Safeguards against erroneous order entry - with emphasis on 'basket orders'

The Rules of the London Stock Exchange ("the Exchange"), including those of the London Stock Exchange Derivatives Market ("LSEDM"), stipulate that member firms must have adequate systems and controls in place to prevent the entry of erroneous orders to the trading system (see Exchange Rule 2101 and LSEDM Rule 4.1.4).

The purpose of this article is to highlight the importance of member firms maintaining appropriate pre-trade controls in order to prevent the submission of erroneous orders into the trading system which have the potential to cause short-term market dislocation, particularly in relation to the Exchange order book. The Exchange would like to stress to all member firms that Exchange circuit breakers or volatility constraint mechanisms, such as the Automatic Execution Suspension Periods ("AESPs", commonly referred to as circuit breakers), should never be relied upon to deal with erroneous orders, or used as an alternative, to in-house pre-trade controls.

Erroneous orders can have a significant impact on trading across single and multiple instruments and erroneous program trades (also known as basket orders) have a particularly high potential to cause trading disruption, primarily due to the nature of their order entry and execution. These execution factors include multiple instruments selected in a single dealing instruction, large notional basket values at closing/expiry auctions and the general 'wave' functionality of program execution, whereby multiple similar waves of orders can be entered into the market.

The wave dynamic can mask potential erroneous order duplication, particularly where the member firm is providing Direct Market Access ("DMA") to a client and does not therefore have full visibility of the parent order size. Maximum order value limits may also prove ineffective where the overall basket consideration, although potentially large enough to cause a significant market impact, remains below an internally approved limit. This is more likely during derivative expiry periods, when larger basket orders and trading volumes are expected. The Exchange has observed instances where a combination of these factors has caused short-term price disruption across multiple instruments.

Member firms should carefully consider effective technical and manual mechanisms (including pre-trade front office intervention) to potentially identify and prevent erroneous duplicate orders being released to the Exchange.

The importance of using sophisticated pre-trade controls around Direct Electronic Access ("DEA") orders were highlighted in the FCA's Market Watch 48. The update also notes that firms with less sophisticated controls may be at risk of not fully complying with the ESMA guidelines on '*Systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities*'. Examples of sophisticated controls as observed by the FCA included:

- Symbol (stock) specific criteria such as percentage of average daily volume (ADV).
- Aggregate/Exposure controls that are symbol (stock) specific.
- Aggregate/Exposure limits broken down into separate time segments (for example 30-60 minute slots).
- Participation (percentage of traded volume) alerts.
- Automated restrictions on non-priced (market) orders.
- Market impact controls.

It should be noted that, whilst the above mentioned controls can be highly effective, they require considered parameters and thresholds to be maintained in order for them to function correctly.

Member Controls Oversight Programme – importance of accuracy of information

Early in 2014, the Exchange introduced the Member Controls Oversight Programme ("MCOP"). This was established in response to the publication by the FCA in August 2013 of finalised guidance on '*Market Operators' oversight of member firm compliance with rules*'. This guidance outlines the approach the FCA expects recognised investment exchanges ("RIEs") and multilateral trading facilities ("MTFs") to take to ensure on-going oversight of the systems and controls which their member firms operate to comply with the RIE's or MTF operator's rulebook.

All market operators are required to have in place proactive, effective, proportionate and risk-based arrangements in order to be able to determine that their members' systems and controls can be reasonably expected to ensure compliance with the respective market operator's rules and trading procedures by both new and existing members.

The Exchange's MCOP is based around a programme of reviews of an identified population of firms over a six-monthly cycle. Firms which are selected for review are required to complete a systems and controls questionnaire covering matters such as the pre-trade controls they operate during each trading phase for each type of order flow; the monitoring by the firm of its trading activity; automated trading management; and how firms ensure that trading staff are sufficiently aware of the Exchange's rules. Following receipt and review of each completed questionnaire, the Exchange determines whether clarifications are necessary and/or whether further discussions are required, either in a meeting or conference call.

The aim of the reviews is to identify the risks to the Exchange of firms whose controls are not of a sufficiently high standard to prevent disruption to orderly trading. Where controls are not considered to be sufficient in relation to the nature of a firm's business, the Exchange will draw this to the attention of the firm and require remedial action.

Accurate and comprehensive completion of systems and controls questionnaires is essential to enable the Exchange to assess the adequacy of a firm's controls. Failure to do so may constitute a breach of, for example, Exchange Rules 1210 and 1211 and LSEDM Rules 1.1.39 and 1.1.40. Furthermore, in the event of erroneous order entry by a member firm or its DEA client, where one has been completed, the Exchange will consider the firm's responses in its systems and controls questionnaire and any discrepancies between the responses provided and the actual controls in operation will be taken into consideration by the Exchange in deciding whether to take disciplinary action against the firm. The Exchange recently took disciplinary action against a member firm for providing inaccurate information in a systems and controls questionnaire.

<u>Updating the Exchange on changes to a member firm's profile and its compliance officer(s) contacts</u>

It is important for the Exchange to ensure that its member firm records remain up-to-date so that it has access to the correct information in the event of queries and problems.

Changes in authorisation

Exchange Rule 1010 and LSEDM Rule 1.1.2 state that "A member firm must at all times be authorised under relevant United Kingdom, or appropriate overseas legislation, or in the view of the Exchange be otherwise sufficiently regulated, in respect of capital adequacy, and fitness and probity". Therefore, any changes to a member firm's authorisation, such as a loss of authorisation or related permissions, must be notified to the Exchange. This notification should be immediate in accordance with Exchange Rule 1050 and LSEDM Rule 1.1.20 which state, that "*A member firm shall, immediately upon becoming aware of any circumstances which have, will or may lead to a contravention of any of the rules…notify the Exchange of such circumstances in as much detail as is available to it*". Failure of a member firm to notify the Exchange in such circumstances may result in a breach of this rule by the member firm.

Membership profile changes

Member firms wishing to change their membership profile have a notification requirement to the Exchange. Exchange Rule 1051 and LSEDM Rule 1.1.21 state that "A member firm shall notify the Exchange in writing, at least 21 calendar days in advance of the proposed effective date, of any proposed changes to its membership profile". The Exchange would expect notification of, at a minimum, the following profile changes:

- name and address of the member firm;
- senior executive officer or compliance officer of the member firm;
- scope of trading activity in relation to on Exchange business, including trading codes;
- access to the trading system; and
- scope of settlement and clearing arrangements in relation to on Exchange business, including settlement and clearing codes.

Advance notification enables the Exchange to manage the associated change in conjunction with the member firm, third party suppliers, central counterparties and central securities depositories. The Exchange also has a responsibility to ensure that sufficient notice is given to other member firms, where appropriate, by publishing a Member Firm Information Sheet. A member firm can update its profile by emailing the Membership Team at membership@lseg.com. For queries or matters which require direct assistance, please contact Membership on (020)7 797 1900.

Compliance contacts

The Exchange also wishes to reiterate the importance of member firms informing it of any changes to their compliance staff and contact details. Exchange Rule 1020.4 and LSEDM Rule 1.1.9 (iv) state that "*A member firm must, to ensure compliance with these rules, at all times have …. one or more compliance officers who shall be identified to the Exchange and be competent to advise the member firm and its employees on the application of these rules*". Correct information is essential to enable the Exchange to contact firms in relation to trading issues and also in relation to other matters such as the completion of MCOP systems and controls questionnaires. Member firms are therefore requested to ensure that they have provided the Exchange with up-to-date compliance contact details. This can be done by contacting the Exchange's Market Supervision team at msu@lseg.com or on (020) 7797 3666, option 2.