Market Watch

Markets Division: Newsletter on Trade Publication Issues

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Financial Services Authority

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Manipulation of the order book – 'layering or spoofing'

We would like to highlight to firms who offer their clients direct market access (DMA) our concerns about order book conduct and the intentional pattern of behaviour called layering or spoofing. We have seen this most frequently when clients:

- layer the order book, in which multiple orders are submitted at different prices on one side of the order book slightly away from the touch;
- submitted an order to the other side of the order book (which reflected the client's true intention to trade); and
- following the execution of the latter order, rapidly removing the multiple initial orders from the book.

This behaviour may give a false or misleading impression about the supply and demand for securities.

Why are we concerned about this?

We believe that this behaviour could constitute market abuse (manipulating transactions) under s118(5) or market abuse (misleading behaviour/distortion) under s118(8) of the Financial Services and Markets Act (FSMA). The Code of Market Conduct at MAR 1 provides guidance on the market abuse regime.

All exchanges and Multilateral Trading Facilities (MTFs) will have procedures in place to prevent this activity from taking place. The London Stock Exchange (LSE) recently covered this topic in its

Compliance Update and reminded member firms of their obligations under LSE rules to ensure they exercise adequate control over the activities taking place on its DMA platforms.[1]

So what will happen next?

Order book transactions are monitored by trading platforms, and where there are circumstances to suggest that abusive conduct has taken place in the order book, we will consider taking action against the individual or firm involved in the trading.

DMA providers should ensure that they have appropriate systems and controls in place to identify and prevent layering and spoofing. Where these systems and controls are not deemed sufficient, we may also consider supervisory or enforcement action against the DMA provider.

Focus on Suspicious Transaction Reports (STRs)

Since the Market Abuse Directive was introduced in 2005 we have received over 1,000 STRs. We greatly appreciate the continued efforts of firms to submit STRs to us in line with their obligations under SUP 15.10 and also their overall support to us in combating market abuse.

While we believe the STR regime to be generally working well, suspicious trading sometimes comes to our attention where firms involved in the trading have not submitted an STR – and where we might have expected to have received a report. So we are increasingly initiating telephone contact with firms as a matter of course in these cases. Please note that this process will not become part of the standard Transaction Enquiry Form but we will instead undertake it on a case-by-case basis.

Our principal intention in undertaking this work is to better understand the reasons firms do not submit STRs and to pass feedback to the relevant firm. The increased dialogue will also help to identify instances where a firm's practices may fall below standards we expect in SUP 15.10.

We acknowledge that identifying suspicious transactions is judgemental. However, we want to ensure that firms have the necessary systems and controls to meet the requirement, do not take an overly legalistic approach to SUP15.10, and/or do not apply a higher test than the '*reasonable grounds to suspect that the transaction might constitute market abuse*'. Where such instances are identified they will be discussed with the relevant firm's FSA supervisor.

Unsure about whether to submit an STR? We are always available to help; please contact:

Market Abuse Helpline
020 7066 4900
market.abuse@fsa.gov.uk

Article 57 requests for information

Under Article 57 of MIFID, a competent authority of one Member State may request the cooperation of a competent authority in another Member State in a supervisory activity or for an investigation. Article 57 also provides that in the case of investment firms that are remote members of a regulated market, the competent authority of the regulated market may choose to address the firms directly, in which event the requesting authority should inform the competent authority of the home Member State of the remote member.

1 **http://www.londonstockexchange.com/traders-and-brokers/rules-regulation/change-and-updates/compliance-update/comp-update-jul-09.pdf**.

Our approach on this, outlined in our Policy Statement PS07/2, was that the Article 57 discretionary power related only to remote members of regulated markets and only to matters concerning the supervision of those markets. Our view at that time was that the competent authority of the regulated market may not approach the remote members of that market for the purpose of the general supervision of those members.

