Stockbrokers Association of Australia
Incorporating SDIA

13 October 2011

The Hon Bill Shorten MP
Assistant Treasurer and Minister for Financial Services & Superannuation
Parliament House
Canberra ACT 2600

Dear Minister,

Stronger Super
- Transactions involving related parties

I refer to your announcement in September of reforms to Superannuation arrangements, *Stronger Super*[1].

I wish to address one aspect of the reforms, namely **transactions involving related parties**. In particular, there is the possibility in requiring such transactions to be undertaken on-market (where a market for the financial product exists), that the new measures may have the unintended consequence of facilitating transactions which would result in **serious breaches** of the ASIC *Market Integrity Rules* and the *Corporations Act*.

The *Information Pack* accompanying the announcement[2] states -

> ### 4.4 TRANSACTIONS INVOLVING RELATED PARTIES
> The Super System Review recommended that the superannuation legislation should be amended so that acquisitions and disposals between SMSFs and related parties must be conducted through a market where one exists. If no underlying market exists, the transactions must be supported by a valuation from a suitably qualified independent valuer. Concerns were raised in consultation that requiring related party transactions to be conducted through a market could involve transaction risk and result in increased costs. However, non-market transactions are not transparent and are open to abuse. Abuse can occur through transaction date and asset value manipulation to achieve more favourable outcomes in terms of contributions caps and capital gains tax.
> The Government will legislate to **require related party transactions** to be **conducted through the market** where one exists… *(emphasis added)*

[1] Media Release No.131 *A Better Deal For Superfund Members* 21 September 2011
[2] Australian Government *Stronger Super - Information Pack* 21 September 2011 page 18

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Existing Prohibitions against Related Party Transactions ('*Wash Trades*')

Our concerns in this area relate only to market transactions. Our Members are Market Participants of ASX and Chi-X and are subject to regulation under the *Corporations Act* and the ASIC *Market Integrity Rules*[3]. Under the *Act* and the *Market Integrity Rules*, transactions on-market between related parties – usually executed by a stockbroker by way of a 'Crossing' - may constitute serious offences. These are commonly referred as **wash trades**.

Corporations Act

Under the *Corporations Act*, section 1041B[4], trading on-market between related parties may amount to **false trading and market rigging**. This is a serious criminal offence which carries a maximum penalty for individuals of 10 years jail and/or a $500,000 fine or 3 times the profit made or loss avoided, and for companies a fine of $5,000,000 (or similar profit/loss provisions).

False trading and market rigging is also a civil penalty provision, so ASIC may take civil penalty proceedings in addition to criminal prosecution. ASIC may also take regulatory action against

[3] Prior to August 2010, a similar provision was enforced by ASX under the ASX Market Rules

[4] **CORPORATIONS ACT 2001 - SECT 1041B**

False trading and market rigging--creating a false or misleading appearance of active trading etc.

(1) A person must not do, or omit to do, an act (whether in this jurisdiction or elsewhere) if that act or omission has or is likely to have the effect of creating, or causing the creation of, a false or misleading appearance:

(a) of active trading in financial products on a financial market operated in this jurisdiction; or

(b) with respect to the market for, or the price for trading in, financial products on a financial market operated in this jurisdiction.

Note 1: Failure to comply with this subsection is an offence (see subsection 1311(1)). For defences to a prosecution based on this subsection, see Division 4.

Note 2: This subsection is also a civil penalty provision (see section 1317E). For relief from liability to a civil penalty relating to this subsection, see Division 4 and section 1317S.

(1A) For the purposes of the application of the *Criminal Code* in relation to an offence based on subsection (1):

(a) intention is the fault element for the physical element consisting of doing or omitting to do an act as mentioned in that subsection; and

(b) recklessness is the fault element for the physical element consisting of having, or being likely to have, the effect of creating, or causing the creation of, a false or misleading appearance as mentioned in that subsection.

Note 1: For ***intention*** , see section 5.2 of the *Criminal Code* .

Note 2: For ***recklessness*** , see section 5.4 of the *Criminal Code* .

