



Welcome to the latest edition of Compliance Update

This edition of Compliance Update provides information and guidance for our members in the following key areas:

- the importance of member firm systems and controls in a fragmented marketplace;
- disciplinary action for breaches of the Exchange's rules; and
- updated guidance on trade reporting responsibilities, in particular when amending or cancelling trade reports.

Over the past year, since the US 'flash crash', the subject of electronic circuit breakers and trading firms' systems and controls has gained increased prominence around the world as a way of maintaining orderly markets particularly in a fragmented marketplace. This update provides an overview of this issue and the role member firm controls play in the absence of formal coordination of controls between trading venues.

The importance of member firms having adequate systems and controls in place is underlined by an Executive Panel case for having inadequate order entry controls, which took place late last year. The Executive Panel heard a further case on another matter where a member firm was found to be in breach of the Exchange's rules as its order entry activity gave a potentially misleading impression as to the liquidity and indicative uncrossing price of a security. The details of both these cases are provided in this update.

Also highlighted is the topic of trade reporting. We revisit the guidance provided in the last edition of Compliance Update as the procedure for off book trade reporting has changed since the introduction of the new trading system. This article clarifies the issues which have been identified by the Exchange in order to help member firms meet their trade reporting responsibilities.

We hope that you find this edition of Compliance Update a useful source of information.

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Member firm systems and controls

Since the introduction of MiFID in 2007 the UK equity market has evolved from a position in which the vast majority of electronic trading was taking place on the Exchange to a fragmented landscape in which multiple venues utilise different technology and, in some cases, are governed by different rules. Many equity trading platforms have also introduced faster technology, allowing new and more complex algorithmic trading strategies to develop.

In the past year, since the US 'flash crash', regulators and policy makers around the world have been increasingly focused on the interconnectivity and potential instability of fragmented equity markets. Two particular aspects of market microstructure that are being examined are the use of electronic circuit breakers/controls by platforms to maintain orderly markets and examining how trading firms control their order entry and that of their clients.

Over the past year the Exchange has had several discussions with the FSA and other key UK equity trading platforms about the implications of the 'flash crash', primarily to ensure we avoid a similar incident occurring in the UK. At the same time the European Commission has been consulting on numerous aspects of equity markets microstructure, including how best to deal with increasing levels of automated trading in those markets.

Whilst it is not yet clear precisely how oversight of trading firms' systems and controls across a fragmented European equity market will be managed in future, the Exchange remains determined that trading on its markets should remain orderly and well regulated.

The Exchange is in the process of introducing a new sponsored access service, whereby non member firms can access the Exchange's trading system directly, without the need for their orders to pass through the sponsoring member firms' usual DMA controls. The Exchange has therefore introduced new, mandatory automated price and volume controls on its own platform for sponsored access, which will in many cases supplement the sponsoring firms' own risk management controls.

Although different trading venues each operate their own controls to ensure their trading remains orderly, at present there is no formal coordination of controls or circuit breakers between venues. The Exchange supports such coordination but does not believe that full harmonisation of platform controls is practical given the pan-European, fragmented nature of European equity trading. The Exchange employs price monitoring thresholds which if breached will place the affected security into an automatic execution suspension period (AESP), although that security may still be available to trade electronically on other markets during the AESP.

Primary responsibility for control over order entry continues to rest with member firms, which should monitor their customers' as well as their own order flow to prevent erroneous, inappropriate, disorderly or abusive behaviour.

This edition of Compliance Update includes an article on an Executive Panel hearing at which a member firm was privately censured and fined due to the impact that a number of erroneous orders it submitted had on the order book. Whilst the Exchange's AESPs prevented more extreme price movements in the affected securities, member firms' controls should be designed to ensure that such orders do not reach the order book and adversely impact the market.



It continues to be important, especially with the introduction by the Exchange of sponsored access and the widespread availability of conventional direct market access, that member firms properly control the order flow coming from their customers that have direct access to the market.

Member firms may be aware that the Canadian Securities Administrators (CSA) issued a Notice of Proposed National Instrument in relation to 'Electronic Trading and Direct Electronic Access to Marketplaces' in April 2011. The notice describes the risks associated with electronic access to platforms and sets out some proposed rules which introduce provisions governing electronic trading by marketplace participants and their customers as well as market operators in a fragmented market. Although the Canadian and European market structures differ somewhat member firms may find the document useful background information.

http://www.osc.gov.on.ca/en/SecuritiesLaw_ni_20110408_23-103_pro-electronic-trading.htm

Notification – misleading impressions – member firm fined for breach of Rule 1400.1

In November 2010, the Executive Panel of the London Stock Exchange (“the Panel”) found a member firm in breach of rule 1400.1 of the Exchange’s rules in that the firm’s submission and deletion of orders during the opening auction in Eurasian Natural Resources Corporation plc (“ENRC”) created a misleading impression as to the liquidity and indicative uncrossing price of the security. The Panel issued a private censure against the firm and imposed a fine of £30,000.

