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Lime
Brokerage LLC
Member NYSE, Nasdaq, FINRA, NFA, SIPC

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OFFICE OF THE SECRETARY

December 12, 2008

Florence Harmon
Acting Secretary
Securities and Exchange Commission
Station Place
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-NYSE-2008-71 and SR-NYSE-2008-100

Dear Ms. Harmon:

As Lime Brokerage LLC ("Lime")[1] has advocated in its previous comment letters regarding the New York Stock Exchange ("NYSE") sponsored access rule,[2] sponsored access raises a host of fundamental issues regarding the oversight of markets and their participants. Providing direct access — without intermediation by the broker-dealer — prevents the broker-dealer from effectively complying with a variety of important investor protection rules and, in turn, frustrates the ability of the exchange to monitor trading on its market and exposes the exchange membership to inappropriate, excessive, potential and uncontrollable risk from one member. In a recent newsletter, the U.K.'s Financial Services Authority ("FSA") reached a similar conclusion, cautioning intermediaries and trading platforms about the many risks posed by sponsored access programs.[3] (A copy of the FSA newsletter is attached to this letter.) The FSA's position provides additional support for Lime's recommendation to the SEC to revisit the sponsored access practices permitted under the NYSE and the other exchanges' rules.

Specifically, the FSA expressed concern about the additional risks posed by sponsored access. For example, the FSA noted that, on the market side, sponsored access increases the "risk of error trades and potential for market abuse," and, on the intermediaries' side, it increases the "credit risk that could arise from the inability of sponsors to monitor their clients' business (and therefore their exposure) in the absence of suitable controls."

As a result of these increased risks, the FSA concluded that the "absence of pre-trade controls would cause serious concerns regarding the adequacy of risk management." Therefore, FSA expects firms and trading platforms to operate both post-trade measures and "effective pre-trade controls to

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1 Lime is a technologically advanced brokerage firm located in New York City that caters to a diverse and sophisticated client base. Lime's clients include professional traders, hedge funds, asset managers, and other broker-dealers. Our customers rely on Lime's robust and advanced technology to execute equities, futures and options transactions on multiple exchanges, ECNs and other trading venues. For more information about Lime, *see* www.limebrokerage.com.

2 Letter from Alistair Brown, Chief Executive Officer, Lime, to Florence Harmon, Acting Secretary, SEC re: SR-NYSE-2008-71 (Sept. 24, 2008); Letter from Mark Gorton, Chairman, Lime, to Florence Harmon, Acting Secretary, SEC re: SR-NYSE-2008-71 and SR-NYSE-2008-100 (Nov. 7, 2008).

3 FSA Market Watch, Markets Division: Newsletter on Market Conduct and Transaction Reporting Issues, Issue No. 30, November 2008 at 10-12 (available at <http://www.fsa.gov.uk/pubs/newsletters/mw_newsletter30.pdf>).

provide sufficient mitigation against risks posed by [sponsored access]." The FSA stated that "a signed declaration from sponsoring intermediary firms saying that they have carried out due diligence on their clients" would not be considered sufficient "unless they are also aware of and satisfied with further details of the controls imposed as a condition of access." Moreover, the FSA would be "concerned if a firm decided to outsource [these controls] to a client."

For these reasons as well as the many reasons set forth in its previous comment letters, Lime urges the Securities and Exchange Commission ("SEC" or "Commission") to institute proceedings to disapprove the NYSE's sponsored access rule.

* * * * *

Lime appreciates the opportunity to express its concerns about the sponsored access rules to the Commission. If you have any questions concerning these comments or would like to discuss these comments further, please feel free to contact me through our Chief Compliance Officer, William St. Laurent, at (212) 219-6092.

Sincerely,

Jeffrey S. Wecker
Chief Executive Officer

cc: Chairman Christopher Cox
Commissioner Kathleen L. Casey
Commissioner Elisse B. Walter
Commissioner Luis A. Aguilar
Commissioner Troy A. Paredes
Brian Cartwright, General Counsel, Office of the General Counsel
Erik R. Sirri, Director, Division of Trading and Markets
Robert L.D. Colby, Deputy Director, Division of Trading and Markets
Daniel Gallagher, Deputy Director, Division of Trading and Markets
Marc McKayle, Special Counsel, Division of Trading and Markets
David Shillman, Associate Director, Division of Trading and Markets
John Roeser, Assistant Director, Division of Trading and Markets
Mary Schapiro, Chief Executive Officer, FINRA
Stephen Luparello, Senior Executive Vice President, Regulatory Operations, FINRA

Lime
Brokerage LLC
Member NYSE, Nasdaq, FINRA, NFA, SIPC

November 7, 2008

Florence Harmon
Acting Secretary
Securities and Exchange Commission
Station Place 100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-NYSE-2008-71 and File No. SR–NYSE–2008–100

Dear Ms. Harmon:

As co-founder of Lime Brokerage LLC ("Lime"), a regulated broker dealer, I find myself in the rather unusual position of petitioning the SEC for more regulation. Lime Brokerage caters primarily to automated traders, and through my involvement with the Company, I have a good understanding of the issues and practices surrounding automated trading. Runaway order placement is the great risk with any automated trading system, as exemplified by the $350 million loss incurred by Mizuho Securities on 12/8/05 on the Tokyo Stock Exchange - http://www.nytimes.com/2005/12/21/business/worldbusiness/21glitch.html. Proper circuit breakers are necessary in order to prevent an out of control trading program from exposing the financial system to a catastrophic risk. Historically, regulated brokerage firms have been required to check customer orders for adequate buying power before an order hits the market. However, the SEC has allowed decades-old safeguards and mandatory supervisory controls to fall by the wayside with its acceptance of a practice known as Sponsored Access.

Sponsored Access is a practice where entities such as hedge funds are permitted to submit orders directly to Exchanges, ECNs and other trading venues, a practice normally only permitted by broker-dealers registered pursuant to the Securities and Exchange Act of 1934. With a Sponsored Access arrangement, the unregistered and unregulated party entering the order directly to the Exchange or ATS does ***not*** submit the order through a registered broker dealer first. Therefore, the pre-trade compliance obligations, like the FINRA "affirmative determination" and compliance with the provisions of SEC Regulation SHO can only be done, if they are done at all, by the end customer, an unregulated entity that the SEC does not normally have jurisdiction over.

Lime Brokerage has spoken to the SEC about Sponsored Access, both informally and in writing, and we were disturbed at the lack of concern or appreciation of the risks of this practice. Computerized trading is here to stay, and computerized trading can be a benefit to the functioning of the markets. However, a sound regulatory framework that prevents out of control trading by computers is necessary to insulate the markets and the public from the hazards that accompany computerized trading.

In the past decade, around the world, there have been numerous examples of multi-hundred million dollar losses caused by computers trading out of control. Luckily, in each case to date, a large brokerage firm was able to absorb the loss, and the market was insulated from the error. However, by removing the layer of checking done by broker dealers, Sponsored Access increases the risk of a catastrophic computer error.

