



# **Case Study**

## **Nomura International PLC**

### **Australia**

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**OVERVIEW** In April 1996, there were signs that a foreign firm, Nomura International PLC, had engaged in questionable trading activity on the Sydney Futures Exchange in Australia. Suspecting possible market manipulation, regulators at the Securities and Investments Commission were immediately concerned about whether Australia's laws provided adequate protection for domestic investors. The situation was further complicated by the fact that Nomura's operations hub was based offshore, in Japan, and trading orders originated from its offices in London and Hong Kong.

The IOSCO Objectives and Principles of Securities Regulation state that:

*“9 The regulator should have comprehensive enforcement powers.*

*10 The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.*

*11 The regulator should have authority to share both public and non-public information with domestic and foreign counterparts.*

*12 Regulators should establish information sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.*

*13 The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.*

*25 The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.*

*26 There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.*

*27 Regulation should promote transparency of trading.*

*28 Regulation should be designed to detect and deter manipulation and other unfair trading practices.*

*29 Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.”*

This case study demonstrates the importance of securing regulatory cooperation, the difficulty in distinguishing acceptable market practice from manipulation and proving such a case, and the difficulty in deciding what is an acceptable outcome when those involved are not within your reach. It is presented by Alan Cameron, then Chairman of the Australian Securities and Investments Commission (ASIC).

- KEY ISSUES**
- Securing international cooperation
  - Taking action when necessary
  - Identifying acceptable outcomes
  - Defining market manipulation under current law
  - Dealing with innocent parties involved in a complex and possibly illegal trading scheme
  - Finding expert witnesses and credible evidence in a complex case.

**OBJECTIVES** The Toronto Centre program provides you with simple but powerful processes to strengthen your leadership skills in your regulatory function. Each case used in the program enhances specific leadership capabilities.

This case is designed to enhance your ability to:

- Identify the key objectives of the regulatory process, as well as the powers and procedures regulators need to meet these objectives in an effective manner
- Understand the impact of cross-border information sharing
- Prepare a persuasive presentation of a plan for change to key stakeholders
- Understand the benefits of using a disorderly market to leverage changes in the legal framework in a country.

## LEGISLATIVE AND COUNTRY BACKGROUND

### a. Australia

Australia is a vast country. Its population of approximately 21 million was until recently largely of Anglo-Saxon heritage (there has been significant immigration since the end of World War 2, first from Europe but more recently from Asia and Africa) and mostly settled in five major cities. Although it is a federation with a written constitution, similar to the US, Australia's government and legal structure is based mainly upon the UK model.

### b. Weaknesses in the financial system

Deregulation in financial services in the 1980s led to changes in the economy. This was the time of great entrepreneurship in Australia and banks eagerly followed the new self-made risk-takers into unfamiliar territory. The result was predictable – bankruptcies. The banking supervisory agency, then the Reserve Bank of Australia, had concerns about the financial system because of recent failures of a building society, a friendly society<sup>1</sup> (which was bought out while insolvent) and a mortgage company. The failures also raised public concerns about the stability of the system and prompted a flight to quality.

### c. The regulatory framework

A new financial regulatory framework came into effect on July 1, 1998 in response to the recommendations of the Financial System Inquiry (the Wallis Committee). Under the new structure three agencies were made responsible for financial sector regulation:

*The Australian Prudential Regulation Authority (APRA)* is an integrated prudential regulator responsible for deposit-taking institutions (banks, building societies and credit unions) as well as friendly societies, life and general insurance companies and superannuation funds.

*The Reserve Bank of Australia (RBA)* has responsibility for monetary policy and for overall financial system stability. The RBA no longer has an obligation to protect the interests of bank depositors; rather, its task is to deal with threats to financial stability which have the potential to spill over to other areas of economic activity and affect consumer and investor confidence.

*The Australian Securities and Investments Commission (ASIC)* enforces company and financial services laws to protect consumers, investors and creditors. It regulates and informs the public about Australian companies, financial markets, financial services organizations and professionals who deal and advise in investments, superannuation, insurance, deposit-taking and credit. The Australian Securities and Investments Commission Act 2001 requires ASIC to:

- Uphold the law uniformly, effectively and quickly.

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<sup>1</sup> Building and friendly societies are community-based mutual societies which operate as non-bank deposit-taking institutions.

- Promote confident and informed participation by investors and consumers in the financial system.
- Make information about companies and other bodies available to the public.
- Improve the performance of the financial system and the entities within it.

#### **d. More about ASIC**

ASIC replaced the Australian Securities Commission (ASC), which had been established in 1991. Before that corporate regulation had been a state and territory responsibility, with coordination of policy through a national commission. But the results had been unsatisfactory and the regulators were seen as under funded and uncoordinated. In particular, they had failed to deal effectively with the excesses of the entrepreneurs of the '80s.