However, the issue was taken to the Committee of European Securities Regulators (CESR) Chairs in order to reach a common EEA view. The consensus was that the scope of direct approaches to remote members under Article 57 also extends to market abuse enquiries in relation to the activities of those remote members on those markets. In light of the decision of the CESR Chairs, we now encourage firms operating as remote members to comply with direct requests by the relevant competent authorities.

Some firms have expressed concerns about the processing of direct requests from overseas authorities. We have proposed to the industry and to CESR the adoption of a common format to data requests, to facilitate the making and handling of requests. We also propose that these requests contain references to the local laws through which the discretionary Article 57 powers are enacted.

We are also aware that some firms have concerns that their client confidentiality obligations prevent them from providing client information unless required by law to do so. In practical terms, this means that some firms are unwilling to respond to direct requests, although they are willing to provide the information to us to pass on to the overseas regulators, subject to the exercise of our statutory powers under FSMA.

We continue to act as an intermediary between the firms and the overseas regulators to resolve this issue. In the meantime we ask that remote members comply with direct requests, and where they feel that they are unable to do so, explain this to the requesting authority.

Short selling

The future regulation of short selling has, in recent months, been the subject of much attention, both in the UK and elsewhere.

Market participants will be aware that at the end of June we extended indefinitely the current regime requiring disclosure of net short positions of 0.25% and above in UK financial sector stocks. Back in February we also provided our views on the permanent regulatory options in relation to short selling when we published a Discussion Paper – DP09/1, 'Short Selling'. In this paper we indicated that we did not favour any type of permanent ban or direct constraint on short selling, but felt we should be able to intervene to ban short selling, either on a blanket or targeted basis, should emergency circumstances so require.

We also believed it would be valuable for transparency around short selling to be enhanced. The transparency model we proposed involved public disclosure of individual positions at or above 0.5% held in all UK stocks. We were clear that we regarded international consensus in this area as very important and that it was possible that our proposals could change in the light of the various international initiatives taking place.

In July the Committee of European Securities Regulators (CESR) published CESR/09-581 *CESR Proposal for a Pan-European Short Selling Disclosure Regime*: **www.cesr-eu.org/index.php?page=consultation_details&id=142**. In this paper, CESR indicated that it had chosen to prioritise the development of a regime for disclosure of short selling, but that it was still considering whether other options were required or feasible.

The disclosure model proposed by CESR was very similar to that we proposed, but differed in two key respects:

- **scope** – the disclosure regime would apply to short positions in all EEA stocks; and
- **two-tier disclosure** – in addition to public disclosure of individual positions of 0.5% and above, it proposed that there should also be confidential disclosure to the regulator at and above positions of 0.1%. The reasoning behind this lower tier for 'private' disclosure to the regulator was that it would help regulators monitor developing risks to orderly markets and market abuse.

Our stakeholders have made it clear to us that one of the most important things to achieve in the short selling context is as much cross-border consistency as possible, particularly within Europe. The CESR proposals are the European regulatory community's response to that call for consistency so we would urge anybody with an interest in this subject to submit a response to CESR/09-581. The consultation closes on 30 September and, in line with CESR practice, there is an Open Hearing on 9 September at the CESR Offices in Paris at which views can be aired.[2]

We intend to publish our Feedback Statement to DP09/1 in early October. We received 54 responses to DP09/1, from trade bodies, regulated and unregulated firms and individuals. We will, of course, take into account all these responses and the CESR proposals in our feedback.

Alternative Instrument Identifier (Aii) implementation date postponed

In Market Watch 31 we stated that the go-live date for the implementation of the Aii would be 21 September 2009. However, in light of some difficulties encountered in rolling out the system for processing Aii transaction reports, we have unfortunately had to postpone the implementation date. We are currently undertaking an immediate re-planning exercise and hope to be in a position to give you a revised date by the first week in September.

The introduction of the three new derivative type classifications (spread bet on an option on an equity, contract for difference on an option on an equity, and complex derivatives) will still be effective from 21 September 2009. But no action will be taken against firms that wish to implement this change at the same time as implementation of the Aii code.