(2) For the purposes of subsection (1), a person is taken to have created a false or misleading appearance of active trading in particular financial products on a financial market if the person:

(a) enters into, or carries out, either directly or indirectly, any transaction of acquisition or disposal of any of those financial products that does not involve any change in the beneficial ownership of the products; or

(b) makes an offer (the ***regulated offer***) to acquire or to dispose of any of those financial products in the following circumstances:

(i) the offer is to acquire or to dispose of at a specified price; and

(ii) the person has made or proposes to make, or knows that an associate of the person has made or proposes to make:

(A) if the regulated offer is an offer to acquire--an offer to dispose of; or

(B) if the regulated offer is an offer to dispose of--an offer to acquire;

the same number, or substantially the same number, of those financial products at a price that is substantially the same as the price referred to in subparagraph (i).

Note: The circumstances in which a person creates a false or misleading appearance of active trading in particular financial products on a financial market are not limited to the circumstances set out in this subsection.

(3) **For the purposes of paragraph (2)(a), an acquisition or disposal of financial products does not involve a change in the beneficial ownership if:**

(a) a person who had an interest in the financial products before the acquisition or disposal; or

(b) an associate of such a person;

has an interest in the financial products after the acquisition or disposal.

(4) The reference in paragraph (2)(a) to a transaction of acquisition or disposal of financial products includes:

(a) a reference to the making of an offer to acquire or dispose of financial products; and

(b) a reference to the making of an invitation, however expressed, that expressly or impliedly invites a person to offer to acquire or dispose of financial products. *(emphasis added)*

licensed entities like stockbroking firms and their staff where such conduct is detected, for example licence suspension or banning orders.

The prohibition applies to anyone who trades – for example the client of a stockbroker - or anyone who facilitates such trading, for example, the stockbroker who executes the crossing.

ASIC Market Integrity Rules

The *Market Integrity Rules*, which came into effect on 1 August 2010 on the transfer of market supervision from ASX to ASIC, only apply to Market Participants (i.e. Stockbroking firms). Under Rule 5.7[5], related party transactions are also a serious matter. They may amount to transactions which create a **false or misleading appearance of active trading, or market or price** of a security.

The maximum penalty for a contravention of Rule 5.7 is a fine of $1,000,000. ASIC may also impose other remedial measures, like ordering the forfeiture of profits and compliance training.

While ASIC has not yet reported any actions under Rule 5.7, there are numerous examples of regulatory action in this area. Some of the biggest fines ever imposed on stockbrokers have been for breach of this rule when it was an ASX Market Rule[6], for example:

- **Tricom Equities** (2009)[7]: this matter involved the largest ever penalty by ASX against a market participant, including fines totaling $1.35m, $500,000 of which involved market manipulation.

Several matters have also involved related party transactions, including:

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[5] **Part 5.7 Manipulative trading**

5.7.1 False or misleading appearance

A Market Participant must not make a Bid or Offer for, or deal in, any Products:

(a) as Principal:

(i) with the intention; or

(ii) if that Bid, Offer or dealing has the effect, or is likely to have the effect,

of creating a false or misleading appearance of active trading in any Product or with respect to the market for, or the price of, any Product; or

(b) on account of any other person where:

(i) the Market Participant intends to create;

(ii) the Market Participant is aware that the person intends to create; or

(iii) taking into account **the circumstances of the Order**, a Market Participant ought reasonably suspect that the person has placed the Order with the intention of creating,

a false or misleading appearance of active trading in any Product or with respect to the market for, or the price of, any Product.

Maximum penalty: **$1,000,000**

5.7.2 Circumstances of Order

In considering the circumstances of the Order, the Market Participant must have regard to the following matters:

…

(h) whether the transaction, bid or offer the execution of which is proposed will involve no change of beneficial ownership.

[6] Prior to August 2010 the relevant rule was ASX Market Rule 13.4

[7] ASX Circular 230/09 dated 10 July 2009

- **State One Stockbroking** (2009)[8]: where the firm was found to have executed numerous transactions involving no change in beneficial ownership, for which a fine of $35,000 was imposed; and

- **IMC Pacific** (2010)[9]: where numerous transactions involving no change in beneficial ownership had occurred, due to inadequate filters and trading system controls, for which the firm was fined $85,000.

As well as the reported cases, the importance of avoiding this type of trading is regularly communicated to the industry by way of guidance[10] and other communications, particularly towards the end of each financial year, when this type of trading tends to happen more frequently for tax reasons[11].

