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For the attention of the chairman/senior partner/compliance officer, all member firms

N33/09

STOCK EXCHANGE NOTICE

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

Introduction

1. The Executive Panel of the London Stock Exchange has recently heard a case 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.

2. Layering of the order book involves the submission of multiple orders on one side of the order book to create the impression of liquidity when the trader's intention is ultimately to trade in the opposite direction.

3. This Stock Exchange Notice sets out the background to the case and provides member firms with guidance, under Rule C020 of the Rules of the London Stock Exchange ("the rules"), in order to assist understanding of the Exchange's concerns in this area and the expectations the Exchange places on member firms.

Case background

4. 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) from October 2007 to January 2008.

5. The Statement of Case prepared by the Exchange's investigation team alleged the following:

- the member firm had a control designed to prevent layering but it failed to operate as intended on a number of occasions, allowing apparent layering activity to occur;

- the control was not robust as weaknesses in its software were exploited by a trader at the order routing client so that it could be bypassed;

- the fact that the control was intended to prevent such orders reaching the 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 incidents in October 2008 occurred despite the Exchange providing the member firm with 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 Executive Panel's findings

6. The Panel found that the firm had breached two of the rules, as follows:

   - the firm breached Rule 2101 on order entry as its controls failed to prevent the submission of the orders to the order book; and

   - the firm 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.

Guidance to member firms under Rule C020

7. 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.

8. 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.

9. 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.

Further information

10. Member firms, other customers and interested parties with questions regarding this Notice should contact Tim Rowe, Trading Services, telephone +44 (0)20 7797 3468 (STX 33468) or email: trowe@londonstockexchange.com.

Nick Bayley
Head of Trading Services

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