

Market Watch

Newsletter on market conduct and transaction reporting Issues

July 2014 / No. 46

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Price spike in HSBC shares

We are providing an overview of the causes of the spike in the price of shares of HSBC Holdings Plc in January this year. This is so firms can examine their own systems and controls, and consider the risk of being involved in a similar event.

What happened?

On 30 January 2014, a series of events, involving a number of actions and decisions, collectively led to a spike in the price of the shares of HSBC Holdings Plc (HSBC). Trades were executed across several trading platforms, before breaching the London Stock Exchange's (LSE's) 10% static limit and triggering a circuit breaker. The FTSE 100 moved 43 points (0.65%).

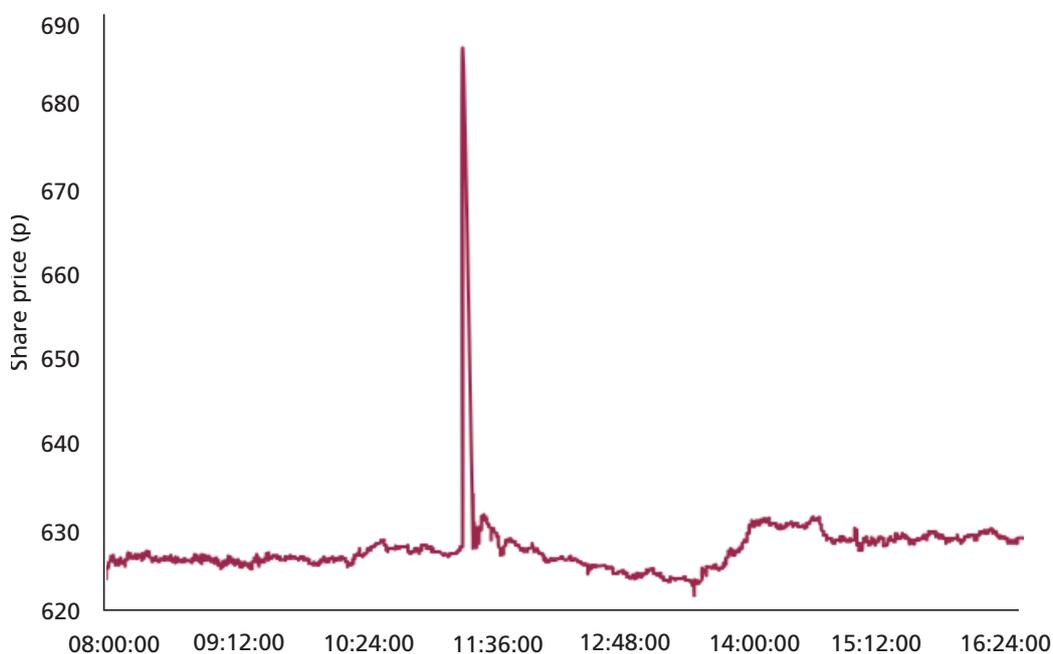
Why did we get involved?

There are several rules and pieces of guidance relevant to these events.

- Principle 5 of the FCA's Principles for Businesses¹ states that 'a firm must observe proper standards of market conduct'.
- The European Securities and Markets Authority (ESMA) guidelines² require investment firms to 'promote fair and orderly trading in an automated trading environment' (Guideline 4).
- Also, where firms provide Direct Market Access (DMA) or Sponsored Access to other firms or clients, they are responsible for the trading of that client, which is in line with Guideline 8 of the ESMA guidelines.¹

¹ PRIN 2.1.1R

² ESMA Guidelines – Systems and controls in an automated trading environment for trading Platforms, investment firms and competent authorities [ESMA 2012/122]

Figure 1: HSBC Holdings Plc Intraday mid-price (LSE), 30 January 2014**Summary of the activity**

Firm A received an order from a client to buy \$2.5m worth of shares in HSBC. The trader at Firm A misunderstood the order as a purchase of 2.5 million shares and entered an order to buy 2.5 million shares using Electronic Trading Services provided by Firm B. The trader used a Percentage of Volume (PoV) algorithm, provided by Firm B, with the participation rate set at 20% and no price limit. A PoV algorithm will automatically input orders to achieve a designated proportion of executed/traded volume. Where no price limit is set, the algorithm will continue to trade in line with the participation rate, regardless of price, until the order is completed.

