
FINAL NOTICE

To: **Morgan Grenfell & Co Limited**
Of: Winchester House
1 Great Winchester Street
London
EC2N 2DB
Date: 18 March 2004

TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS ("the FSA") gives Morgan Grenfell & Co Limited ("Morgan Grenfell" or "the firm"), a wholly owned subsidiary of Deutsche Bank AG, final notice about a requirement to pay a financial penalty.

1 Summary

- 1.1 The FSA has decided to impose a financial penalty of £190,000 on Morgan Grenfell pursuant to section 206 of the Financial Services and Markets Act 2000. This financial penalty is imposed in respect of the firm's conduct towards a customer and the management of conflicts of interest in the course of a blind bid principal programme trade in April 2002 which was in breach of FSA Principle 6 and Principle 8.
- 1.2 The firm's programme trading desk engaged in trading in some of the component securities of the customer's programme trade between the provision of limited information to enable the firm to provide a quote for that trade and the strike time of that trade. The customer paid more than they would otherwise have done for this trade due to the firm's trading in these securities.
- 1.3 The firm had previously carried out programme trades with the customer who was classified by the firm as an intermediate client. The customer was an experienced fund manager ("the customer") with in excess of £30bn funds under management as at June 2002.

- 1.4 The firm failed either to notify the customer in advance that it may trade in the component securities based upon the information supplied by the customer or to ensure that its participation in the market did not cause a material adverse impact to the customer.
- 1.5 The firm agreed compensation for the customer on the same day and has agreed to inform its customers of the basis on which they engage in principal programme trading.

2 Programme trading

- 2.1 Programme trading (also known as portfolio or basket trading) is the term used to describe a single transaction or series of transactions effected by an institution when acquiring or disposing of an entire portfolio, a material part of a portfolio or, as defined by the London Stock Exchange, a basket of at least 20 stocks.
- 2.2 There are two basic categories of programme trade: those conducted on an agency basis and those conducted on a principal or risk basis.
- 2.3 A principal or risk trade is a programme trade in which a number of brokers will tender to acquire the portfolio from or for the institution as principal quoting a premium or discount to a price prevailing in the market at a designated strike time.
- 2.4 Principal programme trades are attractive to clients who want to transact a large number of securities but do not want to assume the risk of the share price moving against them in the period between commencement and completion of trading in those securities. A broker will assume that risk in return for a price calculated with reference to the mid-market price at the strike time plus or minus a number of basis points.
- 2.5 A blind bid principal programme trade is a type of principal programme trade where neither the direction of the trade nor the identity of the component securities are revealed until after the trade has been awarded to a particular broker.
- 2.6 "Pre-hedging" refers to trading by the programme trading desk using information provided by the customer for the purpose of obtaining a quote in order to manage the risk to which the broker will be exposed in the event that it wins the trade.
- 2.7 The execution of a blind bid principal programme trade usually involves the following steps:
 - (1) The customer provides limited information to a number of brokers to enable them to provide a quote for the trade, but without disclosing the identities of the component securities or whether the customer is a buyer or a seller;
 - (2) The customer receives the quotes from the brokers;
 - (3) The customer reviews the quotes and decides which institution will be awarded the trade;

- (4) The customer communicates the award of the trade to the winning broker and a strike time is agreed;
- (5) The customer then provides the broker with the full details of the component securities of the programme trade and indicates whether they are buying or selling; and
- (6) Each stock in the programme trade is supplied to the customer or sold on his behalf at the strike time at the quoted premium or discount to the mid-market price.