Entry and deletion of orders during the opening auction and price monitoring extension

During the opening auction call period on 5 July 2010, the firm entered a number of sell market orders which significantly contributed to moving the indicative auction uncrossing price from 1200p to 823p. The firm also then entered a sell limit order. Six seconds prior to the start of the random uncrossing period the firm deleted its sell market orders, which moved the indicative uncrossing price from 839.5p to 1200p. The firm’s sell limit order remained on the book and the firm also entered a further sell limit order before the start of the uncrossing.

Due to the wide variation between the indicative uncrossing price and the reference price, the trading system automatically put ENRC into a price monitoring extension (a further 5 minute auction period). The firm then re-entered its sell market orders which significantly contributed to moving the indicative uncrossing price again, from 1060p to 839p. The firm also deleted its existing sell limit orders and entered other sell limit orders priced at up to 1050p.

Four seconds prior to the start of the random uncrossing period, the member firm again deleted its sell market orders, which moved the indicative uncrossing price from 832.5p to 1100p and entered two further sell limit orders, one of which was subsequently deleted. ENRC then uncrossed at 1099p, resulting in the firm’s limit orders executing and it selling 21,000 shares.

Market impact

The opening price of ENRC, 1099p, was 30.6% higher than its previous closing price of 841.5p as a direct result of the actions of the firm. The Exchange subsequently cancelled the ENRC opening auction uncrossing trades under rule 2120 and re-stated the opening price of ENRC shares.

Panel’s findings

The Panel found that the firm had breached rule 1400.1, as follows:

- the repeated pattern of order entry and deletion during the opening auction and price monitoring extension gave a potentially misleading impression as to the liquidity and indicative uncrossing price in ENRC; and
- the incident had significant market impact, in that it resulted in the Exchange having to cancel a number of trades and restate the opening price of the security.

The Panel also noted that the firm's trading pattern could potentially have resulted in a breach of rule 1410 (share price manipulation).

Member firm guidance

The Exchange wishes to remind member firms of the guidance to rule 1400 which states that:

All orders entered on to the order book are firm. While the Exchange understands that trading decisions of member firms may change, member firms should not enter orders into the auction or during continuous trading with the intention of deleting or otherwise amending them before execution. This can give a potentially misleading impression of the level of liquidity in the market or the likely auction uncrossing price and volume to other participants. Such activity may constitute a breach of rule 1400.

Notification – erroneous order entry – member firm fined for breaches of Rule 2101

In February 2011, the Executive Panel of the London Stock Exchange (“the Panel”) found a member firm had breached rule 2101 of the Exchange’s rules on two occasions in that it failed to have sufficient order management systems, procedures and controls designed to prevent the submission of erroneous orders to the trading system. The Panel issued a private censure against the firm and imposed a fine of £30,000 for each breach of the rules.

Issue one – 6 August 2010 – Closing auction

During the closing auction on 6 August 2010, the firm submitted a ‘basket’ of erroneously sized market orders to the trading system in 104 securities. The orders caused 21 securities to enter price monitoring and / or market order extensions.

Issue two – 24 August 2010 – Continuous trading

Between 14:00:07 and 14:00:22 on 24 August 2010, the firm submitted 378 un-priced aggressive orders to buy and sell eight order book securities. The orders resulted in 871 executions and set the daily high or low for six of the securities. Five of the securities entered into an AESP as the price movements exceeded the price monitoring threshold for the securities.

Panel’s findings

The Panel found that the firm had breached rule 2101 on both occasions in that the firm did not have sufficient order management systems, procedures and controls designed to prevent the submission of erroneous orders to the trading system.

Member firm guidance

The first case initially resulted from human error during a manual process of creating a basket of orders. The lack of sufficient procedures and controls meant that the firm was not alerted to the fact that some of the orders were unusually large and it was therefore unable to prevent their submission to the Exchange’s order book. In addition, the fact that the trader was not monitoring the orders during the closing auction meant that corrective action could not be taken on a timely basis.

Member firms are reminded that where the creation of orders involves manual processes the need for appropriate procedures and controls to mitigate the possibility of human error is particularly important. The Exchange also expects member firms to monitor their trading at all times and reminds firms that this is particularly important during sensitive pricing periods such as the closing auction.

The second case highlights issues that can arise when internal procedures are not followed. In this case, procedures for the testing and roll out of amendments to an existing trading application were not followed. In addition, a key control was not carried over to the amended application which resulted in multiple erroneous orders being submitted to the trading system.



Member firms are reminded that thorough testing of changes to trading applications is critical to ensuring continued compliance with rule 2101. In addition, extra care should be taken when changes are made to applications which are capable of submitting multiple orders at high frequency given the impact that they can have in a short time period.

Further information

Member firms should note that, although the firm's losses exceeded the threshold for requesting an Exchange enforced cancellation under rule 2120, the trades were not cancelled as the prices were not manifestly erroneous.

Member firm responsibilities regarding trade reporting

In the last edition of Compliance Update, dated October 2010, (<http://www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/compliance-update/comp-update-oct-10.pdf>) the Exchange highlighted a number of points to assist member firms with their trade reporting responsibilities. Following the introduction of the new trading system on 14 February 2011, the Exchange would like to offer further guidance to that previously issued:

- Amending / cancelling trade reports

These procedures have changed since the launch of the new trading system and the Exchange has seen a number of firms not conducting this activity in accordance with the Rules, for example, not reporting the original trade details in the late cancellation ("LC") trade report, reporting LC trades when the original trade report could still be cancelled by submitting a cancellation message and finally not submitting LC trades in instances where they should have been.