Lime Brokerage LLC has previously submitted a comment letter to the SEC regarding the NYSE's amendment of NYSE Rule 123B on Sponsored Access, http://sec.gov/comments/sr-nyse-2008-71/nyse200871.shtml . This letter addresses a rather significant shortfall in the regulatory framework that permits non-regulated entities to police themselves: a process that should be statutorily prohibited immediately.

The practice of Sponsored Access is extremely troubling in a market environment that has been caused, at least in part, by financial entities policing themselves. Through the amendment, the NYSE continues to allow non-members of the New York Stock Exchange ("NYSE") direct access to the NYSE for the entry and execution of orders on the Exchange, a practice at direct odds with existing rules, and best practices. Historically, this practice has been confined to broker-dealers because the party entering the order is responsible for ensuring compliance with various SEC and self-regulatory organization rules and regulations such as FINRA's rules on Supervisory Controls and Affirmative Determination for sales, at a minimum.

The rule changes completely ignore an important layer of market protection. The NYSE would like to continue to allow hedge funds to be responsible for monitoring their own short sale checks, margin and leverage limits, and circuit breakers to prevent out of control trading. Sponsored Access is both bad public policy and contrary to existing rules. The practice of Sponsored Access is analogous to allowing airline passengers to screen their own baggage. If the SEC and FINRA deem certain practices significant enough to create rules like Regulation SHO and Emergency Order 204T, then permitting unregulated end-customers to self-police for compliance with these rules is inappropriate. According to the Securities and Exchange Act of 1934, the regulatory burden rests with the regulated entity and ***not*** the end customer.

The events of the last year have taught us that we need a proper regulatory framework to prevent market catastrophes, such as runaway computerized trading, naked shorting and excessive leverage. The past few years have seen a systematic weakening of the regulatory framework thus increasing the likelihood of these issues arising. The SEC and FINRA need to act to restore a robust regulatory structure to the US equity markets by properly enforcing the existing rules. The SEC and FINRA have ignored the issue of Sponsored Access for the past few years. I can only hope that the current financial crisis has shaken the SEC from its complacency.

In a financial crisis aggravated by a lack of regulatory oversight, the SEC would be foolhardy to permit a regulatory structure that allows customers to police themselves. Unregulated hedge funds operating with the same access and privileges as regulated brokerage firms opens a gap in proper trading oversight. Hedge funds are the wrong entities to prevent naked shorting and compliance with credit standards, like Regulation T and FINRA's margin rules. The SEC and FINRA have outsourced, and at times completely abdicated, the enforcement of rules to hedge funds, and our most recent history has shown this to be dangerously inadequate.

Sponsored Access strips away important protections in an industry that is already being scrutinized for lack of oversight. Although the customers may be professional traders, they do not meet the same standards and assume the same obligations as registered broker-dealers whose systems and procedures are monitored to ensure that they are sufficient for the prudent operation of their business. As SEC Chairman Cox stated on September 26th "The last six months have made it abundantly clear that voluntary regulation doesn't work." Sponsored Access is voluntary regulation taken to the extreme: a practice that should be stopped. I only hope that it doesn't take a catastrophe in this area for the SEC and FINRA to address this issue.

Sincerely,

Mark Gorton
Chairman
Lime Brokerage LLC

Lime
Brokerage LLC
Member NYSE, Nasdaq, FINRA, NFA, SIPC

September 24, 2008

Florence Harmon
Acting Secretary
Securities and Exchange Commission
Station Place
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-NYSE-2008-71

Dear Ms. Harmon:

Lime Brokerage LLC ("Lime")[1] appreciates the opportunity to comment on the New York Stock Exchange's ("NYSE") proposal to amend NYSE Rule 123B (Exchange Automated Order Routing System) to allow members or member organizations ("sponsoring member") to provide non-member clients ("sponsored participant") with direct access to the exchange for the entry and execution of orders on the exchange.[2] The NYSE's proposal to permit sponsored participants to bypass the sponsoring member's system (or a service bureau's system provided by the sponsoring member) and to transmit orders directly to the exchange ("direct access") violates, among other provisions, Sections 6(b)(1), 6(b)(5), and 6(c)(1) of the Securities Exchange Act of 1934 ("Exchange Act"). As a result, there is no reasonable basis to conclude that the proposed rule change is consistent with the requirements of the Exchange Act, as required by Section 19 of the Exchange Act. Accordingly, the Securities and Exchange Commission ("SEC" or "Commission") should institute proceedings to disapprove this attempt to broaden access to the exchange beyond its members.[3]

Billed as a mere technical amendment, the proposal to eliminate the sponsoring member's active role with regard to its clients orders, in fact, raises a host of fundamental issues regarding the oversight of markets and their participants. What the NYSE fails to acknowledge in its brief description of the proposal is that providing direct access — without intermediation by the broker-dealer — prevents the broker-dealer from effectively complying with a variety of important investor protection rules and, in turn, frustrates the ability of the exchange to monitor trading on its market. After all, the exchange does not have direct oversight authority with regard to its members' clients. Therefore, the rule change undermines the fundamental regulatory structure of the Exchange Act.

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1 Lime is a technologically advanced brokerage firm located in New York City that caters to a diverse and sophisticated client base. Lime's clients include professional traders, hedge funds, asset managers, and other broker-dealers. Our customers rely on Lime's robust and advanced technology to execute equities, futures and options transactions on multiple exchanges, ECNs and other trading venues. For more information about Lime, *see* www.limebrokerage.com.

2 Securities Exchange Act Rel. No. 58429 (Aug. 27, 2008).

3 Section 19(b)(2) of the Exchange Act. Moreover, as a procedural matter, we note that the NYSE's rule filing does not meet the definition of a non-controversial filing made pursuant to Section 19(b)(3)(A) and Rule 19b-4(f)(6). As such, the filing should not be effective upon filing.

