



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

This edition of Compliance Update provides information and guidance on a number of current regulatory topics.

We begin by focussing on order book conduct. The Exchange continues to observe order entry behaviour which, whilst not erroneous may be considered to be inappropriate and may have a detrimental impact on the market. The Exchange consulted on the introduction of proposed rules surrounding this behaviour earlier this year. Market participants raised concerns in response to the rules and in acknowledgement of this, the rules were not adopted. However, as there continues to be concern over the presence of such activity, the Exchange confirmed that the next edition of Compliance Update would offer guidance on inappropriate orders and the need for member firms to manage these orders so as to prevent them from reaching the order book.

Another topic considered in this Compliance Update is the obligations of market makers in exchange traded funds and exchange traded products. Market makers are reminded that they must maintain their quotes until the market close. The purpose of this obligation is to ensure that closing prices are derived from current market prices. In addition, all member firms are reminded that they are required to settle trades in a timely manner.

This edition also highlights some shortcomings in member firms' trade reporting. We have provided guidance which is intended to clarify some of the issues that have been identified by the Exchange.

We hope that you find this edition of compliance update useful and informative.

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The Exchange provides guidance on orders which whilst not erroneous, are inappropriate and how such activity can impact the market.

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There have been recent instances where market makers have not been maintaining executable quotes until market close which is impacting closing prices. The Exchange reminds these market makers of their quoting responsibilities and the obligations to settle trades in a timely manner.

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This article sets out member firms' responsibilities when trade reporting. Member firms must ensure that they trade report correctly and the content of the reports are accurate.

## **Member firm responsibilities to update contact details**

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Member firms are reminded of the importance of keeping the Exchange up to date with contact details. The Exchange may need to contact a member firm urgently and often only accepts instructions from authorised individuals so it is essential that contact details of any relevant person, especially within compliance, are current.

[Stock Exchange Notices](#)

# Order book conduct - Inappropriate orders

The Exchange has observed activity on its order books which has, or could have, a detrimental impact on the efficiency and orderliness of the market. In order to identify the cause of this activity, the Exchange regularly contacts member firms to query their orders irrespective of whether they were submitted deliberately or in error.

Rule 2101 states that member firms are obliged to have, at all times, sufficient order management systems, procedures and controls designed to prevent the entry of erroneous orders to the trading system. The guidance to Rule 2101 states that an erroneous order is an order entered mistakenly where there was no intention to trade in the security or an order where the terms entered, mistakenly, did not represent the intended transaction. However, the guidance does not make clear the Exchange's view on orders which are entered intentionally but which have an adverse effect on the market. These orders are considered to be inappropriate.


The Exchange issued Stock Exchange Notice N12/10 on 17 May 2010 to consult on proposed amendments to the rules and to introduce guidance on inappropriate orders and erroneous quotes. During the consultation, market participants raised concerns in relation to the subjective nature of what is considered inappropriate and the consequential difficulties in coding their internal systems. As a result of this feedback, the Exchange issued Stock Exchange Notice 16/10 which advised that the rules in relation to inappropriate orders were not being adopted. Notwithstanding this, the Exchange remains concerned over the impact such orders may have on the market.

An inappropriate order is considered to be an order, the terms of which were not submitted in error but which, in the view of the Exchange, has or could have a detrimental effect on the efficiency and orderliness of the Exchange's markets.

There are a number of scenarios in which the Exchange may query such orders with a member firm. For example, there have been instances where an unusually priced limit order, that would appear to have been entered to take advantage of a large market order on the other side of the order book, has executed and significantly moved the price of the security.

The Exchange's Executive Panel heard a case this year where a large market order was entered during the opening auction and, due to the prices of the limit orders on the other side of the order book, the security uncrossed 405% away from the previous closing price. In this case, the disciplinary action was brought against the member firm which entered the market order under rule 2101. However, this case is also an example of how member firms who respond to a large market order by entering limit orders which are significantly away from the previous traded price can be considered to have contributed to the inappropriate trading activity in the security. In such circumstances the Exchange may decide to cancel any resulting trades and discuss the matter with the member firms contributing to the inappropriate activity.

Another example of inappropriate behaviour is the repeated entry of aggressive small orders in quick succession. Whilst these orders may not be erroneous they often execute against a single passive order on the order book. This activity increases the cost of clearing and settlement, particularly for those participants that do not net settle their trades. In order to avoid entering such orders, member firms may wish to consider the use of alerts to identify



unusually sized orders, whether small or large. Member firms may also wish to consider programming algorithms to take into account the actual or anticipated liquidity in the relevant securities in the period in which the order will be worked, especially when conducting a portfolio trade.

The above are just some examples of inappropriate orders observed by the Exchange. The Exchange has a varied membership base and endeavours to provide a fair and orderly market for all participants. The presence of inappropriate orders can leave some member firms unable to trade economically, resulting in reduction of liquidity and a loss of confidence in the market.

In order to address this issue the Exchange will continue to engage with member firms in a collaborative manner when inappropriate orders have been entered on to the order book and to work with member firms to determine any necessary mitigating action.

# Market Makers in Exchange Traded Funds and Exchange Traded Products

## **Quoting Obligations**

The Exchange has observed an increase in market makers in Exchange Traded Funds (ETFs) and Exchange Traded Products (ETPs) failing to meet quoting and settlement obligations and would like to remind these market makers of their responsibilities under the rules.

There have been an increasing number of instances where market makers have removed their quotes before the end of the closing auction. This action can have a detrimental effect on the derivation of the closing price for an instrument and potentially lead to a price being disseminated that is not representative of the real market price of the instrument.

