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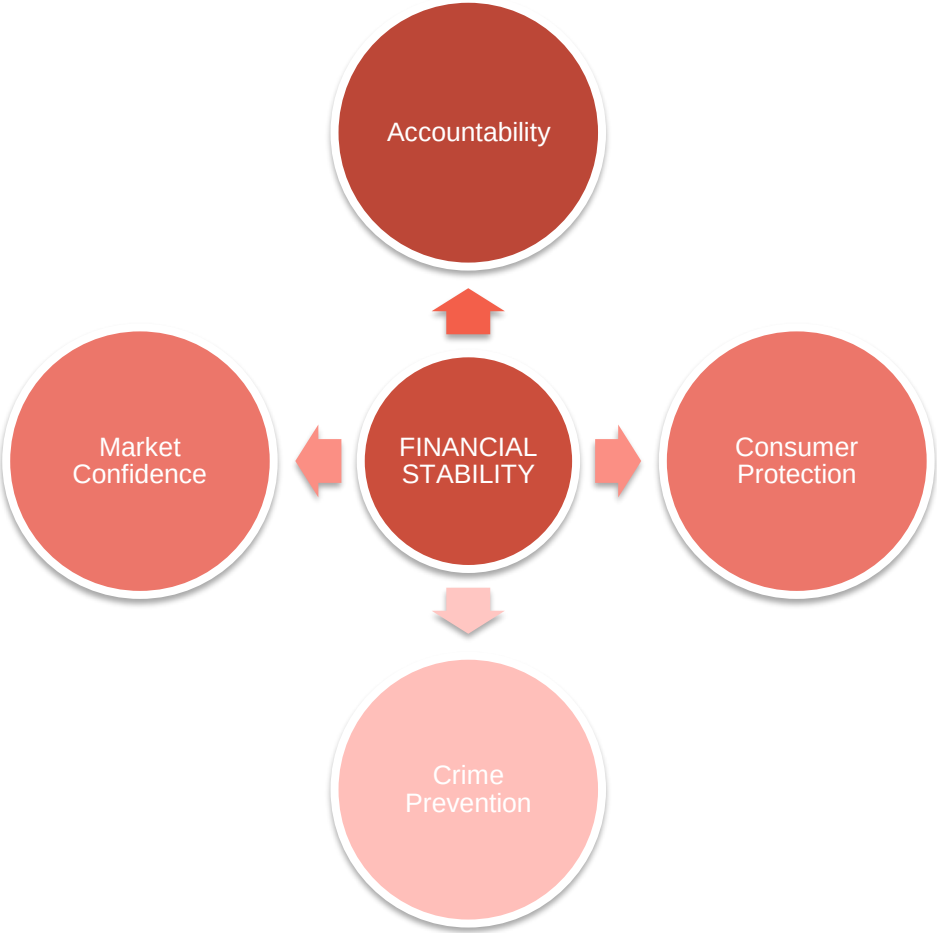
CONDUCT COMPLIANCE AND REGULATION

The reason for regulation



TOO BIG TO FAIL?

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Volcker Rule

"The proposal specifically prohibits a bank or institution that owns a bank from engaging in proprietary trading, and from owning or investing in a hedge fund or private equity fund, and also limits the liabilities that the largest banks can hold."