I. Direct Access by Non-Broker-Dealers Violates the Membership Requirements of the Exchange Act

Section 6(c)(1) under the Exchange Act prohibits exchanges from granting membership to any person not registered as a broker-dealer or associated with a broker-dealer. By allowing non-broker-dealers to obtain direct access to the exchange, NYSE Rule 123B acts as a de facto grant of membership to non-broker-dealers in violation of Section 6(c)(1). Indeed, the ability to effect transactions directly on the exchange is the hallmark of exchange membership.[4] In adopting the membership requirements in Section 6(c)(1), Congress intended to strengthen the oversight of exchange trading by requiring all persons utilizing an exchange's facilities to effect transactions to register as a broker-dealer with the Commission.[5] With this provision, Congress intended to eliminate direct institutional access to the exchanges; it certainly did not intend to provide a back-door opportunity for institutions to continue trading directly on the exchanges.[6]

II. Direct Access Undermines Proper Oversight of Markets and Their Participants

Direct access undermines the basic regulatory oversight structure of the Exchange Act. If a sponsored participant submits an order directly to the exchange, the sponsoring member is unaware of the order until after it is executed. Therefore, the sponsoring member has no way of monitoring the order and evaluating its compliance with various applicable rules and regulations before it is transmitted to the exchange for execution. As such, NYSE Rule 123B establishes a framework in which broker-dealers, as a practical matter, cannot comply with their obligations under various SEC and exchange rules on a pre-trade basis. Therefore, the NYSE has adopted a rule that, by its terms, thwarts its members' ability to comply with the securities laws and rules in violation of Section 6(b)(1).[7] With neither the exchange, nor the sponsoring broker-dealer, able to meet their respective regulatory obligations pursuant to its terms, NYSE Rule 123B ultimately threatens the investor protection role of the securities laws in violation of Section 6(b)(5).[8]

The SEC previously has recognized the significant regulatory impediments to allowing direct institutional access to exchanges. The SEC stated that "in order to ensure the central goals of exchange regulation, direct institutional members or participants in exchanges would have to be subject to the majority of rules and regulations to which broker-dealers are currently subject."[9] In light of these

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[4] *See, e.g.*, Section 3(a)(3)(A) of the Exchange Act (defining a member with a reference to its ability to effect transactions on the exchange).

[5] Securities Acts Amendments of 1975, Report of the Senate Comm. on Banking, Housing and Urban Affairs to Accompany S.249, S. Rep. No. 75, 94th Cong., 1st Sess. (1975).

[6] Moreover, since the sponsored participants are performing functions normally reserved to registered personnel of a broker-dealer, the definition of a "branch office" in FINRA Rule 3010(g)(2) and the definition of OSJ in FINRA Rule 3010(g)(1) could be interpreted to include the customers' places of business.

[7] Section 6(b)(1) of the Exchange Act requires that the exchange be "so organized and ha[ve] the capacity to be able to carry out the purposes of this title and to comply, and (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2)) to enforce compliance by its members and persons associated with its members, with the provisions of this title, the rules and regulations thereunder, and the rules of the exchange."

[8] Section 6(b)(5) of the Exchange Act (requiring exchange rules to be designed "to protect investors and the public interest").

[9] Securities Exchange Act Rel. No. 40760 (Dec. 8, 1998).

concerns, the SEC concluded that it was not "practical" nor did it serve "the best interests of investors or the markets generally to allow non-broker-dealers to be members of national securities exchanges, because of the lack of regulatory oversight the Commission would have over these entities."[10] As the list of rules below attests, these conclusions remain true.

A. Direct Access Makes Compliance with Many Rules Difficult or Impossible

The regulatory void created by direct access affects rule compliance across the board. Examples of important investor protection rules threatened by direct access include:

- Short sales. A broker-dealer may not accept a short sale order unless it makes a pre-trade affirmative determination regarding the availability of the securities for borrowing.[11] With direct access, the sponsoring member knows nothing about the trade in advance and thus cannot perform this required task. Recent emergency rules and SEC orders convey the seriousness of proper order validation for short sales.[12] Failure by the SEC to take action to prevent inappropriate short selling by sponsored participants during periods of turmoil sends a contradictory message to participants in the marketplace.

- Long sales. Broker-dealers are required to ascertain the location of securities to be sold long by a customer before the order is submitted to the market for execution.[13] If the long order is submitted directly to the exchange, the sponsoring member has no opportunity to check on the existence or location of the sponsored participant's long securities.

- Margin rules. A broker-dealer is required to ascertain that its customer has sufficient equity in its account to support a margin transaction (including a short sale). Moreover, broker-dealers also are required to ensure compliance with specific Regulation T or SRO margin rules for day traders. Sponsoring members who permit sponsored participants to make direct access trades have no opportunity to make these determination before the trade is executed.

- Creditworthiness. Under NYSE Rule 123B, the sponsoring member remains responsible to the sponsored participant, and to the other side of the trade, for settlement. Normally a broker-dealer would review its customer orders for size, liquidity, and other factors before undertaking the risks inherent in an execution. With direct access, the sponsoring member has no opportunity to perform this basic risk-management exercise.

- Erroneous trades. A broker-dealer's pre-execution review of its customer orders can reduce the incidence of erroneous trades that may result in sometimes significant market disruption.[14]

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10 *Id.*

11 Rule 203(b) of Regulation SHO.

12 *See* Securities Exchange Act Rel. No. 58572 (Sept 17, 2008).

13 Rule 200(g) of Regulation SHO.

14 Indeed, the high profile examples of extremely large erroneous trades in Tokyo and New York attest to the need for controls to prevent such trades. *See* Andrew Morse and Yuka Hayashi, "Tokyo Market Roiled Again, as Numbers Don't Quite Add Up – Mizuho Errs by Offering Pricey Stock for 1 Yen in $250 Million Mistake," WSJ, at p. A3 (Dec. 9, 2005) (trader mistakenly tried to sell 610,000 shares at one yen a piece in a company instead of selling one share at Y610,000); NYSE Hearing Board Decision 06-220 (Dec. 18, 2006) (order routing system failed to prevent an erroneous transaction to buy $10.8 billion of stocks instead of $10.8 million as intended, causing significant market disruption).

Applying preventative pre-trade measures can reduce the number and significance of clearly erroneous trades. Such desirable controls, however, are not possible with direct access.

- Manipulative trading. Pre-execution review by a broker-dealer can detect and reduce the risk of wash sales, marking the close, and other market practices, whether intentional or unintentional, on the part of the customer, that can have a manipulative effect. The SEC and the self-regulatory organizations have made it clear that in certain areas the broker-dealer is the first line of defense against abusive trading practices.[15] Direct access arrangements, however, make it impossible for a sponsoring member to detect these activities until after the fact.

- Restricted lists. Broker-dealers generally maintain restricted lists to monitor and prevent inappropriate trading in securities of which the customer is the issuer or a control person. Certain issuer or affiliate trades may need to be executed subject to a registration statement, or in compliance with Rule 144 under the Securities Act of 1933, or Rule 10b-18 under the Exchange Act. Customers trading via direct access may be able to avoid these restrictions.

- Regulation NMS. Regulation NMS imposes a variety of duties on broker-dealers that must be performed before or at the time of execution. For example, those routing an intermarket sweep order must ensure that it complies with the various requirements of Rule 611 and the related SEC FAQs.[16] Permitting direct access leaves timely compliance with these measures to unregistered personnel.

B. Oversight by Contractual Agreement Falls Short of Direct Oversight

NYSE Rule 123B places the ultimate responsibility for compliance with the securities laws and rules on the sponsoring member, but it does not explain how the sponsoring member will satisfy these obligations in practice. Instead, NYSE Rule 123B requires the sponsored participant to sign an agreement stating that it will comply with the securities laws. Such contracts only provide the sponsoring member with after-the-fact oversight via contractual remedies – and, only if the problem is discovered. It cannot provide the same level of supervision as real-time oversight of trading activities, as would be imposed if the trades were sent through the broker-dealers own system.

