



Welcome to the latest edition of Compliance Update

This edition of the London Stock Exchange's Compliance Update focuses on a limited number of topical regulatory issues.

We begin this edition by revisiting the topic of order book conduct, focussing on the practice of layering or spoofing. The Exchange addressed this topic in Stock Exchange Notice N78/07. However, since then, we have come across variations of the practice described in that Notice and would like to remind member firms of their obligation to avoid such activity taking place under their trading codes.

Indeed, the Exchange's Executive Panel recently considered a case which was brought against a member firm for allegedly failing to have sufficient controls in place over the order flow of an order routing client, which the Exchange believed had been layering the order book. The member firm in question was found to have breached Rules 2101 and 1020 and the Executive Panel issued a private censure and imposed a fine of £35,000.

In the last edition of Compliance Update the Exchange provided an update on its progress managing the defaults of Lehman Brothers International (Europe) and Teathers Limited (formerly Landsbanki Securities (UK) Limited). In the interim, the Exchange has also declared Madoff Securities International Limited a defaulter on the Exchange. The Exchange continues to manage the defaults as expeditiously as possible and this edition provides a further update on our progress.

We hope that you will find this edition a useful source of information on some of the Exchange's current regulatory priorities.

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This article examines the practice of “layering” or “spoofing” and explains the Exchange’s concerns with respect to these techniques. The article reminds member firms of their obligations to control the activity that takes place under their trading codes and explains how the Exchange will approach any incidents of layering/spoofing that arise. The Exchange understands the challenges faced by firms in this area but will take action where necessary.

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This article sets out the details of two recent disciplinary cases undertaken by the Exchange. Member firms are encouraged to read this article to understand the sorts of circumstances in which the Exchange will make use of its disciplinary powers.

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Since the last edition of Compliance Update the Exchange has made considerable progress with respect to managing its procedures with respect to the defaults last year of Lehman Brothers International (Europe) and Teathers Limited. However, in the intervening period a third default has been declared: that of Madoff Securities International Limited. This article provides a status update with respect to the defaults.

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This article reminds member firms of the importance of notifying the Exchange when any matter arises that is material to a member firm’s ongoing suitability as a member, or where a change is proposed to a member firm’s trading profile. It provides contact details for the relevant team at the Exchange that handles such notifications.

[Stock Exchange Notices](#)

Order Book Conduct: Layering/Spoofing

The Exchange wishes to revisit a topic previously highlighted 18 months ago. On 3 December 2007, the Exchange issued Stock Exchange Notice N78/07, which concerned order book conduct and a practice called layering or spoofing. The notice was prompted by concerns regarding the behaviour of an order routing client of a member firm, which appeared to be engaged in the following process:

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

Since N78/07 was published, the Exchange has witnessed and addressed potential variations of this practice. One such variation involves the use of very large single orders to create the impression of liquidity.

Having observed such activity, the Exchange recently brought a disciplinary case against a member firm. In this particular instance, the case was based on the member firm failing to control properly the order flow of an order routing client that appeared, to the Exchange, to be engaged in layering. The details of the case were published on 29 June 2009 in Stock Exchange Notice N33/09, and are also outlined in our article on disciplinary action in this edition of Compliance Update. The following is an extract from N33/09:

“Member firms are reminded that orders entered by clients under their trading codes remain their responsibility. Member firms should have controls in place to prevent orders entering the market that could be abusive or otherwise harmful to the integrity of the market.

“Orders which layer the order book have the potential to damage the fairness and integrity of the market and may give rise to a breach of Rule 1400 (misleading acts, conduct and prohibited practices), particularly if the orders originate from the member firm's own traders or it is clear that the member firm is otherwise complicit in the activity. Equally, the Exchange may take action against a member firm under other rules, including Rules 1020 and 2101 (as illustrated above), if it deems this appropriate in the given circumstances.