Rule 4101 states that registered market makers must maintain their executable quotes throughout the mandatory period including for the duration of the closing auction. Quotes should not be deleted prior to the uncrossing of the closing auction which can occur at any time between 16:35:00 and 16:49:00. To ensure the security has closed before withdrawing their quotes, market makers should wait for receipt of the closing price message.

## **Settlement Obligations**

Under rule 5000 a member firm shall ensure that every on Exchange trade effected by it is duly settled.

The Exchange is aware that a small number of market participants, including market makers, are persistently failing to settle ETF and ETP trades in a timely fashion. To maintain an orderly market, all participants must ensure that trades are settled in line with the standard settlement for that market.

All member firms are responsible for ensuring the delivery of securities on the agreed settlement date. This obligation exists even if the reason for non-settlement is due to a customer or counterparty failing to settle.

For all on book executions in ETFs and other ETPs the agreed settlement date is the standard settlement of T+3.

# Member firm responsibilities regarding trade reporting

The Exchange uses the data provided in trade reports to carry out a number of different functions, including providing post-trade transparency, monitoring for potential instances of financial crime, market abuse and potential breaches of the Exchange's Rules. Therefore it is extremely important that trade reports' content is accurate. Rule 3040 states that "a member firm must ensure that the content of a trade report is accurate and entered in accordance with the guidance to this rule and the parameters."

The LSE would like to highlight the following points:

- The customer or counterparty field should only be populated with non-member when the customer or counterparty is not a member firm of the Exchange or where it is a member but its membership is limited to trading in central counterparty eligible securities on the order book only. Member firms should ensure that the static data in their systems is kept up to date with the relevant Member IDs. This information can be obtained from the download section of the member firm directory on our website at the following link - <http://www.londonstockexchange.com/exchange/traders-and-brokers/membership/member-firm-directory/member-firm-directory-search.html>
- Where the customer or counterparty is a member firm that employs a settlement agent, the Member ID for the member firm must be used and not the Member ID of the settlement agent.
- The correct dealing capacity and trade type must always be used. Member firms are also bound by Rule 3030 and its guidance, which highlights that member firms are unable to use the deferred publication request trade types when they are acting in an agency or riskless principal capacity.

Additionally, the Exchange has recently observed instances in which both legs of a riskless principal trade are being published. Please note, that when conducting and reporting a trade of this nature, where the size and price of the trade is the same, one leg should be published and, if applicable, the other leg reported as a non-publishing trade (using the NM trade type indicator). We would like to draw member firms' attention to Rule 3011 and its associated guidance, which deals with the duplication of trade reports. Should you have any questions or would like further guidance please contact Market Supervision on 020 7797 3666 option 2.

# Member firm responsibilities to update contact details

The Exchange wishes to reiterate the importance of member firms ensuring that they keep the Exchange updated with any changes to compliance officers and their contact details. This information is necessary as the need to contact a member firm urgently may arise during live trading issues or with regard to potential rule breaches.

Rule 1020.4 states that “a member firm must, to ensure compliance with these rules, at all times have one or more compliance officers who shall be identified to the Exchange and be competent to advise the member firm and its employees on the application of these rules”.

Rule 1051 states that “a member firm shall notify the Exchange in writing, at least 21 calendar days in advance of the proposed effective date, of any proposed changes to its membership profile”.

A member firm can update its details by sending a letter to the following address:

Client Implementation Team  
London Stock Exchange plc  
10 Paternoster Square  
London  
EC4M 7LS

Or by emailing or email: [clientimplementation@londonstockexchange.com](mailto:clientimplementation@londonstockexchange.com) or fax: +44 (0)20 7920 4782

Further information on updating your membership profile can be viewed at <http://www.londonstockexchange.com/traders-and-brokers/membership/updating-your-profile/updating-your-profile.htm>

The Exchange maintains a list of individuals at a member firm who are authorised to instruct the Market Operations team to carry out certain actions on its behalf, for example order deletions. Prior to carrying out such actions, the Exchange has to ensure that the instruction comes from an authorised individual on that list. Member firms are reminded that it is their responsibility to keep these records up to date. Failure to do so may result in delays in being able to undertake such actions. Compliance officers can find the relevant form at <http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/formsagreements/request-order-deletions.pdf>. Please contact Market Operations on 020 7797 3666 option 1 if you have any questions or require further information.

# 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>

N21/10 Confirmation on Proposed Rule Amendments - Market Makers in Order Driven Securities

N20/10 Consultation on Proposed Rule Amendments - Migration to Millennium Exchange

N19/10 Consultation on Proposed Rule Amendments - Sponsored Access

N18/10 Consultation on Proposed Rule Amendments - Market Makers in Order Driven Securities

N17/10 Notification of rule amendments

N16/10 Inappropriate Orders and Erroneous Quotes

N15/10 Lehmans Brothers International (Europe) - In Default - Information for Non Member Counterparties and their Custodians

N14/10 Eurasian Natural Resources Corp Plc Ord USD 0.20 (ISIN: GB00B29BCK10): Cancellation of trades from opening auction 5/07/10

N13/10 ASUSTEK COMPUTER INC GDR (ISIN: US04648R6053): Cancellation of Trades

N12/10 Consultation on Proposed Rule Amendments for Inappropriate orders and Erroneous Quotes

N11/10 Restoration - Insetco Plc

N10/10 Suspension of trading - Insetco Plc (NIC)

N09/10 Temporary Trading Halt - Insetco Plc

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