Violation of the General Conditions of Scoach Switzerland

Decision:

The Sanction Commission has established that participant X has violated lit. b (ensuring fair trading and promotion of market integrity) and lit. c (exercise of due care and conscientiousness) of section 1.19 in conjunction with section 1.13 of the General Conditions of Scoach Switzerland Ltd. (in force until 30 March 2009) in that it failed to take measures to ensure that its order-routing system prevented the following activities on […] 2009:

a. At 3:44 pm, in a situation of non-opening because of an excess of orders at best in the security A, two entries were made to reduce the price to € 0.15 when the market maker was quoting € 35.10 (bid) and € 37.10 (ask) when the underlying securities did not justify this;

b. At 4:00 pm, when the order book for the security B was empty on the buy side and there was an unlimited order on the sell side, four entries were made within 3 minutes and 36 seconds causing the price to fall from CHF 94.97 to CHF 50 although the underlying securities did not justify this.

A reprimand is issued against participant X. The costs of the procedure in the amount of CHF 23'000 are charged to X.

Reasons for the decision:

The Sanction Commission finds as follows:

1. At 09:19:48 am on […] 2009, a participant entered an unlimited sell order for 50'000 B. A little later this order resulted in a transaction with a buy order for 10'000 B at a price of CHF 94.97. On the sell side the order book still contained 40'000 B with no price limit, while the buy side of the book was empty.

   The following transactions were conducted during the afternoon through a technical trader ID of X:

4:01:31 pm	buy 5'000	at CHF 90
4:02:37 pm	buy 10'000	at CHF 85
4:03:15 pm	buy 10'000	at CHF 80
4:05:07 pm	buy 15'000	at CHF 50

   In a period of 3 minutes and 36 seconds the price was reduced from CHF 94.97 to CHF 50 in 4 stages using the same trader ID of X, the underlying securities having undergone no major change. The Exchange Operations department declared these four transactions mistrades and cancelled them.

2. On […] 2008, another participant entered an unlimited sell order for 4'200 A in the order book. This gave rise to an excess of orders at best on the sell side, which automatically entailed a non-opening. The market maker's quoting size rose to 1'000 units on both the buy and the sell sides. There was thus a shortage of 3'200 units to buy to move from the status of non-opening to that of trading. The non-opening was maintained until […] 2009. Then the price was set by the market maker at € 35.10 and € 37.10.

   The following transactions were conducted on that same day, […] 2009, through the system of X (the same technical trader ID):

3:44:45 pm	buy order of X	3'200 at € 0.15
3:44:45 pm	transaction between participant and market maker	1'000 at € 0.15
	transaction between participant and X	3'200 at € 0.15

   The securities underlying the instrument underwent no major change during this time span justifying a fall from € 35/37 to € 0.15. The Exchange Operations department declared these two transactions at € 0.15 mistrades and cancelled them.

3. These facts are not contested by X.

4. On […] 2009, the SVE department of SIX Exchange Regulation filed a request with the Sanction Commission for a sanction against X in respect of the aforementioned facts. It asked for a reprimand to be issued against X for violating section 1.13 para. 5 in

conjunction with section 1.19 in conjunction with section 1.24 para. 1 lit. e and k of the General Conditions of Scoach Switzerland Ltd., by reason of the fact that X had not taken adequate measures to ensure that its order-routing system prevented unfair practices. X then filed a submission with the Sanction Commission. These were followed by a replication from SVE and a rejoinder from X.

The ruling of the Sanction Commission in this matter of law:

Procedure and admissibility

5. In its submission of […] 2009 X asked to be granted an audience. Given that the facts to which the request for a reprimand relates are not contested, and that X has had the opportunity to present its arguments in detail in a repeated exchange of correspondence, there is no need for an audience. According to section 4.3 of the Rules of Procedure the Sanction Commission issues its decision on the basis of the file.

6. It should be pointed out that the Sanction Commission is not bound by the request for sanction from SVE, or by the legal grounds adduced by the investigating body. It applies the law *ex officio*. It only considers the arguments of the parties that are relevant to the resolution of the case, and is not required to pronounce on all the grievances raised by them. It will accordingly limit itself to matters that are necessary to substantiate its decision (see ATF 133 I 270 c. 3.1 *in fine*).