“The Exchange recognises the challenges involved in designing and implementing controls to prevent abusive behaviour but every effort should be made by firms to avoid breaches of the rules. Where incidents arise the Exchange will expect the firm to take appropriate action, which may involve introducing new controls or, if the activity originates from a client, putting that client on a separate trader group or terminating its access. The incident may also warrant discussion with the Financial Services Authority (“FSA”). If the steps taken by the member firm fail to control the behaviour the Exchange may have to

take disciplinary action and/or make a formal referral of the incident(s) to the FSA for investigation under its market abuse powers.”

The Exchange monitors for apparent layering/spoofing activity across all order driven stocks and, where concerns arise, the member firm will be contacted for further information.

Notification - erroneous order entry - member firms fined for breaches of the rules

On 22 May 2009 the Executive Panel of the London Stock Exchange found a member firm in breach of Rule 2101 in that the firm failed to have sufficient order management systems and controls designed to prevent the entry of erroneous executable quotes to the Exchange's trading system.

The member firm had experienced technical difficulties with its quoting software leading to erroneous executable quotes that were 46% away from the last closing price, being submitted to the Exchange. This drove down the price of the security and resulted in an automatic suspension. At the uncrossing of the automatic suspension the security traded several times all at incorrect prices. The Exchange subsequently cancelled the trades on the member firm's behalf.

In setting a fine of £25,000 the Panel took into account the fact that the member firm had been cooperative during the Exchange's investigation of the incident and had implemented new systems and controls which appeared to have had an effect, with the member firm not experiencing any similar issues since. However, the Panel also noted that the erroneous executable quotes should have been identified by the firm's system and that the Exchange had to cancel the trades.

Separately, on 2 June 2009 the Panel discussed a case brought against a member firm for allegedly failing to have sufficient controls in place over the order flow of an order routing client. Specifically, the Exchange believed that the member firm failed to have adequate controls in place to prevent the client from layering the Exchange's order book. Please refer to the separate article on order book conduct for more information on this type of behaviour.

The case related specifically to a small number of alleged layering incidents in October 2008, but arose against a background of the Exchange having discussed with the member firm numerous similar incidents (arising, the Exchange understands, from the activity of the same underlying client) throughout the winter of 2007/08.

The Exchange's case related to the fact that the member firm had a control designed to prevent layering but it failed to operate as intended on a number of occasions. Furthermore, the control was not robust as it was manipulated by a trader at the order routing client so that it could be bypassed. This allowed apparent layering activity to occur in October 2008, despite the fact the Exchange provided the member firm with a clear warning in January 2008 of the possibility of disciplinary action if it did not bring the activity under its trading codes under proper control.

The fact that the control was intended to prevent such orders reaching the order book meant that, effectively, those orders were erroneous from the member firm's point of view (even if they were deliberately entered by the trader at the order routing client).

The Panel found that the firm had breached two of the Exchange's rules. Firstly, the firm had breached Rule 2101 on order entry as its controls failed to prevent the submission of the

orders to the order book. And, secondly, the firm had breached Rule 1020, under which each member firm is required to maintain adequate internal procedures and controls. The Panel issued a private censure to the firm and imposed a fine of £35,000 in respect of the breach of Rule 2101 but decided not to impose a fine in respect of the breach of Rule 1020.

Declarations of default: an update

In the last edition of Compliance Update, the Exchange noted that, since September 2008, it had declared two member firms in default on the Exchange. These firms were Lehman Brothers International (Europe) ("LBIE") and Teathers Limited (formerly Landsbanki Securities (UK) Limited, and not to be confused with Straumur-Burdaras Investment Bank HF, which uses 'Teathers' as a trading name). Since the last edition, Madoff Securities International Limited ("Madoff Securities") was also declared a defaulter on the Exchange, at 16:00 hours on 20 May 2009. This article provides an update on the Exchange's work with respect to the defaults.

LBIE

The Exchange is now in Phase 3 of its data reconciliation process (see the attachment to Stock Exchange Notice N44/08, issued on 19 December 2008) and has issued initial determinations to approximately 45 member firm counterparties. This is being conducted on a staggered and systematic basis as LBIE's joint administrators at PricewaterhouseCoopers LLP are also required to review each initial determination in turn. The Exchange will issue a final Net Amount Certificate ("NAC") once it has determined that it is appropriate to do so, having allowed sufficient time for LBIE and its counterparties to review the initial determinations and provide such evidence as they consider necessary in the circumstances. The Exchange will continue to issue initial determinations to all remaining member firm counterparties over the next few months. The Exchange has not yet issued any initial determinations to non member firm counterparties.