CASE STUDY: UBS KWEKU ADOBOLI

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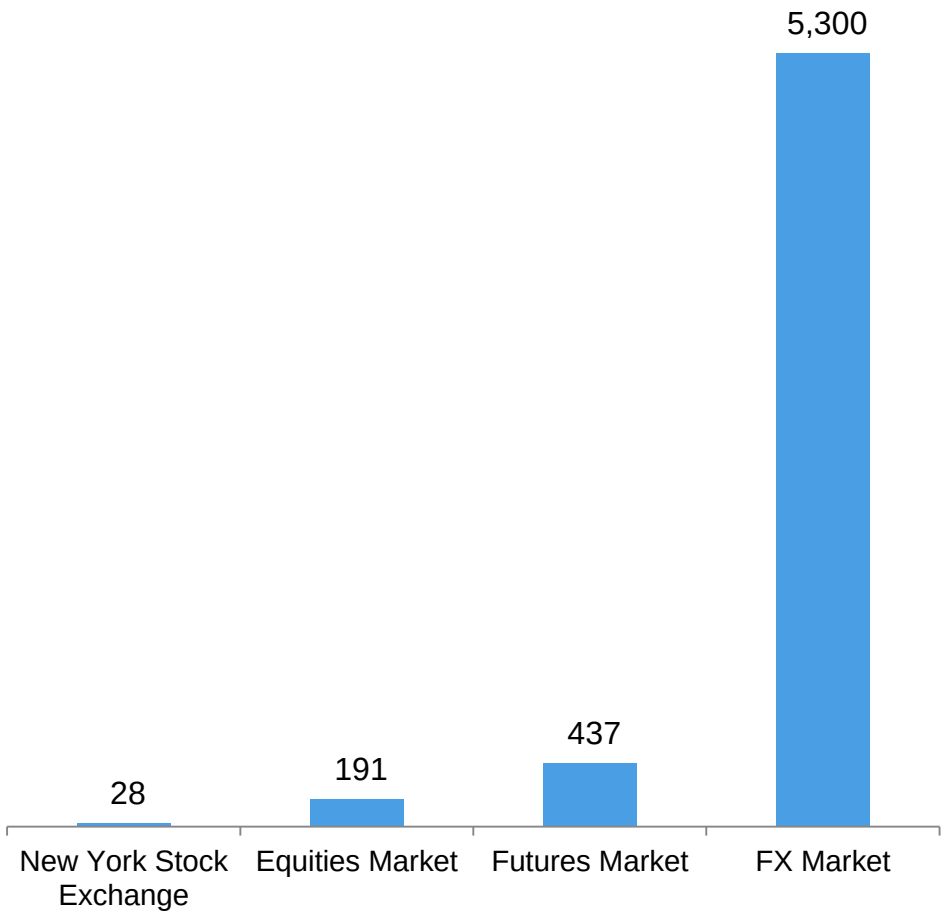
Front Running

"Using prior knowledge of a future transaction that will affect the price of the asset"

LONDON 4pm FX FIX

$Billions Traded each day



ABOUT THE FIX

- Introduced in 1994 by The WM Company and Reuters, called the WM/Reuters Closing Spot Rates service.
- Occurs at 4pm GMT every business day.
- 159 closing spot currencies covered in the closing rate service.

CALCULATING THE FIX

- WM receives data of trades and bid-offer spreads from existing Electronic Broker Systems.
- Most data from Thomson Reuters Market Data System.
- Between 3.59:30 and 4.00:30 there is a 60 second snapshot where best bid order, best offer order and actual trade prices are taken in one second snapshots.
- Not all data will be used since trades are taken by the millisecond – so its only a sample.
- Median bid and offer calculated then the resulting median mid point.
- Further quality checks are then applied with the intent of ensuring accurate fix exchange rates are published.

TRADING AROUND THE FIX

Some trades that the banks do in FX markets have PnL associated with them that relies heavily on the level the fix gets set at, for example:

Guaranteeing a client the fix rate:
Some clients may require their purchase or sale of a particular FX pair to be transacted at exactly the same rate as that day's fix rate.

Why?
Let's say an Equity Fund is benchmarked against a particular global equity index. The compilers of this index use the London Fix levels for various denominated currencies of the equities within the index to convert into $s and hence value the index. In order to avoid slippages in tracking this index, the Equity Fund must ensure it executes its hedging FX trades for the various different currency exposures it has at the same rate the index compiler users, i.e. the fix rate.

Risks
Once a bank agrees to enter into this trade, it bears the risk that the price in which they actually buy/sell the currency in the market at is different to the Fix rate that WM/Reuters publishes. To mitigate any risk the bank trader would buy/sell the FX over the 1 minute fix calculation period as evenly as possible in the effort to try to execute at an average rate that is as close as possible to the fix rate.