7. In its submission of […] 2009 X demands that the question of the responsibility for putting in place infrastructures guaranteeing the integrity of the market, of Scoach or its participants, be submitted to FINMA as a question prejudicial to the present procedure. This application is not admissible before the Sanction Commission. Scoach and its regulatory framework were approved by the former Swiss Federal Banking Commission (SFBC). According to the General Conditions (GC) and procedural regulations, it is the Sanction Commission (or the delegation called upon to give a ruling) that is required to give a ruling on alleged rule breaches by participants. X accepted the Scoach GC, which clearly impose on participants the duty to ensure that the rules of conduct are applied by adopting internal directives and personnel management policies (section 1.19 GC). If the allocation of responsibilities between Scoach and its participants had not been clear, the SFBC would not have approved this section 1.19, or section 1.13 GC in the context of order systems, or section 1.24 GC concerning sanctioning measures, or the market model as such. There are therefore no grounds for acceding to the request of X, all the more so because it is not for the Sanction Commission, in its capacity of an organ of Scoach, to question the decision of the authority that issued exchange authorization.

8. X contends that SVE breached the principle of equal treatment by not requiring all participants to install blocking filters similar to those that it expected X to install, and accuses SVE of a policy of discrimination. This grievance is formulated in entirely general terms and is not substantiated. As such it is not admissible. Even if it were, furthermore, it is not clear how SVE's claim that the violations of exchange rules are always the subject of investigations would be discriminatory vis-à-vis the participants that do not comply with the rules, as X contends.

9. In another grievance of a general nature, X contends that the Scoach market model is inadequate, attributing the mistrades to this inadequacy rather than to any shortcomings (which it disputes) of its own order-routing system. It should be pointed out that the objective of the present procedure is to determine whether X contravened its obligations under the GC and the market model in force. This market model is described in detail on the Scoach website and in its GC. X expressly accepted both of these. It is inconceivable for X to question the market model and the GC that it expressly accepted in the context of a conventional sanctions procedure relating precisely to the violation of these GC. If X thinks the Scoach market model and the GC of Scoach should be modified, it should raise the matter with Scoach.

The violation

10. SVE basically accuses X of violating sections 1.19, 1.13 para. 5 and 1.24 para. 1 lit. e and k GC. Given that the events at issue took place on […] 2009 the matter must be considered in the light of the GC in force at the time, i.e. the GC of 2 July 2007, hereinafter referred to as GC (2007), which were in force until 31 March 2009. The substance of X's written submissions is that the application for a sanction has no basis in the rules because the Scoach GC contain no particular prescriptions specifying how order-routing systems should be parameterized.

10.1 Section 1.13 para. 5 GC (2007), the content of which corresponds to section 1.9 of the current GC, provides that: "The participant is responsible for all entries added to the Exchange System via its order systems."

This provision relates to participants' automated applications, that means systems that automatically transmit orders to the exchange system. X provides its clients with an order-routing system that enables them to participate in the Scoach market through X, while as far as Scoach is concerned, X is the participant. This procedure is authorized by the Scoach rules. If a participant offers such a possibility to its clients, it is - according to section 1.13 GC (2007) (currently section 1.9) - itself responsible for all entries added to the exchange system via its proprietary automated applications that it has put in place. The parameterization of participants' automated applications is reserved to registered traders.

10.2 X contends that section 1.13 para. 5 GC (2007) is unclear and that it must accordingly be interpreted *contra stipulatorem*. In its opinion the only scope of this provision is to make orders legally effective vis-à-vis other Scoach participants, not to force on participants a particular parameterization of their order systems. Neither the text of this provision as a whole nor the formulation of paragraph 5 permits this interpretation. It goes without saying that the global responsibility of the participant vis-à-vis the exchange is unaffected by how its orders are created, i.e. by whether they originate from one of the participant's own traders or from a client using the participant's order-routing system to transmit orders to Scoach.