Moreover, such an agreement does not provide the level of investor protection provided by a registered broker-dealer or associated person performing the trading activities. The sponsored participant and its authorized trader are performing functions that have historically been done only by registered personnel of a broker-dealer who satisfy numerous requirements designed to insure the integrity of the markets. The many prophylactic requirements include being free from a statutory disqualification, passing several examinations (including Series 7 and Series 55), being supervised in their trading activities, participating in Regulatory and Firm Elements of Continuing Education and an annual compliance interview or meeting, and being subject to limitations on personal securities transactions, including the purchase of new issues. If the requirements imposed on broker-dealer personnel are

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15 *See, e.g.*, Remarks by Mary L. Schapiro, President, NASD Regulation, Inc., District 7 Compliance Seminar (Sept. 25, 1997) (urging brokers to be "first line of defense with respect to investor protection").

16 *See* SEC Division of Market Regulation, Responses to Frequently Asked Questions Concerning Rule 611 and Rule 610 of Regulation NMS (available at http://www.sec.gov/divisions/marketreg/rule611faq.pdf).

relevant and meaningful, there seems to be no justification for permitting non-registered persons to participate on an equal, indeed preferential, basis.

III. The SEC Should Amend the Direct Access Aspect of Nasdaq Rule 4611

The NYSE states in its rule filing that NYSE Rule 123B is identical to Nasdaq Rule 4611. In 2007, Nasdaq amended Rule 4611 to allow sponsored participants to enter orders directly into Nasdaq without passing the order through the sponsoring broker-dealer's systems.[17] For the reasons discussed above, the SEC also should use the authority granted to it in Section 19(c) of the Exchange Act[18] to eliminate the direct access provisions from Rule 4611.

IV. Conclusion

The events of the last few days, which resulted in various SEC emergency orders and Federal Reserve interventions in the market, have clearly demonstrated that leaving entities to regulate and police themselves does not work. These events have unfortunately shown that, when left to their own devices, businesses have repeatedly pushed the boundaries of what is ethical, legal and appropriate. Does the Commission really feel it reasonable that **pre-trade** compliance with SEC Emergency Order Rule 204T, eliminating short selling in financial securities, is best left to those that might have a vested interest in doing otherwise? The entire regulatory framework has been built with the intent of having specific control procedures in place to prevent non-regulated entities from having the same access as regulated entities, as the SEC and other regulatory agencies have limited recourse to oversee such end clients. Weakening the regulatory framework by approving NYSE Rule 123B — especially during such tumultuous times in the market — cannot be in the best interest of investors and the public.

As the Courts of Appeals have emphasized, the SEC is held to a high standard when reviewing proposed rule changes.[19] The courts have concluded that the SEC must analyze carefully the basis for and effects of a proposed rule to satisfy its statutory obligations.[20] Such a careful analysis of the NYSE and Nasdaq's rule changes will reveal their many deficiencies as compared to the statutory requirements set forth in Section 6 of the Exchange Act. Therefore, we urge the SEC to institute proceedings to disapprove the NYSE's proposal and to amend the Nasdaq's Rule 4611 pursuant to Section 19 of the Exchange Act.

* * * * *

17 Securities Exchange Act Rel. No. 55061 (Jan. 8, 2007).

18 Under Section 19(c) of the Exchange Act, "[t]he Commission, by rule, may abrogate, add to, and delete from the rules of a self-regulatory organization (other than a registered clearing agency) as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this title and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of the purposes of this title."

19 *See, e.g.*, *Clement v. SEC*, 674 F.2d 641 (7th Cir. 1982).

20 *See, e.g.*, *Chamber of Commerce of the USA v. SEC*, 412 F.3d 133 (D.C. Cir. 2005); *Timpanaro v. SEC*, 2 F.3d 453 (D.C. Cir. 1993).

Lime Brokerage appreciates the opportunity to express its concerns about the NYSE and Nasdaq rules to the Commission. If you have any questions concerning these comments or would like to discuss these comments further, please feel free to contact me through our Chief Compliance Officer, William St. Laurent, at (212) 219-6092.

Sincerely,

Alistair W. Brown

Alistair Brown
Chief Executive Officer

cc: Chairman Christopher Cox
Commissioner Kathleen L. Casey
Commissioner Elisse B. Walter
Commissioner Luis A. Aguilar
Commissioner Troy A. Paredes
Brian Cartwright, General Counsel, Office of the General Counsel
Erik R. Sirri, Director, Division of Trading and Markets
Robert L.D. Colby, Deputy Director, Division of Trading and Markets
Daniel Gallagher, Deputy Director, Division of Trading and Markets
Mary Schapiro, Chief Executive Officer, FINRA
Stephen Luparello, Senior Executive Vice President, Regulatory Operations, FINRA

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Thematic review: Rumours

Introduction

Disseminating false or misleading information about companies, particularly in volatile or fragile market conditions, can be a very damaging form of market abuse which affects both the firm concerned as well as general market confidence. This has been the case in recent months, where unfounded rumours contributed to substantial share price movements in a number of financial institutions. While the most publicised cases pertained to falls in share prices resulting from the spread of unsubstantiated stories, all price movements triggered by unfounded rumours have the potential to distort markets and undermine market confidence. By rumour, we mean information that is circulated purporting to be fact but which has not yet been verified. A statement is unlikely to be considered a rumour if it is clearly an expression of an individual's or firm's opinion, such as an analyst's view of the prospects of a company.

In spring 2008 we investigated a series of unfounded rumours that were circulated in the market. In Market Watch 26 we announced that we had begun a tailored review of firms' policies in relation to handling of market rumours. We wrote to over 50 firms asking them to share their policies with us, including details on how these policies are communicated to their staff. Our sample ranged from small funds up to large global investment banks. After reviewing the responses, we held individual meetings with a representative group of ten firms to discuss the practical application of their policies. We also wanted to hear views on the areas where firms believed the risks of market abuse are greatest and where the issue of handling of rumours is most difficult. Unsurprisingly, we identified a great disparity amongst firms' approach to the issue of rumours. Some had specific policies on how employees should handle rumours with targeted monitoring of trading and communications to ensure compliance, while others covered the issue only broadly within a wider market abuse policy.

This article sets out our findings around three main areas: firms' policies on rumours; training and communication of policies; and monitoring of firms' communications and trading. We have also sought to provide examples of good and bad practice in handling rumours that we discovered during the review and we conclude with a case study and a summary of industry best practices.