RISK OF GUARANTEEING THE FIX: EXAMPLE

- Fund Trader calls Bank Sales person: “I would like to buy ‘half a yard’ of EURUSD, guaranteeing the fix”. The Banks Sales person agrees to the trade and informs his/her Trader.
- The Trader now knows that he/she is obliged to sell Dollars in exchange for 500 million Euros at the published fix rate.
- At 15:59.30, EURUSD is trading at 1.3211-12 and the trader begins to buy, using an Electronic Broker System.
- The trader has a view that the FX rate is going to move higher, so aggressively buys the whole 500million Euros in the first 30 seconds, with an average rate paid of 1.3215. The trader pays $660,750,000 for these Euros.
- The currency rate subsequently moves lower, against the traders view and finishes the period, at 16:00.30 at 1.3200.
- The Fix rate is published as 1.3208. The trader has to sell the 500 million euros at this rate, receiving $660,400,000. **This results in a net loss of $350,000.**

FRONT RUNNING

The illegal (in regulated markets) practice of a Market Maker executing trades on a security for their own account while taking advantage of advance knowledge of pending orders from its customers which may move the price in the Market Makers favour.

FRONT RUNNING EXAMPLE

- Bank equities trader hears the Sales person take an order from a client to buy 10 million Vodafone shares in the central exchange.
- The trader quickly lifts offers in the exchange to buy 250,000 shares for their own account at an average price of 198p.
- A minute later the Trader begins executing the clients order, which is a significantly large buy order which starts moving the price upwards.
- After a long period of time of buying the Trader gets to the last 1 million shares for the client and has moved the price up to 202p.
- The trader sells their shares in the market at 202p. This generated a profit of £10,000 for the trader

COLLUSION

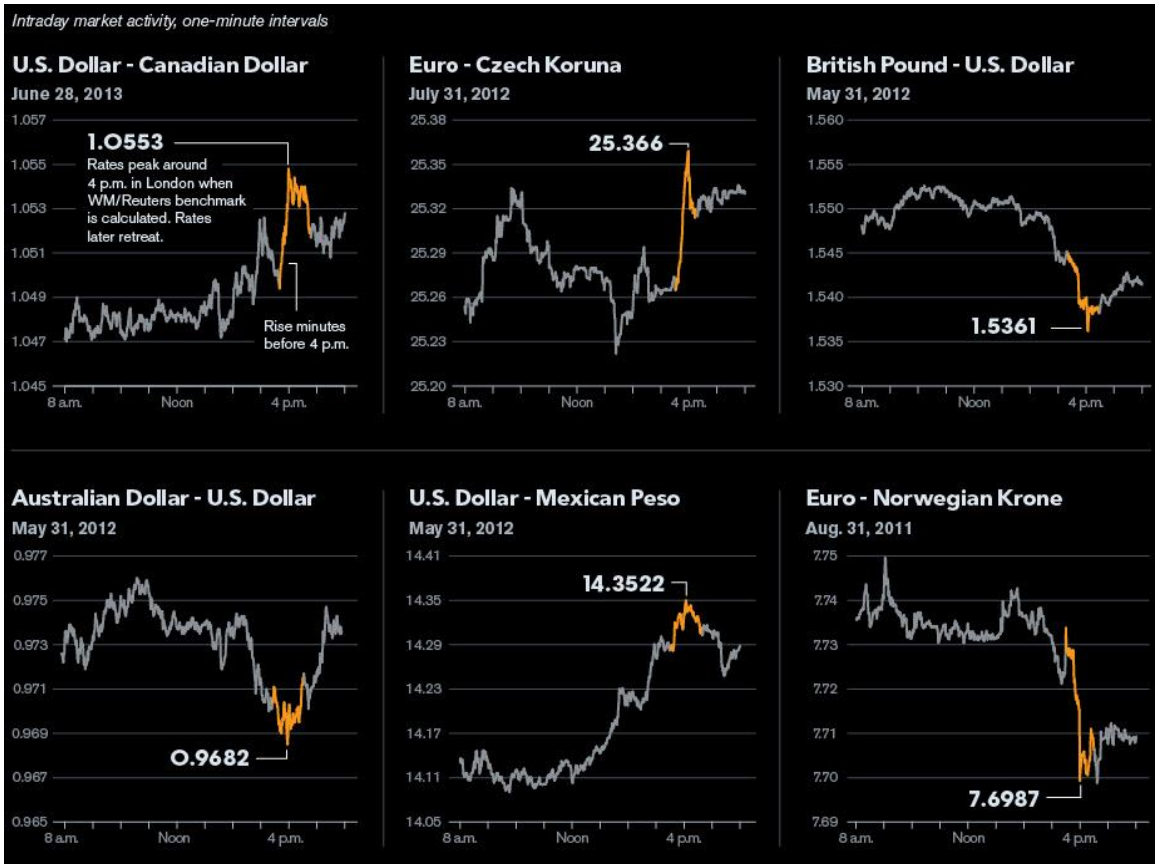
Collusion involves traders cooperating or working together when they should be competing. In financial trading, collusion can take many forms.