We apologise for the postponement of the Aii go live date and thank all the firms and Approved Reporting Mechanisms (ARMs) for their commitment and hard work in order to meet their obligations under Markets in Financial Instrument Directive.

The latest update on the implementation of the Aii is on our website at:
www.fsa.gov.uk/pages/Doing/Regulated/Returns/mtr/aii_update.shtml.

Transaction Reporting User Pack (TRUP) – new version

We are finalising a new version of the transaction reporting user pack with the TRUP working group. This document will contain updated information on transaction reporting with some new sections and some extended sections. The new TRUP will include information on how to report transactions in Aii derivative instruments and will be published on the transaction reporting section of the website shortly.

2 **http:/www.cesr-eu.org/index.php?page=contneu_hearings_details&id=95**.

Common transaction reporting issues

Reporting of principal transactions executed on LIFFE

After Aii is implemented, transactions in derivatives admitted to trading on a regulated market where Aii is the method of identification must be reported to us. As a service to their members, LIFFE has agreed to report its members' principal transactions executed on the exchange and through BClear in fungible instruments.

Firms can decide whether to rely on this service or to report these transactions independently through their ARM. Firms should tell us in writing what they have decided, but will still need to report client transactions separately.

Reporting Aii derivative transactions cleared through exchange platforms (e.g. BClear)

When a transaction conducted through the clearing platform is in a true Aii instrument (i.e. exactly the same in all respects as and fungible with the exchange traded instrument) a reporting firm has the choice of whether to report this transaction as an Aii transaction (exactly the same as for an on-exchange transaction) or as an OTC transaction using the MIC of "XXXX".

Where the derivative instrument differs in any characteristics from an exchange traded instrument (e.g. Strike Price, Maturity Date – what we are terming an "Isotope" of the exchange traded instrument) or is a completely bespoke instrument, the transaction must always be reported as an OTC transaction using the MIC of "XXXX". It is important that the correct time and date should be reported for all transactions.

Example 1

Buy 10 Vodafone Mar 2010 120 Calls on LIFFE

The firm will report this using the Aii code. The counterparty will be the Exchange CCP.

The Aii code for this transaction will contain the following components: Instrument Identification "VOD" (Exchange Product Code of Vodafone), Strike Price 1.20, Expiry Date 19/3/2010, Derivative Type: "O", Put/Call Indicator "C", Venue Identification "XLIF".

Example 2

Buy 10 Vodafone Mar 2010 120 Calls through BClear (Fungible instrument)

Option 1

The firm may report this transaction as a LIFFE transaction using the Aii code. The counterparty will be the actual counterparty to the transaction.

The Aii code for this transaction will contain the following components: Instrument Identification "VOD" (Exchange Product Code of Vodafone), Strike Price 1.20, Expiry Date 19/3/2010, Derivative Type: "O", Put/Call Indicator "C", Venue Identification "XLIF".

Option 2

The firm may report this transaction as an OTC transaction using the Market Identifier Code (MIC) of "XXXX". The counterparty will be the actual counterparty to the transaction.

Components of the report will include: Underlying Instrument Identification "GB00B16GWD56" (ISIN of Vodafone), Instrument Type "A" (Equity), Strike Price 1.20, Expiry Date 19/3/2010, Derivative Type: "O", Put/Call Indicator "C", Venue Identification "XXXX".

Example 3

Buy 10 Vodafone 5/4/2010 123 Calls on BClear (Isotope)

The firm **must** report using the Market Identifier Code (MIC) of "XXXX". The counterparty will be the actual counterparty to the transaction.

Components of the report will include: Underlying Instrument Identification "GB00B16GWD56" (ISIN of Vodafone), Instrument Type "A" (Equity), Strike Price 1.23, Expiry Date 5/4/2010, Derivative Type: "O", Put/Call Indicator "C", Venue Identification "XXXX".

