Financial Conduct Authority

FCA FINANCIAL CONDUCT AUTHORITY

Market Watch

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You can also find issues on our website at: www.fca.org.uk/firms/markets/market-abuse

Abusive high frequency trading (HFT) strategies in commodities markets

Summary of findings

We have found Mr Michael John Coscia and his company, Panther Energy Trading LLC, to have engaged in market abuse by deliberately manipulating commodities futures using an algorithmic High Frequency Trading (HFT) strategy.

We imposed a financial penalty of £597,993 (USD 903,176). The algorithm designed by Mr Coscia was purposefully aiming to induce other market participants to trade so that he could profit from the increased trading through his layering of the order book in Brent Crude futures, Gas Oil futures and West Texas Intermediate Crude futures (WTI). This manipulative strategy, commonly known as 'layering'[1], resulted in a false or misleading impression about the supply, demand, or price for qualifying investments and secured a price for Mr Coscia at an artificial level.

All trading activities, including the submission of orders, originated from the US, where Mr Coscia and Panther Energy Trading LLC were based. The abusive orders were submitted to a UK-regulated market, which meant we were able to detect, investigate and take action against the abusive behaviour. We engaged effectively with fellow regulatory bodies in the US – the CFTC and CME – and these bodies were able to take disciplinary action in their jurisdictions against the individual for similar activities carried out on US-regulated markets. This case demonstrates the ability and willingness for regulators across different jurisdictions to take coordinated action and overcome the complexities of fighting abusive behaviour that affects numerous jurisdictions.

1 In its Guidelines on Systems and Controls in an automated trading environment for trading platforms, investment firms and competent authorities, ESMA defines Layering and Spoofing as 'submitting multiple orders often away from the touch on one side of the order book with the intention of executing a trade on the other side of the order book. Once that trade has taken place, the manipulative orders will be removed'. See further at: www.esma.europa.eu/system/files/esma_2012_122_en.pdf

Summary of the conduct
The algorithmic strategy was designed to float a small order, typically either bidding just below or at the best bid, or offering just above or at the best offer. Once this order was in place, the algorithm was then designed to float several much larger orders into the market on the opposite side of this initial bid or offer. This gave the impression that a large volume of orders had entered the market, moving the price in the direction of the resting small order. On completion of the resting order, all the other orders would then be cancelled, demonstrating that there was no legitimate rationale for the large volume of orders. For further explanation please refer to the FCA final notice and graphical depiction of the behaviour.

Other market participants were induced to place orders in the same direction, i.e. sell orders/offers, on the basis that the large sell orders represented a legitimate indication of seller interest.

Why this behaviour matters
Our strategic objective is to ensure that relevant markets function well. Underpinning this objective are operational objectives of securing an appropriate degree of protection for consumers and protecting and enhancing the integrity of the UK financial system (alongside a further objective of promoting effective competition in the interests of consumers in the markets for specified services). Both of the first two operational objectives are particularly relevant in deterring market participants from engaging in manipulative behaviour.

There has been significant technological development leading to an increased reliance on algorithmic and automated trading, and HFT, a subset of automated trading. Market structures have developed as a consequence of technological evolution and MiFID. Equity markets have seen greater market fragmentation globally, and notable high profile incidents attributed to the use of algorithmic trading have predominantly occurred within equity markets. However, manipulative algorithmic HFT strategies can be adopted across other asset classes, as this case demonstrates.

The behaviour in this instance involved algorithmic trading in an asset class other than equities or an equity derivative. Our finding against Mr Coscia highlights that we will look to sanction behaviour regardless of the asset class or the market in which abusive behaviour is undertaken. One notable example of enforcement action in this area is the penalty imposed on Canada Inc, which was carrying on business as Swift Trade Inc, for layering on the London Stock Exchange.[2]

We recognise that algorithmic trading may be beneficial for market integrity by providing an important source of liquidity. In this instance the abusive strategy provided a false impression of liquidity, which could damage the reputation of legitimate liquidity-provision strategies. We note the risk that one malicious or abusive algorithmic strategy could lead to a decrease in consumer confidence related to all firms exhibiting similar trading characteristics – in the case of algorithmic trading, those trading with speed.

Mr Coscia was able, through a single trading pattern that involved buying and selling 17 lots, to realise a profit of USD 340 in less than one second. This particular trading pattern was often repeated hundreds of times a day, with Mr Coscia typically placing and rapidly cancelling over a thousand large orders in a day's trading. The speed and impact of such an abusive strategy, designed to provide a false impression of liquidity, is significantly detrimental to market integrity.

We expect that with the rise in automated trading the proportion of disciplinary outcomes (both public and non-public) for market manipulation offences will increase. Abusive strategies that act to the detriment of consumers or market integrity will not be tolerated.

2 www.fsa.gov.uk/static/pubs/decisions/stationmasters

Update on suspicious transaction reports

Over the past 18 months, we have significantly increased our focus on the Suspicious Transaction Reporting regime (STRs). We have undertaken - and will continue to undertake - supervisory visits to firms to more closely review the systems and controls in place to identify suspicious transactions. The purpose of these visits is predominantly educational, and we have witnessed substantial improvements in the quality of STR submission from most of the firms visited. This focus has led to a substantial increase in the number of submissions we have received from investment firms over the past six years.

