



## **Welcome to the latest edition of Compliance Update**

This edition of Compliance Update focuses on a number of continuing issues observed by the Exchange since the last edition.

We begin by revisiting the topic of order book conduct during auction calls. We have observed order entry activity whereby limit orders are submitted at prices significantly away from the previous market price in order to take advantage of large market orders on the other side of the order book. The article outlines the need for member firms to monitor the impact that their market orders may have on the uncrossing price and highlights that it is equally important that member firms do not distort market prices by entering inappropriately priced limit orders. Indeed, an article regarding an Executive Panel hearing on the use of market orders is included in this update.

We also look back at the topic of member firm responsibilities regarding corporate actions, addressed in the last edition of Compliance Update. With the number of corporate actions taking place, member firms are reminded that orders and quotes entered on the effective day of a corporate action should be updated to reflect any impact on the instrument's price to prevent confusion in the market.

On another topic, we are aware of the challenges member firms may face whilst trying to meet their quoting responsibilities and have aimed to clarify some issues that have been highlighted to the Exchange recently.

Also highlighted is the issue of member firms requesting deferred publication for off book trades whilst acting in an agency capacity. The Exchange does not permit deferred publication for agency trades, and the dealing capacity on trade reports must always be populated correctly to ensure their accurate publication.

We hope that you find the information in this edition of Compliance Update useful.



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# In this issue

## **Use of market orders and limit orders in the auction**

*Page 3*

The Exchange has seen activity during auction calls where a member firm has submitted a large market order and other member firms have entered limit orders some distance from the last reference price on the other side of the order book to take advantage of the market order. Such activity often affects the uncrossing price and will be investigated by the Exchange.

## **Notification – erroneous order entry – member firm fined for breach of Rule 2101**

*Page 4*

This article sets out the details of a recent disciplinary case undertaken by the Exchange. Member firms are encouraged to read this article to understand the Exchange's concerns regarding the activity described.

## **Member firm responsibilities regarding corporate actions - reminder**

*Page 5*

The article describes the Exchange's concerns that misleading prices may be generated if member firms submit orders or quotes that are out of line with the anticipated new share price after a corporate action. Member firms are reminded to be mindful of corporate actions that may result in the price of a security changing significantly overnight.

## **Market maker obligations during the mandatory period**

*Page 6*

The Exchange provides a reminder of the quoting obligations in order driven securities during the mandatory period.

## **Market makers declaring 'dealer in front**

*Page 7*

Clarification on the use by market makers of the dealer in front provision set out in rule 4221.

## **Agency trades and requests for deferred publication**

*Page 8*

The Exchange reminds member firms that requests for deferred publication using the OK or NK trade type indicators are not permitted for agency trades.

## **Member firms' responsibilities regarding trade report corrections**

*Page 9*

This article sets out member firms' responsibilities to ensure that they are able to submit cancellations and late corrections when there has been an error in a trade report submission.

## **Member firms' responsibilities regarding testing**

*Page 10*

There have been recent instances of member firms testing systems and controls in the production environment. The Exchange reminds member firms that this behaviour is prohibited and that alternative facilities are available to support testing requirements.

[Stock Exchange Notices](#)

# Use of market orders and limit orders in the auction

This edition of Compliance Update includes an article on a recent Executive Panel hearing at which a member firm was privately censured and fined due to the impact that a market order it submitted had on a stock's opening price.

In that case, a relatively large market order was entered in the auction and, due to the prices of the limit orders on the other side of the order book, the uncrossing took place some 405% away from the previous closing price.

The guidance to Rules 2101 and 2103 of the Rules of the London Stock Exchange make clear that it is the responsibility of the firm that enters such a market order to monitor the impact the order will have on the uncrossing price. However, other member firms should not enter limit orders on the other side of the book at a price significantly away from the previous traded price simply to take advantage of the presence of such a market order. Where a market order is entered and a limit order is subsequently submitted to the other side that results in an uncrossing at a price that is significantly out-of-line with the level at which the instrument has been trading, the Exchange may decide to cancel these trades. Furthermore, if it is considered that the firm entering the limit order has contributed to an inappropriate impact on the price of the instrument, it may be necessary for the Exchange to discuss the matter with that firm.

# Notification - erroneous order entry - member firm fined for breach of Rule 2101

On 2 March 2010 the Executive Panel of the London Stock Exchange (“the Panel”) found a member firm in breach of Rule 2101 in that the firm failed to have sufficient order management systems, procedures and controls designed to prevent the entry of erroneous orders to the London Stock Exchange’s (“the Exchange”) trading system.

On 1 September 2009, the member firm submitted a market order onto the order book for Indochina Capital Vietnam Holdings Ltd (ICV) during the stock’s opening auction, which resulted in the stock entering into a Price Monitoring Extension with an indicative price of \$20 and subsequently uncrossed at this level. This was approximately 405% higher than its previous closing price of \$3.955.

Consequently, eight trades were cancelled by the Exchange under Rule 2120 and the opening price of the security was set at \$4.2050, which was the first automatic trade in the stock that day. It was estimated that the member firm in question avoided a potential loss of £500,000 on these trades as a result of the cancellations.

In considering the case, the Panel noted that, whilst the member firm had the intended to trade and fill the order, it did not appreciate the impact that the order would have and in particular did not adhere to the guidance found under Rule 2101, concerning the need for sufficient controls to prevent inappropriate effects of market orders on the uncrossing price of a security.

Additionally, it had proved difficult for the Market Supervision department of the Exchange to contact the member firm during the opening auction to alert it to the potential effects of the order.