Firms' policies on rumours

Why many firms clearly spell out policies in this area

The flow of information, when communicated responsibly, is an essential element of efficient markets. Rumours are legitimately circulated through the financial system for a variety of reasons. It is customary for market participants to discuss rumours when accounting for the source of market volatility; when offering an objective assessment of a rumour's likelihood to a client; and when attempting to better understand observable market behaviour. Nevertheless, rumours must be handled carefully. Their uncontrolled dissemination may lead to rapid and volatile price movements which are unjustified by market fundamentals and undermine general market confidence. Rumours can also be fabricated and spread to manipulate market prices and gain from price movements triggered by them.

It is important that regulated firms take this issue seriously. Many firms do this by drawing clear lines between passing on rumours with appropriate disclaimers and warnings, and the indiscriminate dissemination of unverified and unsubstantiated rumours. This is usually done through the formulation of clear and transparent policies on handling rumours and communicating the policies to relevant staff.

What is the industry practice in this area

In our survey, we asked about the existence of such policies, their scope and content. Although these differed substantially among market participants, certain common features emerged.

- *Definition of a rumour:* Although it is difficult to provide a general all-inclusive definition of a rumour, some firms attempted to list the most common types of communication that could be classified under this heading. In particular, many firms classified unverified information sourced from internet bulletin boards as rumours. Rumours have generally been considered unsubstantiated unless verified by an appropriate official of the company they concern.
- *Prohibition on creating rumours:* Some firms included in their policies a specific prohibition restricting trading staff from originating or circulating rumours of a sensational character that might reasonably be expected to affect market conditions. This has been applied to rumours that may affect the entire market, an industry sector or a particular company. Some firms placed particular emphasis on the importance of staff not creating rumours about competitors when seeking new clients.
- *Trading based on rumours:* While trading based on rumours was not generally prohibited, some firms introduced a blanket requirement that any action based on rumours requires senior management approval. Some firms also ban trading on a rumour if the employee believes it is based on inside information.
- *Conditions under which rumours can be communicated:* While firms generally have no blanket prohibition on passing on rumours to other market participants, most set out conditions that need to be met before doing so.

  For example, where rumours purport to contain information of a material, non-public and/or price sensitive nature, some firms make it an explicit requirement to obtain senior management approval (where possible) before any action is taken, or before such rumours are communicated further. Others choose to set out specific conditions under which public side employees (i.e. sales/trading and research analysts) may comment on a rumour or market speculation. Such conditions usually include the restriction that rumours can only be passed on if they are widely discussed in the market, if the source is reputable and identified in writing, and if the company's comment (if any) on the rumour or market speculation is included. Some firms allow research analysts to discuss unsubstantiated information in published research reports under similar conditions, additionally defining widespread circulation as circulation through a public medium such as a national newspaper or news agency.

Some firms impose restrictions on the recipients who can receive communications related to rumours. Such communication is usually restricted to business purposes only and limited to those individuals who have a business need to know the rumour. Some firms also explicitly prohibit spreading rumours that may stem from inside information.

- *Form in which rumours can be communicated:* Most firms put in place clear guidelines about the form in which rumours can be passed on both within their organisation and to third party recipients. These include warnings and certain disclosures that should accompany such communication.

  The relevant disclosure focuses around four key areas:

  (i) making it clear that the information is a rumour and not fact;

  (ii) including the source of a rumour (where possible);

  (iii) not adding any credibility or embellishment to it; and

  (iv) providing company comment or assessment.

  Many firms apply these requirements, as well as the general guidance to maintain professional communication at all times, avoid sensational or exaggerated language and check factual statements very carefully before issue, equally to formal written communications and to communications issued via Bloomberg, instant messages, emails or chat rooms. Similar guidelines apply to including rumours in published research notes, which are expected to quote the public source that reported the rumour, disclose its unsubstantiated nature and refrain from providing additional credence or embellishment. Some firms have gone a step further by prohibiting their staff from making recommendations or formulating opinions based on a rumour.

- *Involving compliance teams:* Firms generally encourage staff to seek compliance advice if they suspect that they are dealing with a rumour. Some firms requested mandatory reporting to the compliance team whenever an employee believes that a rumour or piece of unsubstantiated information may have been circulated deliberately to influence the market for securities or other financial instruments of a publicly traded company. Others requested involvement of compliance teams whenever an employee receives material non-public information (about a company, a market, a pending government policy making decision, etc.) presented as a rumour but believes it likely to be fact.

FSA's comments on firms' policies on rumours

We welcome the existence of written guidelines on the treatment of rumours. Besides spelling out rules on handling and communicating rumours, they also direct staff attention to the importance of this issue and the need for care in dealing with rumours. The presence of clear guidelines on handling of rumours would seem to demonstrate a commitment to ensuring that unverified information is communicated responsibly and in a way that will not distort the market.

When a firm has an interest in a relevant stock, it may wish to require its staff to attempt to determine a rumour's accuracy with other market participants, counterparties or companies. However, it may be best if firms ensure that rumours are not discussed for the purpose of embellishing or to add credibility to them, and that rumours known to be false are not promulgated at all by their staff. Furthermore, firms could impose prohibitions on passing on or discussing unverified information of a sensational nature, which has not already been widely circulated in the market, where there exists no legitimate business reason for doing so. Where a legitimate business reason does exist, for example where a client is seeking an explanation for an erratic share price movement which that could be explained by the sensational rumour, care could be taken to ensure that the rumour is communicated in a manner that:

- sources the origin of the information (where possible);
- gives it no additional credibility or embellishment;
- makes clear that the information is a rumour; and
- makes clear that the information has not been verified.

We recognise that market participants have a role in advising clients of rumours gaining wide circulation in the market but we urge firms to do this with great care having regard to the above points.

Creating or spreading rumours about competitors in an effort to increase the chance of securing new clients or poaching business from other firms can be a particularly pernicious form of market abuse. If a rumour is already circulating about a competitor, additional care may need to be exercised by firms.

It is important that firms specifically address the issue of rumour handling with employees to ensure they are aware of the potential consequences of circulating false rumours. These could include warnings about internal disciplinary steps and potential actions by the FSA under section 118 (Market Abuse) and section 397 (Making misleading statements to the market) of FSMA; and under FSA's Principles for Business and Statement of Principle and Code of Practice for Approved Persons.

Training and communication of policies

Why many firms believe training is needed

Even the most stringent rules cannot fulfil their objectives if they are not properly communicated to the relevant staff. Such communication should normally involve a training component to ensure that employees fully understand the provisions included in the guidelines to apply them in day-to-day operations and know where to seek assistance. Well-trained employees are in a better position to mitigate the risks associated with handling and using unsubstantiated information, thus contributing to the creation of more transparent markets and strengthening of market trust.

What is the industry practice in this area

The approaches to training differ among market participants. While large companies are usually able to provide dedicated and frequent formal training modules on key compliance issues, smaller firms rely more on informal on-the-job training and infrequent formal sessions.

Nevertheless, most firms have put in place annual market abuse training which requires employees to reaffirm compliance with the relevant policies, alongside an 'if in doubt, contact compliance' approach which is clearly communicated during the training sessions.

