patrick Fu Kor Kuen and Francis Lee Shu Yuen, clients of two brokers claiming commission rebates, for manipulative trading in MB warrants. They were charged under section 295 of the SFO for creating a false and misleading appearance of active trading in a number of MB warrants between January 2004 and January 2005 (see SFC press release dated 6 November 2008).
5. Macquarie terminated its commission rebate scheme in December 2005 following an internal review.

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