It must be pointed out that if the argumentation of X were to be followed, it would result in intolerable consequences for the integrity of the exchange system: each participant could evade its duties of diligence by delegating all its trading activities to its clients, providing only a technical link to the exchange.

It follows from the foregoing that X has the role of guarantor vis-à-vis clients that utilize its order system on the basis of section 1.13 para. 5 GC (2007), and it is responsible for data and transactions conducted via its order-routing system (as if they were its own).

11. Consideration must now be given to whether the transactions at issue constitute unfair practices within the meaning of GC (2007) imputable to X as if they were its own. In this instance, given the circumstances as a whole, the transactions qualified by Scoach as mistrades clearly constitute unfair practices and snake trading, as X by the way has admitted. As such, they are clearly covered by sections 1.19 and 1.20 GC (2007).

In this instance there is no need to decide whether X is responsible in a purely causal manner for these unfair practices on the basis of section 1.13 para. 5 GC (2007), or whether responsibility for orders placed via its order-routing system also requires X to be guilty of negligence in relation to parameterization and surveillance of the system. On the grounds explored below, indeed, X can be accused of not having taken adequate measures to prevent the unfair transactions at issue, so that it is already responsible for an omission imputable to it on the basis of section 1.19 GC (2007).

12.1 We shall begin by noting that based on the obligations that it accepted and the information made available to it (for example on the Scoach website), each participant knows that the Scoach system does not check whether an order can be executed, and nor does it consider whether an order is appropriate taking into account the current state of the market. It is incumbent on the participant's traders to determine the right moment to place an order, and if appropriate to set a limit compatible with the market (*marktgerecht*). The fact that Scoach can subsequently cancel a transaction that is substantially out of line with the market makes no difference. The decision to cancel a transaction described as a mistrade has no consequences for the participant unless it manifestly constitutes an unfair practice. When there are clear indications of unfair practices, Scoach considers whether

the participant has violated its duty to take measures necessary to ensure that trading is transparent and equitable. This duty arises from section 1.19 GC (2007). This principle is applied regardless of whether the participant is known to have transmitted data through its own traders or via its automated applications.

12.2 According to section 1.19 GC (2007), participants must ensure the implementation of “fair and transparent trading (…) and promotion of market integrity" (lit. b) and "the exercise of due professional expertise, care and conscientiousness“ (lit. c). Contrary to what X contends (apparently referring to section 1.19 of the current GC rather than to GC (2007)), this provision constitutes a sufficient regulatory basis for calling on a participant to take adequate measures to prevent its order-routing system from being used for snake trading.

According to the practice in the material published by SIX Exchange Regulation on the internet, participants have a duty to parameterize their order systems to prevent any entry that is not clearly a borderline case. These measures must prevent any manifestly unfair trading via an order system (see the decision of the Sanction Commission of 23 May 2008 regarding the responsibility of the participant for the order-routing system).

In this instance, therefore, it is necessary to consider only whether X could and should have taken measures in accordance with section 1.19 lit. b and c GC (2007) such as installing adequate filters in its order-routing system to monitor transactions conducted when the order book exhibits the following particular combinations: one case – order book empty on one side, unlimited order on the other; the other case – non-opening because of an excess of orders at best on the sell side. These two order-book cases are immediately recognizable by anybody as special situations involving an increased risk of unfair practices and requiring the particular attention of participants. Every trader knows that concerning the Scoach market model there is no automatic intervention in these situations. For the reasons mentioned above, the duty to monitor orders placed with a view to preventing unfair practices in this type of situation also applies to the parameterization of the participant's automated applications. In this instance it is not – as X contends – a matter of answering the theoretical, general question of defining the percentage deviation from the previous price that should trigger an automatic system response. In the two situations at issue, X ought to have made sure automated data were not transmitted to the exchange without being examined.

12.3 The two situations at issue were very particular. Given the knowledge required of traders, any trader could be expected to recognize the sort of combination that necessitates action by a participant holding an order-routing system. Discharging a duty like that conforms with the principle of proportionality. X took no mechanical or manual measures to block these orders, and was hence in breach of section 1.19 GC (2007).