The Panel noted that the incident had a considerable market impact by affecting a number of market participants and the price of the stock, as well as causing some disruption to the orderly operation of the market. As a result, the Panel imposed a private censure on the member firm and a fine of £30,000.

# Member firm responsibilities regarding corporate actions - reminder

Further to our article in November 2009, it is again necessary to remind firms, and their clients, about order entry following certain types of corporate actions, in which the opening price of a security may change markedly from the previous closing price.

The Exchange reminds member firms that, where a corporate action has taken place, they have a responsibility to ensure that their quotes and orders are correctly priced to take the action into account.

There have been further occasions recently where new orders entered in the opening auction on the effective date of the corporate action have not been updated to reflect the change, which can result in confusion, and potentially to the security trading at an incorrect level. In certain cases it could also result in the Exchange having to consider whether the trades should be cancelled.

Corporate action data is available via the Exchange's website. For further information please contact the Corporate Actions Team on +44 (0)20 7797 1220 (STX 31220) or visit the Exchange website at: <http://www.londonstockexchange.com/information-providers/reference-data/corporate-actions/corporate-actions.htm>

Changes to securities are also disseminated hourly via the Exchange's Datasync Service. For further information please contact the Datasync team on +44 (0)20 7797 1220 (STX 31220) or visit the Exchange website at: <http://www.londonstockexchange.com/information-providers/reference-data/datasync/datasync.htm>

# Market maker obligations during the mandatory period

The Exchange has recently observed an increase in the number of instances where market makers have not maintained their executable quotes in order driven securities throughout the mandatory period.

We would like to remind market makers that for each security in which they are registered, an executable quote must be entered within 90 seconds of the uncrossing of the opening auction. Market makers are then required to maintain an executable quote for the duration of the mandatory period, including the uncrossing of the closing auction, which may take place after the scheduled time as a result of price monitoring extensions or market order extensions. The random period before an uncrossing or an extension must also be taken into account.

Rules 4100-4110 provide further information on market makers' obligations in order driven securities and rules 4101 and 4102 focus on market makers' quoting obligations. Details of the timing of auctions, mandatory quote periods and possible extensions can be found in the TradElect Parameters document. <http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/rules-regulations.htm>

# Market makers declaring 'dealer in front'

Rule 4221 of the Rules of the London Stock Exchange entitle a market maker in quote driven securities to declare "dealer in front" where it "has effected a trade in a security and received another enquiry to deal in the same security before having had a reasonable time to alter its price."

It has come to the Exchange's attention that market makers have on occasion declared "dealer in front" when trading has not been conducted on Exchange. The guidance to Rule 4221 clearly states that the use of the dealer in front rule is only applicable where the trades in question were conducted under the Rules of the London Stock Exchange.

The Exchange would like to remind market makers that this rule does not apply when trading off Exchange and that when, "approached by a member firm, other than a market maker in that security, it shall actively offer to buy and sell at its displayed price and in any size up to that displayed in its firm quote", as stated in Rule 4202.

# Agency trades and requests for deferred publication

Member firms are reminded that, under Rule 3030 of the Rules of the London Stock Exchange, requests for deferred publication for off book trades (using the OK or NK trade type indicators) may only be made where the trade is between the member firm dealing on own account and a customer of that firm. Deferred publication is not permitted for agency trades.

Despite this, the Exchange receives occasional requests for the publication of agency trades to be deferred. When these requests have been queried by the Exchange, the member firms in question have indicated a lack of awareness of Rule 3030 or have stated that they have misreported the dealing capacity.

The Exchange reminds firms that: i) requests for deferred publication must not be made with respect to agency trades; and ii) the dealing capacity on trade reports must always be populated accurately.

# Member firms' responsibilities regarding trade report corrections

Rule 3050 requires a member firm to submit an immediate correction where it becomes aware of an error made in a trade report submission.

There have been a number of occasions recently where an erroneous trade report was identified and member firms did not possess the means to correcting the error. This behaviour is especially evident where a trade report is over three days old and rather than cancelling the trade, the member firm is required to submit a correction including the details of both the original and the new trade.

The Exchange reminds member firms that where they submit trade reports through a third party provider they should confirm with the provider that they are also able to submit cancellations and late corrections.

Only in exceptional circumstances is the Exchange able to report a trade on a member firm's behalf

# Member firms' responsibilities regarding testing

There have been a number of occasions recently where the Exchange has identified member firms undertaking testing in the production environment.

The Exchange would like to remind member firms that, due to the potential detrimental impact on the quality of the market, Rule 1420 prohibits firms submitting orders, quotes or trade reports to TradElect for the purpose of testing any systems or controls.

Upon request, the Exchange can provide member firms with access to a separate testing environment and, where required, specific test segments on TradElect, which member firms can use to undertake testing.

Should you require further information on how to conduct testing with the Exchange please contact the Client Technology Group on 020 7797 3939 (email: [ctgroup@londonstockexchange.com](mailto:ctgroup@londonstockexchange.com)). Alternatively, you can view the Customer Development Service Manual at <http://www.londonstockexchange.com/information-providers/technical-library/customer/testing/cts-201-manual-issue.pdf>

# 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/2010/home-2010.htm>

N08/10 Confirmation on proposed Amendments to the Default Rules

N07/10 Amendments of the Admissions and Disclosures Standards

N06/10 Approval of an AIM Secondary Market Registered Organisation

N05/10 Consultation on the International Order Book Trading Service and proposed Rule Amendments

N04/10 Consultation on Proposed Amendments to the Default Rules

N03/10 Notification – Pali International Limited

N02/10 Approval of an AIM Secondary Market Registered Organisation

N01/10 Confirmation of Rule Amendments – the Electronic Order Book for the UK Retail Bond Market