



Welcome to the latest edition of Compliance Update

This edition of the London Stock Exchange's Compliance Update provides information and guidance for our members in three key areas:

- undesirable behaviour that we have observed during auction calls;
- reiteration of guidance on the reporting of unusually priced off-book trades; and
- an update on the LSE's progress managing the defaults that have occurred since September of last year.

We have recently observed certain order entry practices being employed during the auction call period that could constitute market manipulation. This update provides a worked example of the undesirable activity to assist compliance officers.

Also highlighted is the issue of member firms reporting off-book trades using the negotiated trade types (NT and NK) at unusual prices. Although there are numerous circumstances in which an off-book trade may quite reasonably be priced at a level out-of-line with on-book trading, such trades must be correctly reported to ensure their publication does not give a confusing impression to the market.

This edition also provides an update on the defaults of Lehman Brothers International (Europe), Teathers Limited and Madoff Securities International Limited.

Our default processes, particularly in post-MiFID fragmented markets are, unfortunately, very complex and we much appreciate your continued patience in that regard.

We hope you find this edition of Compliance Update useful and informative.

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In this issue

Auction manipulation

Page 3

The London Stock Exchange has seen an increase in activity during the auction call period that may constitute market manipulation. This article sets out the LSE's concerns and provides a worked example of the sort of activity that has been observed. Member firms are reminded of the importance of ensuring such activity does not arise under their codes. Where deemed necessary, the LSE will discuss such incidents with the FSA for potential investigation as possible market abuse.

Use of the negotiated trade types and the special price marker

Page 5

The LSE has noted instances of negotiated trades being reported to TradElect that are at worse prices than could have been achieved on the order or quote book for the given security. Where this occurs there must be a good reason – e.g. that the trade is for non-standard settlement. The LSE is monitoring the use of the NT and NK trade types for negotiated trades and the associated use of the 'special price' marker. Member firms will be contacted if the LSE has concerns that negotiated trades are being reported with unusual prices without good reason.

Member firms' responsibilities regarding corporate actions

Page 6

Member firms are reminded to be mindful of corporate actions, such as share consolidations, that may result in the price of a security changing significantly overnight. This article sets out the concern of the LSE that misleading prices may be generated if member firms submit orders or quotes that are out-of-line with the anticipated new share price. The article also provides a recent example of a suspension that was caused after a security underwent a 10-for-1 share consolidation.

Declarations of default: An update

Page 7

Since the last edition of Compliance Update the Exchange has continued to make good progress managing the defaults of Lehman Brothers International (Europe), Teathers Limited and Madoff Securities International Limited. This article provides a status update with respect to the defaults.

[Stock Exchange Notices](#)

Auction manipulation

In the last few months, the LSE has seen an increase in the number of instances of potential manipulation during the auction call period. These instances have occurred when a genuine, relatively large market order for a comparatively illiquid security has been entered by Participant A that results in the indicative uncrossing price moving away from the last reference price. Another participant (Participant B) then reacts by entering a market order or aggressively priced limit order on the opposite side of the book from Participant A's genuine large market order to move the indicative uncrossing price back towards the previous reference price. However, Participant B subsequently enters a large limit order on the same side of the book as their market order that is away from the indicative uncrossing price. Participant B then deletes their market order just before the auction concludes, causing the indicative price to shift and the uncrossing to occur significantly away from the last reference price, taking into account any relevant price monitoring extensions.

To help illustrate the LSE's concerns, an example of this activity is shown below for security X, which has a previous closing price of 100p.

At 07:51:00 a genuine buy market order ("MO") is entered by Participant A for 4,000 shares, which sets the indicative uncrossing price. This order is shown below in red. Its entry causes the indicative uncrossing price to move to 125p as it will execute against all the sell orders already on the book.

Time	Bid Size	Bid (p)	Ask (p)	Ask Size	Time
07:51:00	4,000	MO			
07:50:00	500	95	100	250	07:50:00
			102	150	07:50:00
			110	300	07:50:00
			125	500	07:50:00

At 07:53:30 Participant B enters a market order (in red) to sell 3,750 shares. This reduces the indicative uncrossing price to 100p as this order and the 250-share sell order at 100p will execute against the market order on the opposite side of the book.

Time	Bid Size	Bid (p)	Ask (p)	Ask Size	Time
07:51:00	4,000	MO	MO	3,750	07:53:30
07:50:00	500	95	100	250	07:50:00
			102	150	07:50:00
			110	300	07:50:00
			125	500	07:50:00

At 07:54:00 Participant B enters a further limit order (in red) to sell 5,000 shares at 109.5p. The indicative uncrossing price remains unchanged at 100p.

Time	Bid Size	Bid (p)	Ask (p)	Ask Size	Time
07:51:00	4,000	MO	MO	3,750	07:53:30
07:50:00	500	95	100	250	07:50:00
			102	150	07:50:00
			109.5	5,000	07:54:00
			110	300	07:50:00
			125	500	07:50:00

At 07:59:57 Participant B deletes the sell market order for 3,750 shares. As a result, the indicative uncrossing price increases to 109.5p.

Time	Bid Size	Bid (p)	Ask (p)	Ask Size	Time
07:51:00	4,000	MO			
07:50:00	500	95	100	250	07:50:00
			102	150	07:50:00
			109.5	5,000	07:54:00
			110	300	07:50:00
			125	500	07:50:00

At a randomised point between 08:00:00 and 08:00:30 the auction uncrossing occurs at a price of 109.5p. The sequence of events described above has therefore moved the expected uncrossing price from 100p to 109.5p.