3 The facts

- 3.1 Between 11.24 and 11.31 on the day in question, the customer contacted three brokers to request quotes for a programme trade. The three brokers, one of which was Morgan Grenfell, were asked to provide a quotation in respect of a blind bid principal programme trade comprising 55 FTSE 100 securities. The value of the trade was approximately £65 million. Morgan Grenfell was the first firm to be approached for a quotation.
- 3.2 Neither the identity of the component securities of this programme trade nor whether the trade was a buy or sell was disclosed to any of the firms who were invited to bid.
- 3.3 More detailed information was provided in respect of seven stocks which were intended to be substantial components of the programme trade. The information supplied in respect of these seven component securities of the customer's programme trade included the percentage of average daily volume, the multiple of normal market size and the value of that security within the portfolio.
- 3.4 The firm correctly identified the seven component securities of the programme trade from the information the customer had provided. The firm also guessed that the customer was intending to buy the portfolio.
- 3.5 The firm has stated that having decided to bid for the trade the programme trading desk dealt in these seven stocks in order to hedge against the risk to which the firm would be exposed if it won the customer's order. One of the seven component securities was Daily Mail and General Trust.
- 3.6 The firm commenced trading in all seven of the component securities at 11.41.
- 3.7 The firm then provided two quotations (a buy and a sell price) to the customer at 11.43.
- 3.8 The programme trade was awarded to the firm at approximately 11.59. The firm was informed that the customer was a buyer. It was agreed that the strike time would be 12.02:15.
- 3.9 The firm continued to trade in seven of the component securities of the programme trade until just after the strike time.

- 3.10 In the twenty minute period between the commencement of proprietary trading and the strike time, the firm represented 93.52% of the total purchases in Daily Mail and General Trust and the price of the stock rose by 9.99%.
- 3.11 During the same period, the price of the remaining six stocks increased between 1.12% and 3.81%.
- 3.12 It was at these increased prices that the programme trade was struck. The customer paid more than it would otherwise have done due to the firm's trading in the seven component securities.
- 3.13 There was no intention on the part of the firm to move the share price. However, given the illiquidity in some of the securities, the volume of trading and the period over which the trades were executed, it was likely that the firm's trading would impact on the price of the securities.
- 3.14 The two unsuccessful brokers for this trade, who were provided with the same bid information as the firm, did not trade on the basis of the bid information. It is apparent that at least one of the unsuccessful brokers had also deduced the direction of the trade and the identity of at least six of the seven component securities.
- 3.15 The firm did not identify the impact on share prices until approximately 12.30.
- 3.16 The customer was alerted to the movements in several of the component securities by both of the unsuccessful brokers at 13.33 and 13.41. Subsequently, the customer approached the firm for an explanation for the increase in the price of two of the component securities.
- 3.17 After a period of four hours and a series of conversations between the firm and the customer, the firm made a payment to the customer to compensate for the increase in price in respect of Daily Mail and General Trust.
- 3.18 The firm maintains that it believed the customer would be aware that the firm might be active in the market and would make use of the limited information provided by the customer. However, at no stage, whether in relation to the specific trade or in their general terms of business, had the firm notified the customer that pre-hedging activity might be undertaken.

4 Relevant provisions

- 4.1 Under FSA Principle 6 an authorised firm must pay due regard to the interests of its customers and treat them fairly.
- 4.2 Under FSA Principle 8, a firm must manage conflicts of interest between itself and its customer fairly.
- 4.3 The FSA Handbook defines a *customer* as a *client who is not a market counterparty*. The definition of *client* includes a *potential client*.
- 4.4 In the context of the programme trading, the FSA recognises that regard must be had to the professional nature of the market.

- 4.5 Further guidance on the application of these principles in the context of programme trading is to be found in Chapter 7 of the FSA Conduct of Business Sourcebook and in Board Notices 438 and 500 issued by the Securities and Futures Authority.