Firm A had a hard consideration limit for single orders, which meant that any order over an agreed financial value would be automatically rejected. The order to buy 2.5 million shares of HSBC breached this limit and was therefore rejected by Firm B. The trader at Firm A then attempted to submit an order for 1.5 million shares, but this still exceeded the single order limit and was therefore also rejected. The trader, in the absence of the use of a formalised override procedure, then requested assistance from his contact at Firm B on how to input the order.

Firm A had been a client of Firm B for some time, they were regarded as experienced professionals and this scenario had occurred previously because of the consideration limit for that firm. The trader at Firm B suggested a solution that had been used previously and had become regarded as standard practice. He told the trader at Firm A to break up the order into five orders of 500,000, with the expectation that the orders would be submitted consecutively upon completion or simultaneously with a reduced participation rate.

The trader broke up the order as directed, submitting five orders in rapid succession using the same PoV algorithm, but he set each order to the original 20% participation. Consequently, Firm A's five orders were effectively competing with one another and collectively trying to purchase 2.5 million shares, at a participation rate of 100% with no limit price. As a result, the HSBC share price spiked from 629p to 688p.

The trader's mistake in confusing an order to buy \$2.5 million-worth of shares with an order to buy 2.5 million shares, though of concern, was not the cause of the spike; that would have been a very large order, but given the specific circumstances could have been executed at 20% of volume without causing the market to spike. The problem was simultaneously entering five orders, all trying to work at 20% PoV without any price limitation.

Under the 2014 revisions to the Markets in Financial Instruments Directive (MiFID II), new requirements will be introduced in the future concerning algorithmic trading. Details about these requirements are being developed by ESMA, which recently released a discussion paper on the relevant regulatory technical standards³ and will finalise proposals to be submitted to the European Commission at a later date. The FCA is actively engaged in ESMA's work.

In the meantime, this scenario raises various questions that may provide an opportunity for firms to review the systems and controls around their automated and DMA trading. In particular, firms could consider whether it would be prudent to set price limits when using this type of algorithm or maximum limits on participation rate. Additionally, it may be helpful to consider if multiple orders from the same client should be treated as discrete and whether there are circumstances in which a PoV algorithm cannot be submitted without a price limit (for example above a certain specified percentage of ADV).

Firms may also consider the effect of Guideline 4.2(f) of the ESMA Guidelines. Where limits are in place, is it appropriate to circumvent those limits or should an override procedure involving compliance always be used?

This is not an exhaustive study of the events and we encourage firms to continue to consider the likely impact of all aspects of their trading, and trading they facilitate, on the orderliness of the market.

Manipulation in fixed income markets

Summary of findings

The FCA recently published a Final Notice about manipulative trading by Mark Stevenson, a former Credit Suisse trader, in the 8.75% 2017 UK government bonds (gilt). The manipulation was designed to give a false or misleading impression of the price of the gilt with the goal of profiting, potentially at taxpayers' expense, later that day through sales of that gilt to the Bank of England as part of its Quantitative Easing operations.

Why this behaviour matters

Fixed income markets are no less important for the safeguarding of market integrity than equity markets. Markets are susceptible to manipulation at a number of time periods including, as this case highlights, intra-day manipulation.

This article provides some suggestions that firms and market participants may wish to consider to ensure that they are well placed to be able to identify any vulnerabilities to manipulation and any attempts at manipulation in fixed income markets.