Notifications to the FCA under SUP 15.10

Year	Misuse of information and insider dealing	Manipulation, misleading practices or other market abuse	Total STRs
2013 (to 31 May)	439	58	497
2012	918	100	1018
2011	499	85	584
2010	434	75	509
2009	313	65	378
2008	277	69	346
2007	308	20	328

Whilst the number of STRs received has increased, we have continued to see consistently high-quality submissions across the industry and we continue to encourage firms to exercise their judgement when making submissions. If appropriate, we will provide feedback to firms to help and educate about the type of notifications we expect to see. We have also increasingly made contact with firms to discuss instances where suspicious transactions have not been reported to us, and we will continue to look for patterns of consistent under-submission, or defensive reporting.

The STR regime remains key to our ability to protect and enhance the integrity of the UK financial system and will remain a focus over the forthcoming year.

STRs may now be submitted using the following form: www.fca.org.uk/firms/markets/market-abuse/suspicious-transaction-reporting

RBS fined £5.6m for transaction reporting failings

We have fined the Royal Bank of Scotland (RBS) £5,620,300 for incorrectly reporting transactions they made in wholesale markets, and in some instances, failing to report transactions at all.

RBS failed to properly report 44.8 million transactions between November 2007 and February 2013; and failed altogether to report 804,000 transactions between November 2007 and February 2012. This represents 37% of relevant transactions carried out by RBS in this period, and breaches FCA rules on transaction reporting and its requirements for firms to have adequate management and controls.

Many of the problems with RBS' own systems were compounded by the takeover of ABN Amro Bank N.V. in October 2007. We consider that, given the considerable resources available to RBS, it should have been able to overcome these challenges and ensure adequate systems and controls were in place.

Tracey McDermott, Director of Enforcement and Financial Crime, said:

'Effective market surveillance depends on accurate and timely reporting of transactions. We have set out clear guidance on transaction reporting, backed up by extensive market monitoring, and we expect firms to get it right. As well as a financial penalty, firms can expect to incur the cost of resubmitting historically incorrect reports. We will continue to take appropriate action against any firm that fails to meet our requirements.'

Our overall objective is to ensure that markets function well. Accurate and complete transaction reporting by firms is an essential tool in delivering this objective. We use these reports in a number of ways – including identifying and investigating suspected market abuse, for example insider trading and market manipulation. Where we see any evidence of firms not acting properly we will not hesitate to act.

These failures are particularly concerning because we already provide extensive guidance to firms on how to submit and check these reports, and we have taken action against seven firms, including Barclays and Credit Suisse, for similar reporting errors. The size of the fine reflects the serious nature of the issue. RBS agreed to settle at an early stage of the investigation, and received a 30% reduction of their fine.

NYSE Euronext LIFFE central counterparty

Under section 7.18.1 of the Transaction Reporting User Pack where the counterparty is a central counterparty (CCP), the BIC for the CCP must be used. LIFFE confirmed via its info-flash no.LO13/52[3]) that as from 1 July 2013 the CCP is ICE Clear Europe Limited and its BIC code is ICEUGB2LXXX. Therefore, effective from 1 July 2013, transaction reports identifying trades on LIFFE using the CCP in the counterparty field should use ICEUGB2LXXX. Transaction reports for trading prior to 1 July 2013 and any subsequent corrections to those reports should continue to use the BIC for the CCP as at the trade date or the transaction reports will be rejected.

3 https://globalderivatives.nyx.com/sites/globalderivatives.nyx.com/files/lo13-52.pdf

Turquoise derivatives transfer to London Stock Exchange (LSE)

As set out in Market Watch 41, Turquoise Global Holdings Limited (TGHL) is operated as a Multilateral Trading Facility (MTF) and therefore transactions for derivative instruments admitted to trading on Turquoise Derivatives are OTC derivatives.[4]

However, because these instruments were previously traded on EDX London, which was a Recognised Investment Exchange (RIE), to avoid firms having to make systems changes to comply with the current rules, we allowed firms to either report as OTC derivatives or to continue to report as on-exchange transactions as if they were derivatives admitted to trading on a regulated market.

The LSE has entered into an agreement to purchase the derivatives business from TGHL.

If the sale goes ahead the instruments will be admitted to trading on a regulated market segment of the LSE.

Transactions in these instruments will therefore be subject to the rules applying to instruments admitted to trading on regulated markets.

There will be a new LSE MIC code applicable to these instruments.

As set out in SUP 17 Annex 1 21 where the venue is a regulated market the venue identification field should be populated with the Swift MIC code. Under TRUP 3 where the venue is a regulated market firms should validate the MIC against the MIC on the ESMA database: http://mifiddatabase.esma.europa.eu/.

4 An OTC derivative is defined in SUP as 'a derivative traded solely over the counter'.
'Over the counter' is subsequently defined as '(in relation to a transaction in an investment) not on-exchange'.
In turn, 'on-exchange' means:
'(a) (in relation to a transaction in the United Kingdom) effected by means of the facilities of, or governed by the rules of, an RIE or a regulated market;
(b) (in relation to any other transaction) effected by means of the facilities of, or governed by the rules of, an exchange.'