The ASC was a federal body but operated under a cooperative agreement with the states, a deal which unraveled for constitutional reasons in the late 1990s, and was replaced by new laws supported by a formal reference of power by all states to the federal government.

The ASC combined corporate regulation with financial markets regulation in a way found in few jurisdictions, and had responsibility for market integrity and consumer protection across the financial sector added when it became ASIC in 1998. ASIC, as it is now called, combines corporate regulation with financial markets regulation in a way found in few jurisdictions, and had market integrity and consumer protection across the financial sector added to its mandate in 1998. The timeline in this case spans the two regulatory regimes. However, for ease of reading we have referred to the regulatory body as ASIC throughout.

#### **LEGAL AND REGULATORY FRAMEWORK**

The following provides a summary of the main Australian laws at the time of these events that are relevant to this case:

- S 998(1) and S 998(3) of the *Corporations Law* prohibit the sale and purchase of securities that do not involve a change of beneficial ownership.
- S 998(1) of the *Corporations Law* prohibits conduct that creates a misleading appearance of active trading on the Australian Stock Exchange (ASX) in illiquid securities.
- S 1260(1) (b) of the *Corporations Law* prohibits actions that would create a false and misleading appearance with respect to the price for dealings in contracts in the futures market.

These laws create criminal offences, which require to be proved beyond reasonable doubt, in jury trials. But they also provide for civil enforcement, in the sense that the regulator could seek injunctions restraining breaches of the laws, declarations that the laws had been breached, or damages. Such civil cases are brought before judges without juries. While ASIC was allowed to prosecute criminal cases in its own right, it always deferred to the Director of Public Prosecutions (the DPP) in major cases. ASIC was the sole decision maker in civil cases unless the civil case would preclude a criminal case based on the same facts, when it was required to consult the DPP.

At the time, ASIC had memoranda of understanding in place, and good relations, with the relevant regulators in London and Hong Kong.

Since the events here described, the Australian Stock Exchange (ASX) and the Sydney Futures Exchange (SFE) have merged, and the laws governing them have been consolidated, but at the time, they were separate, as set out above.

**TIMELINE** April 4, 1996.

**CONTEXT** On Thursday, April 4, 1996, Alan Cameron, Chairman of the Australian Securities and Investments Commission, was about to enjoy a much-needed holiday in Australia's Outback. He turned on the car radio in his rented car to hear news that did not fit with a holiday mood. The Sydney Futures Exchange had publicly announced that it was referring actions taken by Nomura International PLC (Nomura) of London to the Commission.

### READING

**Nomura:** Nomura International PLC is an arm of the Tokyo-based Nomura securities group, one of the oldest and largest in the world. It had been founded in 1872 and had grown to a firm with over US \$150 billion in assets. It had a registered dealer, Nomura Australia, in Australia, but it was not involved in the activities of March 29, 1996 set out in this case.

**Index arbitrage operations:** In February of 1995, Nomura began index arbitrage operations in the Australian market. The strategy consisted of purchasing on the Australian Stock Exchange (ASX) all of the 353 stocks included in the All Ordinaries Index (All Ords), in the proportions that those stocks were so included, and selling Share Price Index (SPI) futures contracts on the Sydney Futures Exchange (SFE). Nomura's position grew from an initial US \$3 million to US \$435 million in little over a year.

**Significant short position:** In March 1996, the SFE had expressed concern to Nomura over its significant short position in March contracts – about 15% of open interest. This amounted to a significant bet that the All Ords would decline. The SFE recognized that any attempt to liquidate the extensive position on the expiry date of March 29 could lead to a disorderly market. Mr. Robert Mapstone, co-head of Nomura's equities division in London, assured the SFE that Nomura had no intention to engage in practices that would result in a disorderly market. Based on these reassurances, the SFE expected much of Nomura's position to be rolled over, rather than liquidated.

However, Nomura allowed its March futures contracts to go to expiry on March 29. At the same time, it bought more "sold" positions (which also went to expiry), and about US \$50 million of June "sold" contracts. Further, according to initial reports, it was believed that Nomura PLC had instructed a number of Australian share brokers to sell the whole of its very large share portfolio aggressively in the last few minutes of trading. Moreover, it was known from reports from other brokers that Nomura had placed orders to buy a small quantity of some of the same shares at a 5% to 20% discount to the market.

Volume was considerably heavier in the final minutes of trading, with Nomura attempting to sell shares worth over US \$600 million. This was more than the normal daily volume of the exchange. Additionally, it now appeared that Nomura was both the seller and buyer of shares in Metal Manufacturers Ltd. (MML) and National Mutual Property Trust (NMPT), although as a result of its own mismanagement it had "only" bought two parcels of shares from itself. If everything had gone according to "plan", some 40-50 parcels should have been bought and sold by Nomura.