Rules 3050-3052, as amended on 14 February 2011, state how trade report corrections should be made in the new trading system. The following guidance is taken from page 55 of the Guide to the New Trading System (<http://www.londonstockexchange.com/products-and-services/trading-services/guide-to-new-trading-system.doc>):

"Trades are only retained on the trading system up to and including the day of publication. The process for cancelling or correcting a trade report therefore depends on the day the trade is due to publish.

When submitting an amendment before or on the day the trade is due to publish the process is:

- *cancel the original trade report by submitting a cancellation message using the original trade code;*
- *if correcting, submit a new trade report containing the corrected details.*

When submitting an amendment after the day of publication the process is:

- *submit a new trade report with trade type indicator 'LC' containing the details of the original (incorrect) trade report. Please note LC trade types publish to the market;*
- *if correcting, submit a new trade report containing the corrected details".*

- Monitoring of trade reporting

Member firms should ensure that trades they wish to bring "on Exchange" are reported to us. Member firms should monitor trades they have reported to the Exchange as there may be instances where these reports have been rejected by the trading system, for example attempting to cancel a trade report by submitting a cancellation message containing the original trade id the day after the trade has published would be rejected by

the trading system. These trade reports should be re-reported in the correct manner as soon as possible.

Revised When issued dealing guidance

The Exchange has recently revised and re-issued its guidance regarding When issued dealing. This guidance was changed following an increase in the number of applications being received for an extended When issued dealing period (typically requesting a four rather than a three day dealing period). Where an extended When issued dealing period was requested, it was necessary to publish a Stock Exchange Notice to specify the settlement period and procedures on each occasion. The guidance is now generic and covers both standard and extended When issued dealing periods. This guidance was published as an attachment to Stock Exchange Notice N08/11 and can be viewed on the regulatory page of the Exchange's website.

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

In summary, the revised guidance now reflects the differences in functionality of the settlement systems being used. For on Exchange off book trades it also stresses that firms should ensure that no settlement of When issued trades takes place before the security itself is Listed/admitted to trading.

Member firm notifications and reminders

SETSqx Market Maker obligations

The Exchange has observed an increase in market makers in SETSqx securities closing their quotes before the end of the mandatory period and would like to remind these market makers of their obligations under the rules. Rule 4201 requires market makers to maintain firm two way prices in each security in which they are registered during the mandatory period. The mandatory period begins at the uncrossing of the opening auction call period and lasts until the uncrossing of the closing auction call period, which can occur at any time between 16:35:00 and 16:49:00 in individual securities due to possible price monitoring extensions being triggered.

System Difficulty Flags

The Exchange would like to advise that when a member firm notifies the Exchange that it is experiencing system difficulties, flags will no longer be disseminated to the market. Member firms should however continue to inform the Exchange where system difficulties are being experienced so that we are able to assist firms if necessary.

Member Firm - Request for LSE to delete orders

Member firms' attention is drawn to Rule 1500 and specifically to the guidance relating to order and quote deletions which confirms the procedure to be followed should a member firm require the Exchange to delete orders or quotes on its behalf. It confirms that a member firm must provide its member ID and trader group in order for us to action the request in a timely manner.

Failure to provide the member ID and the trader group may cause a delay in processing requests as the Market Operations team will need to locate this code prior to proceeding with the instruction.

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/2011/home-2011.htm>

N13/11 Notification of rule amendments

N12/11 Invista Real Estate Investment Management (ISIN: GB00B1CKTY16): Cancellation of trades 24/06/11

N11/11 Amendments to the Admission and Disclosure Standards

N10/11 Notification - Lyxor ETF World Water GBP (ISIN: FR0010542134, TIDM: LWAT or LWAU)

N09/11 Market Makers in Order Driven Securities - Reminder of Rules Implementation Date

N08/11 When Issued Dealing - Revised Guidance

N07/11 Disciplinary action - erroneous orders - firm fined £60, 000

N06/11 Noventa Limited Ord GBP 0.8 (ISIN: JE00B3YDHF95): Cancellation of trades from opening auction 11/03/2011

N05/11 Amendments to the Admission and Disclosure Standards

N04/11 Notification - National Westminster Bank PLC 9% Ser 'A' Non-Cum Prf GBP 1 (ISIN: GB0006227051, Symbol: NWBD, Instrument ID: 3955)

N03/11 Order Book for Retail Bonds("ORB") - When Issued Dealing Tesco Personal Finance PLC 5.20% Sterling Bond Due 2018 (ISIN: XS0591029409, TIDM: TS52)

N02/11 International Order Book Security - When Issued Dealing OJSC "Chelyabinsk Tube-Rolling Plant" (ISIN:US16352P2039, TIDM: CHEP)

N01/11 Market Makers in Order Driven Securities - Revised Rules Implementation Date