Specific examples of firms' practices include the following:

- *One-to-one training with Compliance Officers* where employees are given the opportunity to discuss the firm's policies and procedures in relation to the handling of market rumours.
- *Scenario-based training* where participants are required to answer questions regarding how they would act in certain situations. Such scenarios may, for example, focus on what a trader, on receiving a

rumour from a client, should do with that information depending on his/her analysis of the reasons behind the client passing on the information.

- *Computer-based training* where modules are tailored to fit the requirements of different business areas. The courses contain examples of individuals receiving unverified information and participants are required to answer multiple choice questions on what subsequent course of action would be deemed appropriate behaviour.
- *E-mail updates and reminders to staff* whereby some firms sent email reminders on market abuse issues periodically while others chose to highlight topical issues when they came up, such as the recent share price movements caused by false rumours. These were targeted to the relevant employees.

Many firms have placed special emphasis on senior managers to ensure that they supervise staff effectively in relation to handling of rumours. Managers were required to organise specific training sessions and confirm that they had taken appropriate steps to ensure employees were aware of the relevant policies and procedures.

Some firms viewed it as particularly important to remind staff and management about the rules on handling rumours at the time of greater market volatility and nervousness. This was in the form of short training modules, email communication to staff sent by senior management and distribution of hard copies of relevant rules and policies.

FSA's comments on the training and communication of policies

We welcome the introduction of formalised training modules that focus on the treatment of rumours and handling of unsubstantiated information. The form of training and communication to staff may differ among firms, depending on their size, primary focus, and their role in the financial market place. Nevertheless, formalised training programmes help place handling of rumours higher on the compliance agenda and ensure staff learn about any new policies and measures put in place. Such programmes help communicate the rules to the staff and decrease the likelihood of non-compliance through misunderstanding or ignorance. We also welcome pro-active approach taken by firms to remind staff and management about the particular need to strictly comply with rules on handling of rumours in nervous and volatile markets, when both the opportunity for and the adverse impact of spreading rumours increase.

Monitoring of firms' communications and trading

Why many firms believe monitoring is needed

Even if the best rules are put in place and employees are well trained in their application in day-to-day work, human nature is likely to lead to occasional breaches either through errors or intentional actions driven most commonly by profit maximising objectives. Monitoring of communication and trading cannot completely prevent this but can act as a powerful additional deterrent and a valuable source of evidence when things do go wrong. Targeted monitoring of communications is an important tool to ensure that employees are complying with firm's policies and create a credible deterrent to those who wish to disseminate false/misleading information. Monitoring of trading activities can help identify suspicious events and trades that might have been associated with the creation or dissemination of rumours.

What is the industry practice in this area

We observed the following industry practice:

- *Monitoring of communication:* Comprehensive monitoring of staff communications is neither practical nor cost effective. As a result, firms that choose to pro-actively monitor their staff communication tend to either obtain a random sample of emails and review them or use targeted word searches on emails or Bloomberg/instant messages. Although we are not aware of firms that would decide to pro-actively review messages on blogs, some firms increased the intensity of their random searches during times of increased market volatility when rumours are more likely to occur and are spread around the markets. Most firms considered reviewing all blogs as a mammoth task which is neither practical nor feasible.
- *Monitoring of trading:* Most trading activities are generally recorded for regulatory purposes. Depending on their size, firms use a range of means for identifying suspicious trades. Practices range from checking for anomalies in trading patterns, such as an unusual profit, to systems designed to pick up significant price changes. Many firms have implemented automated systems that would alert them to potentially suspicious price movements. These alerts are usually set up based on a set of quantifiable parameters which can easily be changed to suit market conditions. If a suspicious price movement occurs, the firms would review their trading and also work out profit or loss. When material profit (or loss avoidance) is detected, the firm would then review retrospectively all relevant emails, phone calls, Bloomberg/instant messages, etc. If suspicious activity is uncovered, the internal investigation would, be accompanied by relevant disclosure to the FSA.
- *Interaction with compliance staff:* Some firms attach substantial value to trading floor based compliance staff. They believe this facilitates more frequent contact between employees and compliance specialists and creates an opportunity to raise and discuss any concerns on an informal basis. This is seen as particularly important for rumours, as in many circumstances employees could be deterred from escalating certain issues in a formal manner.

FSA's comments on monitoring of firms' communication and trading

The monitoring of trading activities as part of firms' general surveillance practices is a strong tool in the fight against market abusive behaviour. Monitoring is seen by many in the industry as essential both for risk management and compliance purposes. We welcome the increasingly common introduction of automated alert systems which draw the attention of compliance officials to suspicious price movements and trigger retrospective investigations of relevant communications.

Close interaction of staff exposed to rumours with compliance officials can decrease the risks of mishandling of unsubstantiated information. There are some advantages of locating compliance teams in the same physical space as the staff who can benefit from their guidance, but we caution firms to avoid placing over-reliance on the assumption that communications of concern will always be overheard by compliance teams. It appears that pro-active communication monitoring may be a more effective way to deterring spreading of rumours and unsubstantiated information.

Conclusion

Commitment to the key regulatory principle of maintaining confidence in the financial system requires a serious and decisive approach to handling the origination and dissemination of unsubstantiated information. This is particularly important in the current turbulent markets. Our survey of regulated firms uncovered varied practices in dealing with rumours.

Nevertheless, this article sets out industry best practice in this area. These include the introduction of formal policies on the handling of rumours. Among other requirements, these policies set clear rules as to whom, in what circumstances, and in what form such information can be passed. They also spell out a clear prohibition on utilising rumours for the purposes of market manipulation. Policies on handling rumours are communicated to staff through formalised training programmes and compliance then monitor both pro-actively and retrospectively by investigating communication surrounding suspicious price movements. We believe such an approach can minimise the risk of non-compliance and of undermining market confidence through inappropriate use and dissemination of unsubstantiated information.

Case study

We thought it would be helpful to outline a hypothetical scenario based on rumour related cases we have recently reviewed. Shortly after lunch during a period of financial turbulence, a trader at an equity desk of an authorised brokerage ('Trader A') received a phone call from a day trader at a non-regulated trading group. During this phone call 'hot news' was passed to Trader A, stating that regulators had requested a named investment bank to cease trading.

Although no reason was given for the alleged regulatory action, Trader A decided that the news was of sufficient magnitude to send it immediately and without further verification via the Bloomberg messaging system to around 10 - 12 of his closest trading contacts. It was not made clear that this was a rumour that had not been substantiated. One of the recipients, working at another authorised and large firm ('Trader B'), decided that such crucial market sensitive story should be shared immediately and forwarded the message via Bloomberg's messaging system to approximately 150 of his contacts. As a result, in less than half an hour from the original phone call, the news had reached an employee at the investment bank the subject of the rumour who immediately alerted his management. Within minutes the FSA was informed and the rumour was retracted by Trader B's firm.