COLLUSION EXAMPLE

- Traders sharing information about large buy or sell orders, allowing one another to profit from the impact the execution of that order has on the price.
- Traders agreeing trading strategies and pricing strategies.
- Traders sharing private information or rumours in the effort to influence the price of an underlying security.
- Traders agreeing to buy or sell together maximise market impact, or to hold off on buying or selling.

BANGING THE CLOSE

This refers to aggressive buying or selling of currencies in the 60-second “fix” window, using client orders stockpiled by traders in the period leading up to 4 p.m. Traders may have colluded to increase the market impact during the fix.



BANGING THE CLOSE: EXAMPLE

- Trader at a bank receives an order at 3:45 pm from a client to sell 1 billion Euros in exchange for Dollars at the 4 pm fix. The exchange rate at 3:45 p.m. is EUR 1 = USD 1.4000.
- The trader establishes a sizeable trading position of 250 million Euros, which he sells at an exchange rate of EUR 1 = USD 1.3995.
- Since the trader now has a short Euro, long Dollar position, it is in his interest to ensure that the Euro moves lower, so that he can close out his short position at a cheaper price and pocket the difference. He therefore spreads the word among other traders that he has a large client order to sell Euros, the implication being that he will be attempting to force the Euro lower.
- At 30 seconds to 4 p.m., the trader and his/her counterparts at other banks - who presumably have also stockpiled their “sell Euro” client orders - unleash a wave of selling in the Euro, which results in the benchmark Fix rate being set at EUR 1 = 1.3975. The trader closes out his/her trading position by buying back Euros at 1.3975.
- **The trader nets a profit of $500,000 in the process.**

REGULATION IN FX

The FX spot market is not regulated in any country…

- Since there is no regulation in FX spot, the act of front running is not actually illegal.
- The rationale behind this is that because the FX market is so huge and so liquid, that a trader front running ahead of a large client order bears significant risks such that the execution of the client order will not necessarily move the price in the favour of the trader.

…but, colluding with other traders is illegal:

- The manipulation of prices by collusion is illegal, regardless of which market.
- Hence the process of "Banging the close" in FX, involving both front running and collusion is a crime.

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MiFID II

Objectives and core measures

Financial services firms have seen sweeping regulatory changes since 3 January 2018