Populating the Trading Date and Trading Time fields

The trading date for a transaction entered in the trading date field must be presented in the correct format as specified by the ARM (e.g. in UK format rather than US format).

Please note that, where a transaction has been undertaken outside of the UK, the trading date and time, and where applicable, the maturity date, should reflect the day and time in UK time when that transaction report reaches the FSA. For example, a trade executed in Tokyo on Wednesday 21 February 2007 at 08:30 local time would be reported to us with the UK trading date, Tuesday 20 February 2007, and UK time 23:30.

The trading time should therefore be reported in Greenwich Mean Time (GMT) or, during the summer, in British Summer Time (BST). Firms may need to contact their ARM(s) to see whether they need to switch from/to GMT/BST or whether their ARM(s) will meet this requirement for them.

Failure to ensure the trading date and maturity date are reported to us in UK time may cause a one day contract traded outside of the UK to be rejected by your reporting system(s) as the contract may appear to be expiring before the trading date.

Firms must also ensure that we receive the trading time information as in ISO 8601 Time Format HH:MM:SS and so they should contact their ARM(s) to see if this requirement is met.

If your firm works a client's order as riskless principal and holds the stock on your own book until the order is complete, you must book the client transaction at the time you have agreed with the client.

When a firm uses an external broker to fill an order on a market and that external broker fills the order in several transactions, the time of trade in the transaction reports should reflect the time at which the firm becomes the beneficial owner (i.e. the allocation time).

Where the trading time is not made available, the default time of 00:01:00 UK time must be used (this value will need to be presented in the format applicable to the ARM (s) used). Using this default time will ensure that these transaction reports are picked up during our monitoring of trading before a price sensitive announcement. Where the 'seconds' element of the trading time is unknown or not captured, it should be defaulted to '00'. However, firms should strive to capture this information correctly.

Where reporting firms are unable to meet the requirement to fill the trading time field with the correct trading time and instead provide the time at which the trade is entered in to their system, firms should make best efforts to minimise any discrepancy between the trading time and the booking time.

It is important that all reporting firms ensure that times and dates reported are accurate and that accuracy is not diminished by systems wrongly adjusting these times and dates. Reporting firms are asked to check that both their internal systems (in whichever geographical location they reside) and their submitting firms' systems (ARMs) are not misinterpreting the information sent to them for submission to us.

Populating the Venue Identification field for OTC transactions executed through an MTF

You should report transactions in OTC instruments executed through an MTF as OTC transactions and the Venue Identification should be marked as OTC using the Market Identifier Code "XXXX".

Transaction reporting forum

We held our second transaction reporting forum on 3 August. This was heavily oversubscribed, so we are pleased to announce that we are planning an additional forum date for those firms who were unable to attend. We will publish a summary of the items discussed, together with slides, on our website shortly.

We would like to thank all firms who attended both this and our first transaction reporting forum on Friday 3 April – in particular our guest speaker, Ross Barrett, Policy Director of Capital Markets at the British Bankers' Association (BBA). Ross spoke about the collaborative way we have worked with the BBA and the industry on transaction reporting related issues. A summary of the items discussed at the first forum and slides is on the transaction reporting section of our website at:
www.fsa.gov.uk/transactionreporting.

Data quality

Firms need to ensure that their transaction reporting is accurate and complete. So they must have appropriate systems and controls to enable them to comply with their regulatory obligations.

Furthermore, the transaction reporting arrangements within firms should include periodic reviews of transactions reports. To facilitate this, we encourage all firms to request a sample of transaction reports we have received so that firms can check those reports against their own records. To request extracts of transaction reports, please use the web form at:

www.fsa.gov.uk/pages/Doing/Regulated/Returns/mtr/managing/request/index.shtml.

More information on managing the quality of your data is available in Market Watch 29.

Contact us

This newsletter is produced regularly by the Market Conduct and Transaction Monitoring teams in our Markets Division. If you would like to receive this newsletter by email, or have any comments on it, please contact **market.watch@fsa.gov.uk**.

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