It is clear that these two ill thought through decisions by traders A and B could have resulted in massive market wide repercussions, including substantial disruptions to trade and business of the affected investment bank. We take such matters extremely seriously. By the end of the day, the FSA had traced the rumour back to its origin and had conducted interviews with all key contributors. The main excuse given by the traders was that they 'did not stop to think' in the thick of trading action and 'did not recognise the consequences that their actions could have had' on the market, market participants and in particular, on the affected investment bank. Neither of them attempted to benefit from the spread of the rumour by taking favourable positions in the investment bank that was subject to the rumour.

While there appears to have been no intention to disseminate information that was false, the traders had a genuine (if arguably naïve) belief that the 'rumour' status of the statement was evident when the rumour was passed on. Furthermore, there was no attempt to profit from the rumour.

However, we are clearly unhappy with these events and would have expected that in both cases particularly given the turbulent market conditions, the traders would have recognised the unverified, speculative and damaging nature of this rumour and should not have spread it to other market participants in the manner that it was. By virtue of the two traders at authorised firms passing on the rumour especially via an information service, the rumour gained significant credence that was unwarranted considering the source and veracity of the rumour.

Furthermore, the traders had not conducted even simple checks, e.g. they could have checked the FSA website, any of the FSA helplines for information, or indeed any of the news agencies for announcements on any regulatory action pertaining to major investment banks. Such verification could have been conducted (i) quickly and (ii) without unduly communicating the rumour to other market participants. Alternatively, the traders could have elevated the matter to their line managers or compliance teams before undertaking any further action. At the bare minimum, the traders could have mitigated the damage by ensuring that they clearly stated the information was a rumour and that the information had not (yet) been verified before posting on a message service or loading onto an information service.

We raised these issues with senior executives at both firms and certain steps were taken before the outcome of our enquiries. Some of these steps are worth highlighting for the benefit of all firms:

- Retraining of staff in those teams involved in spreading the rumour, on matters related to market abuse and dissemination of unsubstantiated information. It was made very clear during the training that the possibility alone of having a market effect is enough to constitute market abuse, regardless of whether there was intent to do so;
- Distribution of hard copies of rules to all staff in the companies who could find themselves in similar situations;
- A stern email by senior management to all employees in the firm, highlighting the key events that took place and reminding staff to handle information responsibly and not spread rumours in the market, alongside with warning about the serious consequences for staff involved in such actions; and
- Random monitoring of desks' Bloomberg messages for evidence of market abuse has now been incorporated into the firm's compliance monitoring programme. The routine compliance training and induction programme has also been adjusted to place more emphasis on market abuse and the handling of rumours.

Whilst we welcomed the prompt action taken and the seriousness with which both firms approached the matter, we much prefer all firms use appropriate training and reminders as a preventative measure as well.

Please note that we have not discussed in this case study any actual or possible FSA enforcement action against any of the individuals or firms involved.

Summary

Industry best practices on handling rumours

There are three key elements of an effective regime to address the issue of handling rumours:

1. Adoption of relevant formal guidelines and policies on handling rumours. Such policies should include:

    - definition (where possible) and most common examples of rumours found in the market;
    - clear prohibition on originating rumours;
    - clear prohibition of spreading rumours about competitors to attract new business and customers;
    - limitations on whom, in what circumstances and with what disclaimers rumours can be passed; and
    - internal procedures that need to be adhered to and compliance / senior management involvement needed (where practical) when acting on the basis of or communicating rumours.
    - a warning that in nervous and volatile markets when unsubstantiated information is more likely to be present, extra caution needs to be taken when handling rumours. Firms may wish to consider adding additional procedures on handling rumours in such cases.

    It is particularly important that if rumours are passed on (both inside and outside the firm), they are passed on by ensuring that:

    - the origin of the information is sourced (where possible);
    - the information is clearly stated to be a rumour;
    - no additional credence or embellishment is given to the rumour; and
    - the information is clearly stated to be unsubstantiated/not verified.

2. Provision of adequate training. This can be done in a formalised way through inclusion of modules on handling of rumours in annual market abuse training. Such training can be delivered to groups of employees or on a one-to-one basis. It can include both e-learning modules and case studies based on the most common situations in which staff encounter rumours in their everyday job. Senior management attention should also emphasise the importance of the training to increase/maintain staff awareness and ensure that they have in place ways of monitoring staff non-attendance at such training. Staff need to be reminded about the obligation to comply with rules on handling rumours, particularly in nervous and volatile markets when unsubstantiated information is more likely to be present in the markets.

3. Adequate monitoring of firms' communications and trading. Most common approaches include pro-active monitoring of communication (e.g. routine sampling of phone calls, emails, instant messages and Bloomberg messages) and retrospective reviews after suspicious price movements and trades. The FSA should be involved whenever relevant compliance breaches are detected. Encouraging regular interaction with compliance staff can also reduce the risks of mishandling rumours.

Sponsored access (SA)

Recently we have been contacted by several UK-based trading platforms wanting to allow intermediary firms to offer clients direct access to their markets through a system known as SA. This article was developed following talks with a number of intermediaries and trading platforms (Recognised Investment Exchanges and Multilateral Trading facilities) and it aims to help them comply with applicable regulatory requirements when offering SA.

This article seeks to remind market participants of relevant regulatory requirements and it sets out our view of the risks involved and our expectations of the protections and controls that firms and trading platforms should consider when seeking to comply with the requirements. If a firm or trading platform were to consider a different approach, it would need to satisfy itself and us that its approach adequately addresses the risks arising from SA and enables it to comply with relevant regulatory requirements.

What is SA?

SA is an adaptation of the concept of direct market access (DMA). DMA gives clients of firms that are members of a trading platform the ability to have a direct connection to the trading platform without becoming members themselves. Clients submit orders to the sponsoring intermediary firm, which are then automatically routed through the internal systems and controls of the intermediary and onto the trading platform. SA is similar, except clients send orders directly to the trading platform without passing through the internal systems of the intermediary firm. Under both types of access the intermediary firm retains full responsibility for all orders submitted by its clients.

The need for risk management

In the absence of proper controls, SA presents additional risks to those posed by DMA for trading platforms and intermediaries. On the market side there is, for example, increased risk of error trades and potential for market abuse. On the intermediaries' side, credit risk could arise from the inability of sponsors to monitor their clients' business (and therefore their exposure) in the absence of suitable controls.

In terms of risk mitigation, our view is that post-trade measures have a vital role to play in an SA model; for example: real-time copied feeds to sponsors of their client activities; client IDs allowing real-time identification; and the ability of trading platforms and sponsors to delete client orders and/or terminate clients' access to the order book. While post-trade measures are important for ongoing monitoring of client activity and market security, we consider that the absence of pre-trade controls would cause serious concerns regarding the adequacy of risk management. As such, we expect firms and trading platforms to conclude that post-trade measures are not enough in isolation; they need to operate alongside effective pre-trade controls to provide sufficient mitigation against the risks posed by SA.