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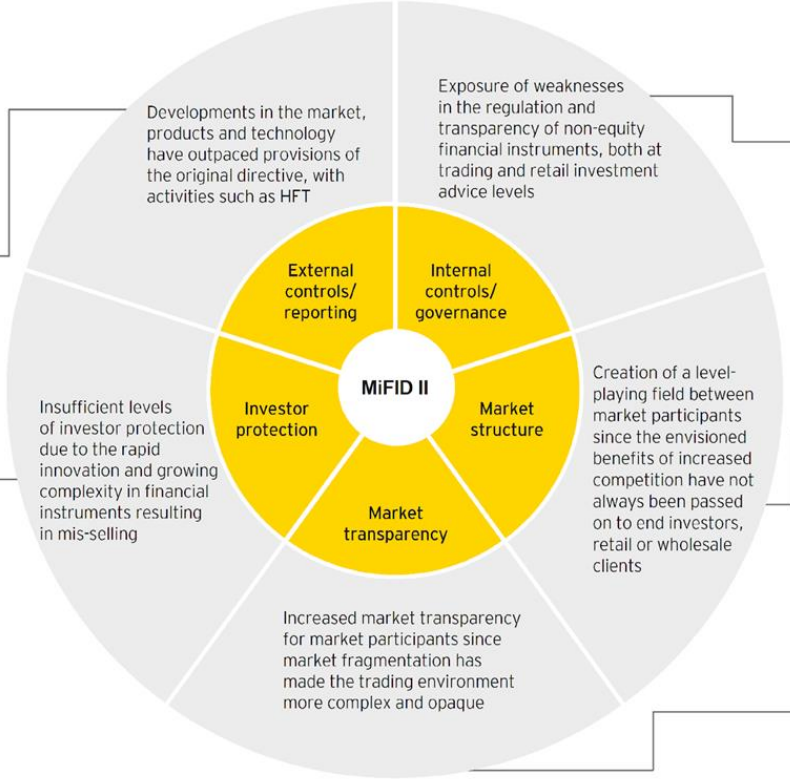
MiFID II OBJECTIVES AND MEASURES

- Developed in response to the 2008 Global Financial Crisis, the regulation will affect any business involved in the manufacturing, distribution and trading of financial instruments in the European Union
- From 2018, firms will need to remove conflicts of interest and demonstrate how they're helping the investor
- Focus on transparency, protecting the investor and putting the investor's best interest first

The changing regulatory framework

- Trading bans and position limits for commodity derivatives
- External circuit breakers for HFT trading (breaker at venue level)
- Testing of algos by participants
- Additional reporting requirements to regulators (trade and transaction reports, algo reporting, expanded asset class and data scope)
- National competent authorities to apply sanctions when in breach
- Regulatory oversight of product, including ban or limitations on marketing to retail investors
- Third-country access through national regimes until effective equivalence test by European Commission allowing passporting

- Revised suitability and appropriateness regime especially for "complex" products with embedded derivatives (including UCITS)
- Ban of inducements to independent advisers and discretionary managers and more stringent disclosure regime for payments paid and received
- Enhanced conduct rules when designing new products and tightened execution-only regime



- Enhanced governance with prescription around governing board and committee composition, fitness and propriety, and time commitment
- Implementing systems capable of record-keeping for a minimum of five years
- Increased scope and role of compliance (semi-independence)
- "Tone from the top"

