

P&L Squawkbox & the ACI Model Code

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There are people in this industry trying to shoot themselves in the foot, but the collateral damage will include the wider industry.

The losses from last week's event continue to build as more are revealed, especially in the hedge fund world where BlueCrest and Fortress are both reported to have taken a serious hit and in the case of the former, shut one of their funds. They are not the first and won't be the last.

But that is not what is worrying me. If I may philosophize for a moment, in life one has to take the ups and down – think Kipling. It is the same in trading; sometimes you just have to take losses. I cannot think of a bigger PR disaster than chasing clients for losses after you unilaterally changed the rates on their trades. Not only is it awful PR, it is likely to end up costing nearly as much in legal fees when the inevitable happens and the lawyers get involved.

My understanding is that one or two banks in the immediate aftermath of the mayhem were trying to change rates but very quickly realized this was not a good path to follow. Saxo Bank clearly didn't get that memo and now finds its name splashed over the world's press chasing down small investors for money they don't have after the bank unilaterally changed the rates it offered on executed trades. A good example of the press can be found here

This brings home the fear I expressed on Monday, that institutions will try to push the loss onto the individual. This cannot end well for the industry.

It's a tricky one of course, because Saxo clearly believes it is on solid legal ground, it has a Product Disclosure Statement that covers just about everything, but is it? The problem is that the system generated trades and then the institution tried to roll them back. What would have happened had a voice trader quoted those prices, or exercised those stops? The trade would have to stand I would have thought?

I have written previously about how best practice guides need updating to better reflect the modern market and this is yet another example of that. ACI – The Financial Markets Association has done a tremendous amount of work to update its Model Code, but this highlights just how much is left to be done.

Part of the problem last week was systems generating trades automatically from stop loss orders. The Model Code has a clause about stop losses on e-platforms, it reads as follows:

“Additional attention should be paid where e-trading platforms automatically execute stop-loss orders. In accepting these orders, whilst an institution assumes an obligation to make every

reasonable effort to execute the order promptly, there is no guarantee of fixed price execution to the counterparty unless otherwise agreed by both parties in writing (my italics).”

The Model Code is the most comprehensive best practices guideline out there but even that cannot yet cover everything. The closest I could find is in the “Dealing Through Brokers” section, which states, “Dealers should regard themselves as bound to a deal once the price and any other key commercial terms have been agreed.”

This could conceivably be transferred to the electronic market, but then the Code goes on to state, “However, holding voice brokers unreasonably to a price is viewed as unprofessional and should be discouraged by management.”

The problem facing the best practice codes (and probably the lawyers when it gets to that stage) is how to decide whether holding someone offering auto-stops to a price is “unreasonable”?

The problem for everyone here was that there were trades at most big figures all the way down – the amounts were minimal but trades were executed and that removes the threat of them being “off-market” which would involve a cancel and re-book. The market traded there so it could be reasonable to assume that the institution concerned could cover the trade. But of course it wasn’t able to.

In a voice driven world, as The Model Code states, there would be no guarantee of the rate, the trader would not guarantee the level, especially in such a high risk situation (and we all knew there were huge stops below 1.2000) so why should stops be guaranteed in the electronic world? Well they shouldn’t, but here is the problem. The system generated a trade; it was matched and in many cases sent to CLS or a prime broker, where it was again matched and the admin done.

At what point does a trade become a trade? It sounds a silly question, but current events are bringing this into question. I would have thought when the trade is confirmed by both parties then it’s done, which is a bit of a problem in the e-world, where auto-confirmations speed up the process to the extent that the only thing likely to stop these trades getting down is pulling the plug on the platform.

Of course, pull the plug on the platform and you pass the buck to your clients, but it’s probably a more subtle way of stuffing them than going after the clients after the event. Your credibility will be damaged, but not destroyed – cynical as that view may be.

My personal view is that the parties simply need a log of trades on EBS for EUR/CHF on January 15. If the market traded within 100 points of the stop then there was a legal trade in the market and unfortunately that’s the way it goes for the institution.

The problem is though, that it’s a very dangerous precedent saving your clients from massive losses. Those brokers that honored the stops and took the hit themselves appear to be having a field day telling everyone how they wouldn’t dream of changing rates like some others. All well and good, but they are also effectively saying to their clients they would do it again. What happens if an

even bigger event happens (I can't think it will, but then none of us foresaw the magnitude of last week's mayhem). What happens if they cannot or will not? We're back in the courts.

For now though, and from a personal point of view, I would really prefer those that have made money day-in-day-out from their customers take their hit when it (very occasionally) comes along. Also, these events highlight the amount of work facing those managing best practice guidelines and stresses how they need to ensure they more accurately reflect the modern market.

It may be legally OK to change these rates (I'm still not sure), but morally it looks wrong – it just looks like the big guy beating up on the little guy while he's down.

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