Use of information

- 4.6 Whether there is a conflict of interests or an obligation to treat customers fairly may depend on the specificity of the information provided by the customer. For purposes of illustration, in the circumstances of this case, the firm was not prohibited from trading in the FTSE 100 purely because the customer had informed the firm that the 55 securities in the portfolio trade were FTSE 100 securities. This information is not specific enough to create a conflict of interest.
- 4.7 While the information that is provided by the customer when requesting a quote may be limited, it is sensitive information as to the customer's intentions. The principles of fair treatment and effective management of the potential conflict that arises in this situation require that a firm should not use such information for the purposes of its own trading to the detriment of the customer unless it has notified its customer that it intends to do so and that this may impact on the prices obtained.
- 4.8 Subject to paragraphs 4.9 to 4.11 below, an authorised firm is not prohibited from *reasonable participation* in the market prior to the award of a principal programme trade, for which the firm has bid on a blind basis, if it can do so while maintaining fair treatment for its customers. For the avoidance of doubt this applies for the entire period between the provision of information to enable a firm to provide a quote until the strike time.
- 4.9 However, *reasonable participation* does not mean unrestricted participation. An authorised firm is constrained in the use that can be made of information provided by the customer for the purposes of enabling the firm to bid.
- 4.10 It is anticipated that firms will put in place systems and controls that seek to minimise the impact that any pre-hedging by the firm is likely to have on the customer's interests. It is recognised that even the most advanced systems and controls cannot exclude the possibility that a firm's pre-hedging may cause a material adverse impact on their client's position. However, it is for this reason that fair treatment and the effective management of conflicts of interest require that a firm should ensure that customers are at least informed that the firm may engage in pre-hedging and that such activity may impact on the price that the customer ultimately pays.
- 4.11 For clarification, the receipt of information supplied for the purpose of providing a quote does not restrict a programme trading desk's ability to trade in the following situations:
- (1) the execution of a prior customer order; or
 - (2) book management which the firm can demonstrate is unrelated to the information supplied by the customer in that it is unprompted by information received from a potential client to enable a firm to bid, prior to the award of a trade.

5 Analysis of the firm's conduct

- 5.1 In this case, the firm's pre-hedging had the potential to affect the price that the customer would ultimately pay for the basket which it was considering purchasing. The firm believed that the customer ought to have appreciated that it would make use of information as to the customer's intentions in order to engage in such market activity. However, no specific notification was ever given (whether in relation to the particular trade or generally) regarding the firm's practice in this regard.
- 5.2 The firm's trading resulted in an adverse impact on the customer arising from its market activity prior to the strike time. Therefore, in the absence of any indication that the customer was informed, the firm did not take the necessary steps to ensure compliance with the obligations of fair treatment and management of conflicts of interest.

6 Penalty

- 6.1 The FSA Principles require all authorised firms to treat customers fairly and to manage conflicts of interest fairly. These obligations are fundamental to maintaining confidence in the financial system. The non-disclosure of the basis upon which the firm engaged in programme trading impacted upon the ability of the customer to compare bids on an equivalent basis. There was insufficient consideration of whether the firm's participation in the market was reasonable. The FSA is satisfied that the imposition of a financial penalty is therefore appropriate in the circumstances of this case.
- 6.2 However, in setting the level of penalty, the FSA has had regard to a number of mitigating factors:
- (1) The firm did not intend to move the price of the component securities of their customer's programme trade;
 - (2) What fair treatment and management of conflicts requires in a given situation often requires a considerable degree of judgement on the part of an authorised firm. The firm formed the view that that these obligations imposed no restrictions on the use the firm could make of information provided by a potential customer for the purposes of enabling the firm to provide the customer with a quote for a programme trade. While it considers that this view was incorrect, the FSA accepts that it was genuinely held;
 - (3) Once the impact of its trading on the customer's position had become clear, the firm agreed to compensate the customer and fully co-operated with the FSA in its investigation; and
 - (4) The firm has now voluntarily taken steps to inform its customers of the basis on which it engages in principal programme trading.

7 Important notices

- 7.1 This Final Notice is given to the firm in accordance with section 390 of the Act.

Penalty

- 7.2 The Penalty must be paid in full. The Penalty must be paid to the FSA no later than 31 March 2004, being not less than 14 days beginning with the date on which the Notice is given to the firm. If all of any of the Penalty is outstanding on 31 March 2004, the FSA may recover the outstanding amount as a debt owed by the firm and due to the FSA.

Publicity

- 7.3 Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as it considers appropriate. The information may be published in such a manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.
- 7.4 The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

FSA contacts

- 7.5 For more information concerning this matter generally, you should contact Lisa Demartini (direct line: 020 7066 1436/fax: 020 7066 1437) or Sara George (direct line: 020 7066 0172/fax: 020 7066 0173) of the Enforcement Division of the FSA.

Andrew Procter
Director
Enforcement Division