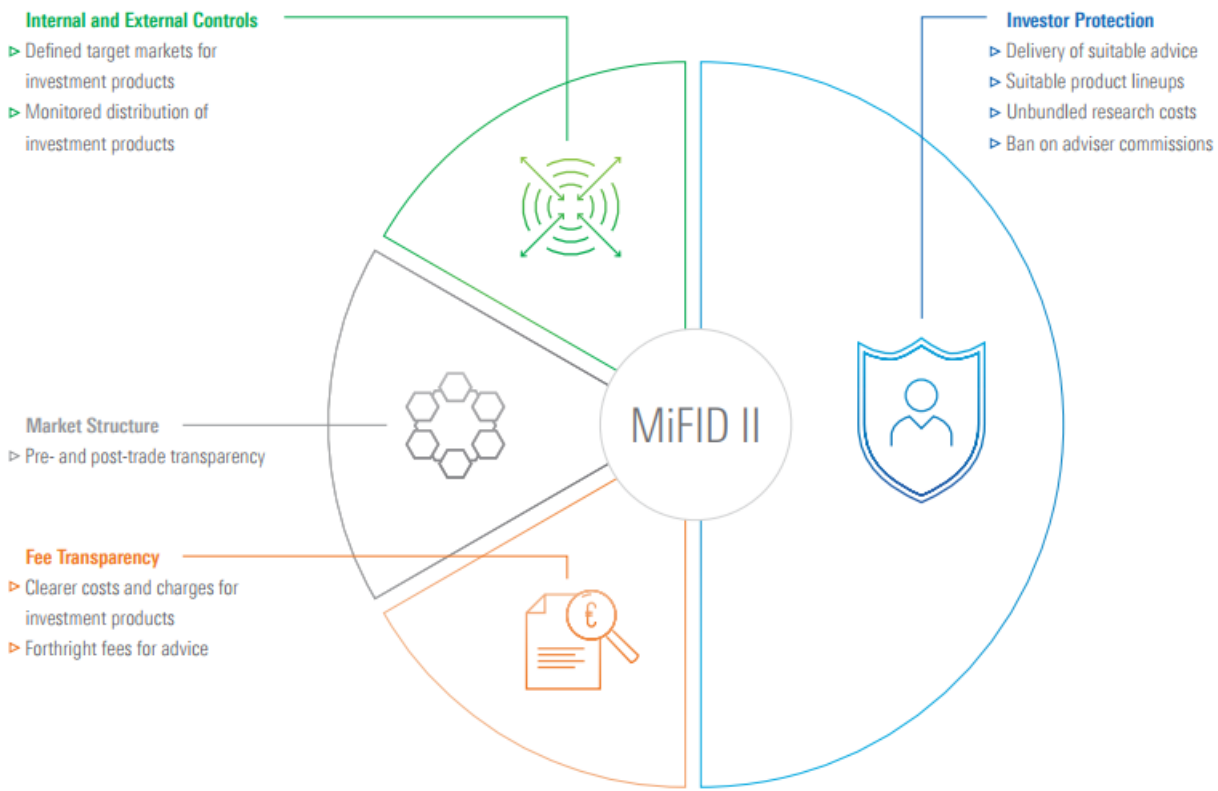
- Equity trading obligation on RM, MTF and SI only (no off-market trading)
- Mandatory trading obligation for OTC derivatives
- Introduction of organized trading facility (OTF) for non-equity instruments
- Limitation on trading on dark pools for equities and equity-like products
- Open access to trading venues, CCPs and benchmarks

- Increased regulatory and client reporting requirements for all asset classes on RM, MTF, OTF and SI
- All RMs, MTF and OTFs to publish bid/ask and depth of market (per product)
- Public firm price quoting requirements for SIs for liquid instruments
- European Consolidated Tape (ECT) approaches
- Synchronized business clocks for trading venues and members

Source: EY 2017

OBJECTIVES AND MEASURES

1. Investor Protection
2. Fee Transparency
3. Internal and External Controls
4. Market Structure



Source: Morningstar 2017

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MiFID II

Pre-trade and Post-trade transparency & Transaction reporting

Market Structure Changes

A new market structure to achieve pre- and post-trade clarity with the objective of making a more level playing field. These changes are necessary to address the fact that benefits of increased competition have not always been passed onto the investors, retail or wholesale clients

Impact to clients?

- Greater view of pricing of instruments across the market
- Client name remains anonymous and is never distributed
- Capturing of voice flows will serve to inform clients of quality of execution received across the industry

PRE- & POST-TRADE TRANSPARENCY AND TRANSACTION REPORTING

- Pre-Trade Transparency (Pre-TT) is the requirement to make public firm quotes that are given for in-scope instruments. Quotes are to be made public as soon as technically possible, bringing a level of transparency to OTC markets

- All organised trading will take place on either (a) regulated trading venues (OTFs), or (b) by a formal regulated internal process within the bank known as systematic internalisers (SI) – or execute client orders outside a regulated market.