³ www.esma.europa.eu/system/files/2014-548_discussion_paper_mifid-mifir.pdf

Summary of the conduct

On 10 October 2011 Mark Stevenson, a trader with almost 30 years' trading experience, manipulated the market price of the UKT 8.75% 2017 (the bond) higher in advance of a reverse auction by the Bank of England (BoE), for which this bond was an eligible security for purchase. He then offered £850 million of the bond at a discount to the prevailing market price in an attempt to make his offering appear comparatively good value to the BoE. However, the BoE decided to reject all offers in this bond owing to the sharp intra-day change in yield.

Stevenson accounted for 92% of the market share of the inter-dealer broker market volume in the bond on 10 October 2011 and his volume was itself equivalent to 27 days of normal trading. The trading was carried out with the purpose of manipulating the reference market price used by the BoE to assess offers. Specifically, in conducting the reverse auction, the BoE compared offering prices relative to their proximity to the mid-market price on the Debt Management Office's screen (the DMO mid) at 14:45 on the date.

Stevenson agreed to settle on the basis that he acknowledged he had deliberately traded with the intention of manipulating the price of the bond. It is important for market participants to appreciate the difference between trading on the grounds that securities are attractively valued and trading designed to impact the price of a security.

Outside of some limited safe harbours, trading with the purpose of moving or maintaining the price may be market abuse. This has been the subject of a number of cases in the equities and commodities markets. This particular case is the first such outcome in fixed income markets, which are subject to the same rules in relation to market abuse.

The price movement in the bond was artificial and abnormal in that pre-auction period where it outperformed adjoining gilts by 13 basis points in yield. Stevenson's 92% market share was an evidential factor but was not the reason why he was found to have committed deliberate market abuse. Firms may wish to consider how they can enhance their detection of higher than normal rates of participation, which may result in impacts on the prices, particularly on or around certain key dates or events.

Surveillance implications

The characteristics of the fixed income markets present compliance teams with several surveillance-related challenges. The large number of outstanding bond issues, limitations in price transparency, the fragmentation between voice-brokered and screen-traded products, the role that a market-maker plays in the price discovery process, and the lack of a central order-book are all factors that challenge trade surveillance as a control for market abuse.

Firms may wish to consider whether a more joined-up approach to surveillance, by combining automated trade surveillance with information gained from human-based front office oversight, could enhance their ability to monitor for potential abuse. We emphasise that the Suspicious Transaction Reporting (STR) regime also applies to the fixed income markets and we expect firms to provide STRs as required.

Considerations for firms

This case highlights the circumstances that might prompt a firm, its traders and other market participants, to consider whether they are able to identify manipulation in the fixed income markets.

Firms, their traders and other market participants may wish to consider the following, which may assist in informing views of the risks of breaching FCA rules:

- Is the trading based on the view that the securities are cheap/expensive or is the trading itself designed to impact the value of the securities?
- Is there a valid reason for a security to be purchased at ever tighter spreads / sold at ever wider spreads versus comparable issues?
- Is the trading of a sufficient volume to cause price movements?
- How does the firm assess whether its rate of participation in trading in any given security is reasonable?
- Does the price revert to the previous levels following this trading?
- What checks does the firm carry out on the trades it is executing (whether for its own book or for clients)?
- Are those checks sufficient to identify any unusual trading patterns/communications?
- Are there any further checks, or different ways of checking the information, which would enable firms to better detect for market abuse?
- Are there particular market events that may accentuate incentives for undertaking potentially abusive trades (eg. auction, month end, Quantitative Easing, pricing of a new issue)?
- When pricing a new issue at a spread relative to a government bond benchmark, has the firm reviewed its own trading in the benchmark particularly in the lead-up to pricing?
- Has the firm taken all reasonable steps to identify any potential manipulation attempts and to manage these where relevant?
- Has the firm trained its staff on the potential implications of manipulative trading in fixed income including providing specific examples relevant to this market?