12.4 X contends that a blocking filter should have been designed that would not prevent the transmission of legitimate orders to the exchange. This contention is correct insofar as "legitimate" orders are concerned. In this instance, though, it was not a question of preventing "legitimate orders" from being placed but of avoiding the placement of orders that obviously stemmed from unacceptable behavior: through X, a person reduced the price of stock A from € 35.10/€ 37.10 to € 0.15 when the underlying securities did not justify this. According to information from X, another client (and therefore another person responsible for placing orders, though SVE cannot verify this) reduced the price of stock B from CHF 94.97 to CHF 50 in 3 minutes and 36 seconds when the underlying securities did not justify this. What made it possible for these two cases to come about is that they both constituted special order-book situations (non-opening by reason of an excess of orders at best on the sell side, unlimited sell order when the buy side was empty), and X's automated application failed to block these orders.

12.5 Furthermore, X has not seriously contested its obligation to put filters in place. Thus, X has put in place a filter that blocks the placement of orders when the price exceeds its previous level by a factor of 20. It is also considering *a posteriori* whether a client generated an exaggerated proportion of mistrades. X also contends that it is not possible to determine whether deviations of 5-10% are still compatible with the market, and therefore whether or not they should be filtered. These are entirely general considerations. They may well be correct in themselves, but they are not material to the extraordinary situation in the case at issue. In both these types of situation, contrary to what X contends, the participant can be called upon to guarantee that its automatic order-routing system is halted and the transactions and limits examined. If X is not in a position to put such precautions (filters) in

place or claims that such measures are simply not possible, then it follows that X must no longer be authorized to offer its client order-routing services.

12.6 X also contends that such filters would not be compatible with the *best execution* obligation prescribed for traders by article 11 para. 1 lit. b of the Federal Act on Stock Exchanges and Securities Trading (SESTA). This contention is incorrect. Securities traders are obliged not to execute any client transaction without examining it. They must ensure that the rules of the exchange are obeyed. The two cases at issue are not borderline cases. They constitute a clear abuse of two situations that are particularly easy to recognize. Furthermore we are concerned in this instance not with X's activity in its capacity as securities trader on behalf of its clients, but with the fact that X offers third parties the facility to place orders themselves via its automated applications. Now, the condition on which X is entitled to offer its clients an order-routing system and, in reality, the price of offering that service, is that X accepts full responsibility to Scoach, as specified in section 1.13 GC (2007): "The participant alone shall be responsible and liable for persons who enter data into the Exchange System through its terminals."

The sanction

13. In the event of a violation of the Scoach General Conditions, the sanctions against participants specified by section 1.24 GC (2007) (now 1.20) take account of the gravity of the offence and the degree of fault. The list in section 1.24 para. 2 GC (2007) provides for sanctions ranging from a simple reprimand to a fine of CHF 10 million. Contrary to what X contends, section 1.24 GC (2007) particularly permits the punishment of breaches of sections 1.13 and 1.19 GC (2007).

14. By failing to parameterize its order-routing system or to take any other adequate measures to prevent the transactions described in section 1, X permitted unfair trading practices. As the file shows, a subsequent examination of its order-routing system found that X had satisfied the requirements of SVE. But this does not rule out the possibility that a new omission may emerge at a later date. In the present case X failed to show the diligence required to prevent its system from being abused in two cases that evidently required closer attention. It was obvious in both cases that measures needed to be taken. The violation is therefore not so minor that it can be dealt with without imposing a sanction. However, the violation can be qualified as slight. Having regard for the circumstances and in view of the fact that X has incurred no previous sanctions, a reprimand is adequate – and it should be sufficient to induce X to take appropriate measures in future.

15. Section 1.24 GC (2007) provides that Scoach may publicly announce sanctions against participants. Given that neither the breach committed by the participant nor the sanction is serious, publication is not felt to be necessary in this instance. However, section 6.3 para. 3 of the Rules of Procedure permits the decision to be published in anonymous form on the website in order to inform other participants and the market of the practice of the Sanction Commission.

16. Given the foregoing, the costs of the procedure are imposed to X (CHF 8’000 for SVE, CHF 15’000 for the Sanction Commission).

19.04.2010
(Translation)