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MiFID II

Investor Protection: Research & Inducements

RESEARCH & INDUCEMENTS

- In-scope clients must pay for services categorised as research, execution and non-minor benefits
- The supply of "non-execution" services cannot be influenced by the levels of payment for execution - this could otherwise be considered to be inducement.
- Some services can be given or received without payment - known as Minor Non-Monetary Benefits (MNMB)
- If content from a research analyst if publically available, institutional sales can reference such content

UNBUNDLING OF SERVICES

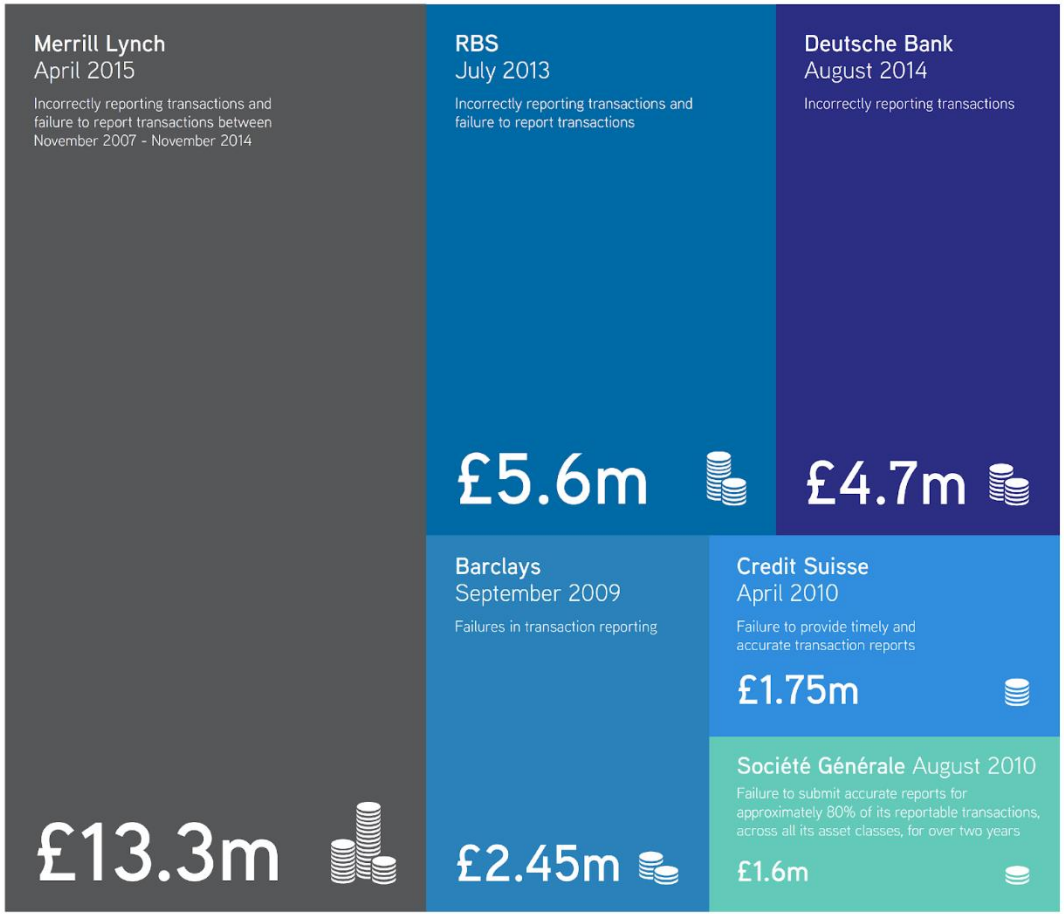
From January 3rd 2018, all investment firms will need to separate costs for execution, research and other services

One year on…

- Visibility around costs: Under Mifid II, investment firms which execute client orders are required to summarise and publish their top five execution venues in terms of trading volumes and values for each class of financial instrument (their so-called RTS 28 report).
- Five of the main wealth managers in the UK have directed their flow to execution only market-makers – there is often a significant price improvement