**ASIC notified:** On Wednesday, April 3, representatives from the SFE and the ASX notified Alan Cameron, Chairman of ASIC, of their serious concerns about the trading that took place on Friday, March 29. They revealed that the relatively small fall in the All Ords of 26 points and the more dramatic decline in the price of two rather illiquid entities, MML and NMPT, were likely the result of a single trading strategy designed by Nomura.

MML had closed at bids 15% below the previous day's close, while the price for NMPT was down 20%. The relatively small effect of the trading strategy on All Ords was due to the fact that many of the brokers could not or would not execute Nomura's sell orders. This, they speculated, was because the brokers considered the sell orders not to be believable. Reports were even coming in that some orders had been placed from London to sell some of the leading companies' shares at prices 5 to 20% below the previous day's closing prices.

**Determining Nomura's intentions:** Before taking action, Mr. Cameron knew that he would have to determine what an acceptable arbitrage trading strategy was for the ASX and SFE. While there were relevant sections in both s. 998 and s.1260 of the Corporations Law, it was possible that the actual conduct of Nomura fell between the two, that is, Nomura was not technically in breach of either.

Of particular concern was the difficulty of determining Nomura's intent. Even assuming Nomura's actions could be disentangled, intention had always been regarded as crucial to the concept of manipulation. Proving that it was Nomura's intention to manipulate the markets would be difficult. Furthermore, all of the orders had come from London, or Hong Kong. There was no one in Australia who was directly involved, other than a host of brokers who had received their instructions, piecemeal, on March 29.

**TIMELINE** Late April, 1996

**CONTEXT** Soon after being notified by the SFE and ASX, Mr. Cameron realized that he had no choice but to proceed with finding a solution to the problem created by Nomura's questionable trading activity. He knew that he had to get credible evidence of wrongdoing. Even if a criminal case failed because of gaps in the law, it was imperative to find that out definitively.

**READING** **Investigation:** Any investigation into the activities of Nomura would be difficult given the fact that it was a non-resident firm. Mr. Cameron needed to gain support from the relevant parties in Hong Kong and London. He needed to build a strong case, or risk diminishing the reputation of the Australian markets by challenging Nomura as Nomura may well argue that ASIC had been naïve in not understanding its sophisticated trading strategies.

**Expert evidence:** Mr. Cameron identified the steps he needed to take. First he needed to gather more information from the Australian exchanges and brokers to make certain that the full extent of Nomura's proposed operation was known. Next, he had to determine who would be credible and willing witnesses to provide expert evidence given that the Nomura trading operation was hardly routine behavior.

Mr. Cameron also needed to determine what the Director of Public Prosecutions would consider an adequate factual basis to prove in a criminal case, that Nomura's intent was to manipulate the market. Nomura would most certainly argue that it was engaging in arbitrage activities that were entirely legal. Finally, there was the question of who one could prosecute since the local office was not involved. What were the available options?

**International cooperation:** With these key questions and issues in mind, and recognizing that he had to build a credible case on solid evidence, Mr. Cameron wondered if it might be possible to garner support from other parties to make the case for international cooperation stronger. Mr. Cameron realized that he would have to persuade the Securities and Investment Board in the UK to cooperate. He might also need the cooperation of Scotland Yard, the Ministry for Trade and Industry, and of course, the SFE and the ASX.

**Domestic involvement:** Equally important, Mr. Cameron had to determine how to treat the brokers who were presented with Nomura's buy and sell orders that day. Were they to be treated as suspects, or willing witnesses?

**TIMELINE** May, 1996

**CONTEXT** Mr. Cameron realizes that to contain the impact of the problems posed by the Nomura trading activity, he needs to find credible evidence of wrongdoing and, where necessary, to identify any possible gaps in the Australian laws. He is aware that he needs to carry out his investigation in a manner that is mindful of the needs and concerns of the major stakeholders involved in this situation.

The enforcement of rules that seek to restrain market manipulation and prevent the creation of artificial conditions and fraud are complex and present a challenge to even the best equipped regulatory agencies.

#### CHRONOLOGY OF EVENTS

February 1995	Nomura begins index arbitrage operations in Australia.
March 1996	Sydney Futures Exchange (SFE) expresses concerns to Nomura over its significant short positions. Nomura reassures the SFE of its intentions.
Friday, March 29, 1996	Nomura lets its March futures contracts expire. Nomura instructed Australian brokers to aggressively sell its positions at the close of trading.
April 3, 1996	Representatives from the Australian Stock Exchange and the Sydney Futures Exchange (SFE) alert Alan Cameron concerning possible irregularities in the trading strategies employed by Nomura PLC of London on March 29.
April 4, 1996	The SFE formally refers the case to the Australian Securities Commission.