A number of member firms have questioned how the issue and payment of a final NAC works in practice. Again, information on this was provided in Stock Exchange Notice N44/08. The Exchange's default rules D120, D121 and D140 are clear as to how Stock Exchange market contracts must be handled. This will result in a net amount certification being issued by the Exchange, certifying the net amount to be paid to or claimed from the defaulter according to the default rules, which is stated to be provable in any subsequent insolvency proceedings. It is not a matter for the Exchange as to how the parties (in this case LBIE - through its joint administrators - or a counterparty) agree payment terms.

Teathers

The Exchange is also in Phase 3 of its reconciliation process and has issued initial determinations to some 25 member firm counterparties on a staggered and systematic basis. Whilst no NACs have as yet been issued, the Exchange anticipates that this should commence shortly.

Madoff Securities

The Exchange is finalising its data collection and reconciliation phase for on Exchange market contracts and should enter Phase 3 shortly with the issuance of initial determinations.

Further information

Further information on each of the defaults is available on the Exchange's website via the following link:

<http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/default-information/default-information.htm>

Member firm suitability and notification requirements

The Exchange reminds member firms that, under its rules, member firms are responsible for immediately notifying the Exchange of any matter that is material to the member firm's ongoing suitability as a member firm. This is outlined in Rule 1022. This will include the appointment of a receiver, administrator or the imposition of disciplinary measures imposed by a regulatory body in any jurisdiction. Further guidance to this rule can be found in the rules of the London Stock Exchange.

Member firms wishing to change their membership profile in any way, ranging from a change of name or additional trading services to a change of clearing or settlement arrangements have a notification requirement to the Exchange. This is outlined in rule 1051 and requires written confirmation of any change at least 21 calendar days in advance of the proposed effective date. This notification period allows the Client Implementation Team to manage the associated change in conjunction with the member firm, third party suppliers, central counterparties and central securities depositories. The Exchange also has a responsibility to ensure that sufficient notice is given to the market, where appropriate, by way of a Member Firm Information Sheet.

Notifications should be made in writing or via email to the Client Implementation Team at clientimplementation@londonstockexchange.com. If you have any queries or if you require assistance please contact Client Implementation on 020 7797 3232.

Stock Exchange Notices

Stock Exchange Notices, including those listed below, can be viewed on the Exchange's website at:

<http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/stock-exchange-notices/2009/home-2009.htm>

N34/09 Madoff Securities International Limited – In Default – Termination of membership

N33/09 Alleged layering of the order book: Guidance to member firms under Rule C020 following recent disciplinary action

N32/09 Madoff Securities International Limited – In Default – Data reconciliation and net amount certification process – Next steps

N31/09 Consultation on the International Order Book Trading Service

N30/09 Consultation on Proposed Rule Amendments – Gilt Inter Dealer Broker Service Provision

N29/09 Lehman Brothers International (Europe) – In Default - Hammer Prices Updated – Version 11 Dated 12 June 2009

N28/09 Madoff Securities International Limited – In Default – Fixing of Hammer Prices

N27/09 Madoff Securities International Limited – In Default – Application of default rules and submission of unsettled trade and loan details by counterparties

N26/09 Sibir Energy Plc (ISIN GB00B04M0Q71)

N25/09 Declaration of default – Madoff Securities International Limited

N24/09 Notification – Mansion House Securities Ltd

N23/09 Sibir Energy Plc (ISIN GB00B04M0Q71)

N22/09 Sibir Energy Plc (ISIN GB00B04M0Q71)

N21/09 Teathers Limited – IN Default – Data reconciliation and Net Amount Certificate process – Next steps

N19/09 Confirmation of rule amendments for the introduction of central counterparty clearing in the International Order Book

N18/09 Notification - IAF Securities Limited