- Research Incentives as research priced separately from execution: cost cutting & reduction of number of analysts
- Shareholders now have a breakdown of how their money is spent – funds need to be able to demonstrate they are getting good value from their research
- Research-driven brokers: Rothschild & Redburn Europe

The cost of non-compliance



Sales & Trading

Workflow in the European Union

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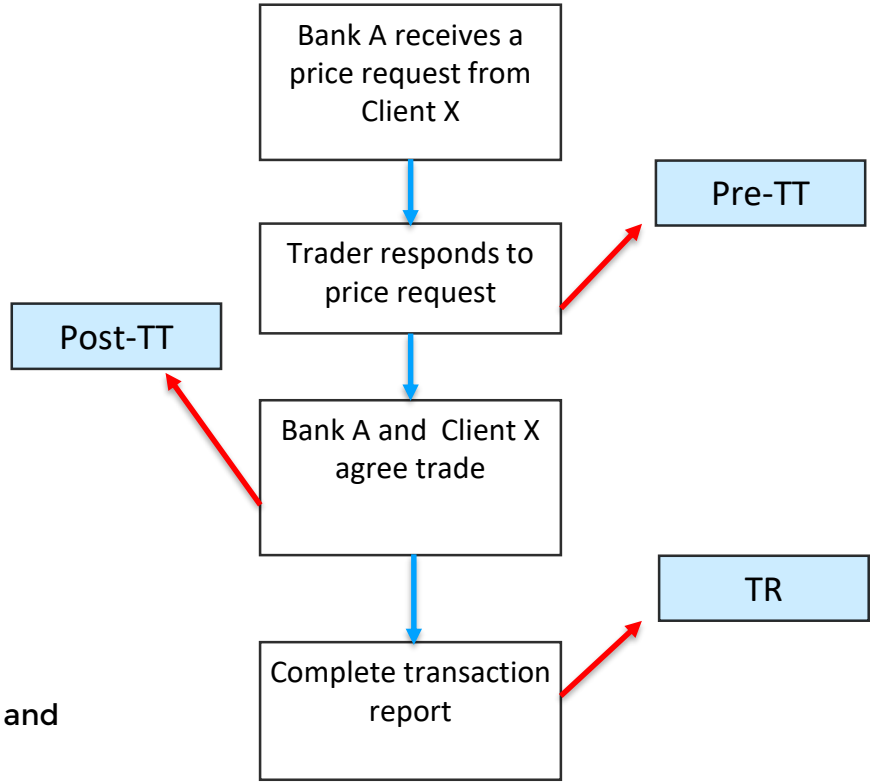
How has workflow changed?

DETAILED AND TRANSPARENT RECORDING

Forcing sales traders to keep detailed and transparent records of every request, price and execution could add up to 30 seconds to the existing sales process – additional time may result in a loss of business.

SALES TRADER WORKFLOW

Many banks and institutions now add an additional electronic workflow layer to the usual sales process. Voice requests (including calls, Bloomberg chat and Reuters Dealing) must all be inputted into an electronic system in order to report all requests with a timestamp before a price can be quoted.



CASE STUDIES

- Case Study 1: Dealers based within the European Union and outside the European Union.
- Case Study 2: Client axes – What if a client give the side and price? (RFQ)

SALES TRADER CONDUCT

FROM A DEALER'S PERSPECTIVE?

- Do not quote a price without a 'Sales trader workflow' request from the institutional sales desk
- Even if the client asks for a LHS or RHS, you need to provide a two-way quote

SALES TRADER CONDUCT

- All requests from clients have to be recorded – this includes: client name, timestamp, product requested, amount requested, client side, mid-price of quote
- Post-Trade Transparency requires executed trades to be published within 15 minutes (this will be reduced to 5 minutes by January 2021)
- Institutional Sales must be aware of which clients receive what level of unbundling service when comes to distribution of research

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Other Controls

1. Large Trade Approval
2. Personal Trading Account
3. Wall Crossing
4. Internal Compliance Exams
5. Undertakings for Collective Investment in Transferable Securities (UCITS)