While we do not think that new Handbook rules and guidance are necessary to deal with the particular features of SA, intermediaries and trading platforms offering SA will need to be sure that they continue to comply with all the relevant regulatory obligations. Our rules and guidance of particular relevance to SA (from the perspective of intermediary firms and trading platforms) include the Principles for Businesses (PRIN), Senior Management Arrangements, Systems and Controls (SYSC), Transaction Reporting (SUP 17), Market Conduct (MAR) and the Recognised Investment Exchanges and Recognised Clearing Houses – requirements applying to Recognised Bodies (REC).

Here we aim to remind market participants of some of the relevant requirements and explain what we would expect intermediary firms and trading platforms wishing to offer SA to be doing in order to comply.

Requirements applying to intermediaries

The most relevant requirements for intermediaries include Principle 3, which provides that:

"A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems"

SYSC 4.1.1R requires that a common platform firm must have"...*effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and internal control mechanisms, including sound administrative and accounting procedures and effective control and safeguard arrangements for information processing systems".*

For DMA and non-DMA business, intermediary firms currently meet the regulatory requirements regarding systems and controls by (among other things) imposing pre-trade controls on orders and implementing post-trade measures to monitor trading activity. For SA business, we would expect intermediary firms to impose pre-trade controls and post-trade measures with a similar or equivalent outcome in order to ensure compliance with their regulatory requirements.

These controls and measures may in practice be operated by a range of parties (e.g. the trading platform, the sponsoring intermediary firm, a combination of the two, or another party such as a specialist vendor) and may include outsourcing. However, firms are reminded that, if a sponsoring intermediary firm outsources critical or important operational functions, it remains fully responsible for fulfilling its obligations under the regulatory system. Therefore we would expect the sponsoring intermediary firm to be responsible for setting the limits applicable to client business at all times in order to avoid undue operational and credit risk. While day-to-day operation of the controls may be outsourced, we would also be concerned if a firm decided to outsource them to a client (see SYSC 6.1 (compliance) 7.1 (risk management) and 8.1.6R (outsourcing) and the MiFID connect outsourcing guide at: http://www.mifidconnect.org/content/1/c4/92/35/MiFID_Connect_Outsourcing_Guide.pdf).

If a firm were to consider a different approach, it would need to satisfy itself and us that its approach adequately addresses the risks arising from SA and enables it to comply with relevant regulatory requirements.

We would also like to remind intermediaries of their transaction-reporting responsibilities under SUP17. When an intermediary is providing SA, it is not sufficient to submit a report detailing the market-side transaction. They will also need to submit a client-side report identifying the client, which includes all the details required under SUP 17. This is essential for us to monitor for market abuse.

Requirements applying to trading platforms

Clearly, trading platforms wishing to offer SA need to ensure that business conducted through their facilities is fair and orderly in order to meet the relevant requirements in REC (for Recognised Investment Exchanges) and MAR 5 (for Multilateral Trading Facilities). The most relevant requirements are outlined below.

Recognised Investment Exchanges (RIEs)

Paragraph 4(1) of the Schedule to the Recognition Requirements Regulations[1] states that a UK RIE "must ensure that business conducted by means of its facilities is conducted in an orderly manner and so as to afford proper protection to investors".

1 The Financial Services and Markets Act 2000 (Recognition Requirements for Investment Exchanges and Clearing Houses) Regulations 2001 (SI 2001/995).

While REC 2.6.27G explains that in considering compliance with the recognition requirements the FSA will:

"have regard to the extent to which the UK RIE's rules, procedures and the arrangements for monitoring and overseeing the use of its facilities: (1) include appropriate measures to prevent use of its facilities for abusive or improper purposes; (2) provide appropriate safeguards for investors against fraud or misconduct, recklessness, negligence or incompetence by users of its facilities;...(6) include appropriate arrangements to reduce the risk that those facilities will be used in ways which are incompatible with relevant regulatory or legal requirements".

Multilateral Trading Facilities (MTFs)

MAR 5.3.1R requires firms operating an MTF to have transparent and non-discretionary rules and procedures for fair and orderly trading. MAR 5.5.1R also requires firms operating an MTF to have effective arrangements and procedures in place for monitoring their members' compliance with the rules of the MTF.

We would expect trading platforms offering SA on their markets to be sure (both initially and on an ongoing basis) that intermediary firms providing SA to clients on their markets have adequate pre-trade controls in place to manage the risk to fair and orderly markets. We expect trading platforms to conclude that it is not enough for them to rely on a signed declaration from sponsoring intermediary firms saying that they have carried out due diligence on their clients, unless they are also aware of and satisfied with further details of the controls imposed as a condition of the access.

As well as pre-trade controls, we expect trading platforms to conclude that it is equally important for intermediary firms offering SA to implement adequate post-trade measures. Post-trade measures are likely to need to include real-time copied feeds to sponsors of their client activities, client IDs allowing real-time identification and the ability of trading platforms and sponsors to delete client orders and/or terminate clients' access to the order book.

If a trading platform were to consider a different approach, it would need to satisfy itself and us that its approach adequately addresses the risks arising from SA and enables it to comply with relevant regulatory requirements.

Conclusion

We do not object to UK trading platforms offering SA, provided the additional risks are mitigated satisfactorily. We think that intermediaries and trading platforms both have a role to play in ensuring they meet their initial and ongoing regulatory obligations, including in relation to outsourcing. We expect firms and trading platforms to conclude that appropriate pre-trade and post-trade controls and measures are a vitally important part of effective risk management, and that while they are the responsibility of and need to be set by the intermediary firm, trading platforms also need to be sure that appropriate controls are in place. If a different approach were to be adopted we would expect a firm or trading platform to be able to satisfy itself and us that its approach adequately addresses the risks arising from SA and enables it to comply with relevant regulatory requirements.

Credit default swaps (CDS) and the market abuse regime

We sometimes get questions as to whether a CDS is covered by the UK market abuse regime.

Although CDSs are not admitted to trading on a prescribed market, we consider that most CDSs are likely to be caught by the UK market abuse regime.

CDSs will be caught by the insider dealing and disclosure of inside information provisions where they are 'related investments', i.e. where they are an investment whose price or value depends on a price or value of a qualifying investment (such as the underlying bond). They will also be caught by section 118(4) of FSMA (misuse of information) where the relevant behaviour occurs in relation to CDSs whose subject matter is a qualifying investment.

Market behaviour in relation to CDSs may also be caught by the market manipulation, misleading behaviour and market distortion provisions. An example of abusive behaviour would be where the behaviour consists of effecting transactions in CDSs which give, or are likely to give, a false or misleading impression as to the price of one or more qualifying investments (e.g. shares or bonds), other than for legitimate reasons.

Contact Details

This newsletter is produced regularly by the Market Conduct and Transaction Monitoring teams in our Markets Division. If you would like to receive this newsletter by email, or have any comments on it, please contact market.watch@fsa.gov.uk

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