Complying with the current law – two legged transactions or off-market transactions, not crossings

A practical consequence of the current law and market integrity rules is that when a client wishes to execute a transaction between related parties – either to transfer listed securities to (or from) a Superannuation account from (or to) a personal account, or to crystalise a loss for tax purposes – there is a sale (or purchase) of the shares on-market by one account, and a separate but corresponding purchase (or sale) of the securities by the other related account. However, such pre-arranged sales may also be illegal under the prohibition on ***regulated offers*** in the Act[12]. Therefore, in order to remove **all risk** of contravening the law or rules, these transactions must be effected by a **direct transfer off-market**.

Apart from the risk of contravening the law or rules, another reason to avoid executing these transactions on-market is that it introduces **market risk**. In the current market which is characterized by periods of volatility, prices can move quickly, so market risk can be significant. Market risk can also arise if there is a price sensitive announcement (e.g. a takeover) made between the two legs.

Complying with the proposed law – crossings?

From the language of the latest *Information Pack*[13], it is not necessarily clear whether it is saying that that these transactions must be by way of a **crossing on-market,** but that is certainly the strong suggestion. If the Government will really '*…legislate to require related party transactions to be conducted through the market…*', then either:

a. it will result in transactions that are illegal due to the '**wash trading**' prohibition outlined above, or

[8] ASX Circular 172/09 dated 27 May 2009

[9] ASX Circular 196/10 dated 7 June 2010

[10] ASX Market Rules Guidance Note 1 *Prevention Of Manipulative Trading – Transactions Involving No Change in Beneficial Ownership* dated 3 January 2006

[11] For example Email from ASIC to all broking firms *Message to Market Participants re Trading at End of Year* dated 29 June 2011; ASX Circular 222/10 *Trading Near Financial Year End* dated 22 June 2010; ASX Circular 206/09 *Trading Near Financial Year End* dated 19 June 2009

[12] In executing the two transactions, there is the chance that they constitute a *regulated offer* which is prohibited under section 1041B(2)(b)

[13] *Information Pack* paragraph 4.4, set out on page 1 above

b. if instead it means that the trades must be executed on-market in **two legs** as outlined above, it leaves open the possibility that they are illegal due to being pre-arranged ***regulated offers.***

Solution

These transactions are executed for the purpose of moving assets to or from a Superannuation account, and not to create a false or misleading market, or to otherwise manipulate the market. They are merely transactions to achieve a transfer of securities between related entities. In this sense, they are not 'normal' transactions, because they do not reflect or draw upon existing supply and demand in the market. Therefore, they should be able to be executed off-market, provided that they are at the market price. Alternatively, if executed on-market, the existing crossing rules ensure that crossings are executed at or near the market price. It is therefore difficult to manipulate prices by way of crossings.

We would therefore submit that:

a. if the Government is to require such transactions to be conducted **on-market,** there should be a **suitably-worded exemption from the false trading or manipulation provisions** of section 1041B of the *Act* which would allow such transactions – whether by way of a crossing or two matched transactions - to take place,

or, as an **alternative solution**,

b. such transactions ought to continue to be permitted **off-market,** at a price set ***by reference to the market price on a licensed market***, rather than actually being ***executed*** on that market. This would ensure transparency and accuracy in asset pricing. Market data and prices are available in real time, and historical prices are also available. Therefore, there would be no uncertainty as to the relevant market price at the time of the relevant asset transfer.

Both these solutions would avoid inadvertent (but serious) contraventions of the *Act* by the client - and serious breaches of the *Market Integrity Rules* and/or the *Act* by their stockbroker – while ensuring transparency of pricing in SMSF asset transfers.

Market manipulation, which includes trading between related parties, is one of the key compliance and risk areas in stockbroking. Accordingly, its prevention is the focus of much compliance training, monitoring and supervision in stockbroking firms, and market surveillance by regulators. If the proposed tax changes were to take effect, we fear that our Member firms would be called upon to execute transactions between related parties on-market, with serious consequences for the broker and the client.

We would be happy to discuss these matters further. Should you require any further information, please contact me on the above details.

Yours sincerely,

David W Horsfield
Managing Director/CEO