The LSE has concerns over this type of strategy as it may constitute a breach of Rule 1400, which relates to misleading acts, conduct and prohibited practices. As the guidance to that rule makes clear, the LSE recognises that member firms' trading decisions may change during the course of an auction call period. However, a breach of Rule 1400 would occur if, for instance, Participant B never intended for its market order to trade, and that order had been entered solely to create a misleading indicative uncrossing price. In addition, member firms are advised to consider Rules 1400 and 1410 and associated guidance, and in particular the reference to the late deletion of orders in auctions.

The LSE considers that such a strategy may breach the FSA's market abuse rules and will therefore inform the FSA of incidents where it believes this strategy may have been used.

Use of the negotiated trade types and the special price marker

The LSE would like to remind member firms of the definition set out in its rules of a negotiated trade – i.e. a trade for which the NT or NK trade types should be used:

negotiated trade

a trade conducted in an EU regulated market security that is not subject to pre-trade transparency on TradElect[®] and which is on terms that are no worse than those that could be achieved on the relevant Exchange order or quote book (or where the share is not traded continuously, is on terms that are no worse than those that could be achieved on a relevant venue with continuous trading), after taking into account any relevant trading, settlement and clearing costs

The LSE has become aware of instances of member firms reporting off-book, negotiated trades using the NT or NK trade types at worse prices than could have been obtained on the relevant order or quote book. As the definition above sets out, a member firm may have reason to undertake a trade at an unusual price – for instance, if it will be subject to a non-standard settlement period – and for this reason the LSE allows for trade reports to be marked with a 'special price' (or 'SP') marker. However, this reporting condition should only be used when there is a good reason. The guidance to Rule 3040 of the LSE's rules provides a non-exhaustive list of such reasons. The rules can be found at:

<http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/rules-lse-2009.pdf>

The LSE reminds member firms to use the NT and NK trade types and the SP marker appropriately, and in accordance with the LSE's rules. Reporting trades to the LSE that are at unusual prices without justification may create a confusing impression of the trading in a security. This, by extension, may damage price discovery and undermine market confidence.

The LSE will continue to monitor the use of NTs, NKs and SP markers and will contact member firms that it believes may be using them inappropriately.

Member firms' responsibilities regarding corporate actions

As a result of certain types of corporate actions, the opening price of a security may change markedly from the previous closing price.

The LSE 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 change into account.

There have been a number of occasions recently where new orders and quotes 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 the security trading at an incorrect level.

If there is a change to the four-way key for an instrument as a result of a corporate action, the LSE will delete existing orders. However, if the four-way key is unchanged, the existing orders will remain available for execution unless deleted by the firm.

By way of example, on 31 July Segro Plc (SGRO) underwent a share consolidation whereby every 10 existing shares were consolidated into 1 new ordinary share. On 30 July Segro closed at 27p, and therefore the price the following day was expected to be around 270p. However, it was apparent from the orders and quotes on 31 July that the consolidation had not been taken into account and the stock went into an automatic suspension as a result of orders being priced at the pre-corporate action level.

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

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

Declarations of default: An update

In the July 2009 edition of Compliance Update, the LSE noted that, since September 2008, it had declared three member firms in default on the LSE. These firms were Lehman Brothers International (Europe) ("LBIE"), Teathers Limited (formerly Landsbanki Securities (UK) Limited) and Madoff Securities International Limited ("Madoff Securities"). This article provides an update on the LSE's work with respect to the defaults.

LBIE

The LSE is in Phase 3 of its reconciliation process (see the attachment to LSE Notice N44/08, issued on 19 December 2008) and has issued initial determinations to approximately 90 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 LSE will issue final Net Amount Certificates ("NACs") 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 LSE will continue to issue the final initial determinations to the remaining member firm counterparties over the next month. The LSE has also started to issue initial determinations to non member firm counterparties.

Teathers

The LSE is now in Phase 4 of its reconciliation process (see the attachment to LSE Notice N13/09, issued on 5 March 2009). It has issued initial determinations to some 50 member firm counterparties on a staggered and systematic basis. It has also issued approximately 14 NACs.

Madoff Securities

The LSE has now entered Phase 4 of its reconciliation process (see the attachment to LSE Notice N32/09, issued on 23 June 2009) and should be concluding the default process shortly.

Further information

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

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

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>

N48/09 Reliance Industries LD GDR (ISIN: US7594701077): Cancellation of Trades

N47/09 Consultation on Proposed Rule Amendments – Electronic Order Book for the UK Retail Bond Market

N46/09 Guidance – Friends Provident Group Plc (GB00B3T69350) Scheme of arrangement

N45/09 Lehman Brothers International (Europe) – in Default – Notification of Lending Arrangements

N44/09 Confirmation of Proposed Rule Amendments – Gilt Inter Dealer Broker Service Provision

N43/09 Confirmation on Proposed Rule Amendments for Unsettled Lending Arrangements Subsequent to a Declaration of Default

N42/09 Notification –Van der Moolen Effecten Specialist BV and Van der Moolen Derivatives Ltd

N41/09 Cancellation of Trades: Indochina Capital Vietnam Hldgs Ltd. (ISIN: VGG476901050): Opening Auction of 1 September 2009

N40/09 Amendments to the Admission and Disclosure Standards in respect of Depositary Receipt instruments

N39/09 Approval of an AIM Secondary Market Registered Organisation

N38/09 Confirmation of rule amendments – AIM Secondary Market Registered Organisations

N37/09 Confirmation of rule amendments

N35/09 Madoff Securities International Limited – In Default – Hammer prices updated – Version 2 dated 3 August 2009