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NASDAQ STOCKHOLM'S DISCIPLINARY COMMITTEE	DECISION 2017:10	November 29, 2017

Nasdaq Stockholm

Morgan Stanley & Co. International Plc

Decision

The Disciplinary Committee issues a warning to Morgan Stanley & Co. International Plc.

Motion

Morgan Stanley & Co. International Plc ("MSI") is a member of Nasdaq Stockholm AB (the "Exchange"). At the time of the alleged violations, the membership was subject to the Nasdaq Nordic Member Rules version 3.1, December 1, 2016 (the "NMR"). MSI has signed an undertaking to comply with the NMR as long as MSI is a member of the Exchange.

The Exchange has argued that MSI has violated items 4.6.1 and 4.6.2 of the NMR, in part by invoking Sold-Out-Buy-Back status ("SOBB") to take a dominant position with respect to the two certificates BULLWTIX4AVA1 and BULLWTX5AVA1, and, in part, by utilizing this position in its capacity as a market maker to have quoted prices for the certificates which did not correspond to a correct market value, which created unfair conditions for trading in the certificates. The certificates constitute derivatives of underlying assets.

MSI has denied that it has violated the aforementioned provisions.

A hearing in the matter was held before the Disciplinary Committee on November 15, 2017, at which the Exchange was represented by Joakim Strid, Gustav Liljekvist and Niklas Ramstedt. MSI was represented by Paul Fitzgerald, Richard Freeman and *advokat* Anders Malm.

The Disciplinary Committee's assessment

Background

The Exchange has argued: According to MSI, MSI incurred losses as a consequence of two transactions in two certificates (which were derivatives of a certain underlying asset). MSI was aware that, after the transactions, its counterparty in the two transactions held long positions in the two certificates. By temporarily requesting what is commonly referred to as SOBB status regarding the two certificates, the only opportunity for the counterparty to get out of its positions was to sell the certificates back to MSI at a price determined by MSI. MSI thereby created and took a dominant position with respect to the trading in the two certificates. Whether MSI demanded SOBB status or only Buy-Back status is of no relevance since the consequences are the same. The prices quoted by MSI for the two certificates were considerably lower during the period after the SOBB status was made public as compared with the prices during the preceding period when normal trading conditions prevailed. There are no references to price changes in the underlying assets for the certificates or other relevant factors which might objectively explain why the price was lower in relation to the price during the preceding period. During a telephone conversation with the Exchange and MSI on February 17, 2017, a representative of MSI mentioned, numerous times, how MSI's counterparty had unfairly made a profit at MSI's expense in the two transactions. Even if this circumstance has not been referred to in the later correspondence, no conclusion can be drawn other than that the price for the two certificates was held down during the SOBB period as compared with what otherwise would have been the case and that the reason for this was to influence the prices at which MSI's counterparty in the two transactions would be able to get out of its positions. Numerous references, both in telephone conversations and in correspondence, have been made to the Exchange's guidelines for cancellation of transactions. These references can only be interpreted to mean that MSI quoted the price as low as possible for the two certificates without risking a cancellation of potential transactions. These circumstances support the conclusion that MSI's pricing during the SOBB period was not based on the prevailing market price of the certificates, but rather in order to gain advantages in the potential transactions.

MSI has argued: There was abnormal trading in the certificates on February 10 and 15, 2017. A buy order for a remarkable quantity was followed by a sell order for the same quantity, which were carried out during a short period of time. On February 16, MSI's IT team began to suspect that the reporting of pricing for the reference asset (i.e. the underlying asset for the certificate) might be the subject of delay, which might expose MSI to the risk that other actors such as Flow Trader might carry out arbitrage at the expense of MSI. At this point in time, MSI realized that it was not conducting its operations under normal circumstances and that the pricing of the certificates was probably being affected in such a way that MSI's pricing did not respond to the correct theoretical value of the reference assets. After Flow Trader had made two purchases of certificates at a price below the theoretical price as it had been calculated by MSI, MSI requested, by an e-mail sent to the Exchange, that the certificates be changed to Buy-Back. This did not give rise to any comments or measures on the part of the Exchange. At approximately the same time, MSI adjusted the price of the certificates downwards by 9 percentage points in order to respond to a 2% change in the underlying reference asset. On no occasion did MSI request that SOBB status be activated. MSI requested that the certificates be designated Buy-Back. The statement "*we don't want to sell more of them"* and that they are thereafter "*sold out"* have been used in earlier communications with the Exchange with respect to other products. On February 17, a number of conversations took place between MSI and the Exchange during which the Exchange attempted to obtain clarification as to why MSI requested SOBB status and whether the quoted prices reflected a correct value. During the conversations, MSI's representative sought guidance from the Exchange as to how the situation should be handled correctly in accordance with the NMR. On February 21, MSI's IT team concluded that the delay in the pricing amounted to six seconds. MSI then adjusted the price from the 9% lower price, which had been set when only buy orders had been placed, to a price which was 5% lower and which corresponded the risk exposure which MSI could handle. On February 22, Flow Trader carried out a sell order in the market and left its positions from February 16. In summary, MSI went to Buy-Back in order to avoid further risks with the certificates as a result of the incorrect pricing which was affected by technical circumstances. There was no intention to unduly influence the pricing in the trading system. It is normal that a market maker takes a dominant position since most, if not all, of the transactions on an exchange are carried out *vis-à-vis* the market maker.

Item 3.2.6 of the Rules of Nasdaq Nordic for Covered Warrants and Certificates 3 July 2016 states:

> The issuer undertakes to maintain satisfactory routines for a market maker service vis-à-vis the market. The issuer undertakes to quote bid and ask prices for the covered warrants in the trading system, **under normal conditions**, related to the market or the issuer's technical system. If the issuer ceases to quote prices it shall immediately notify the Exchange and, as soon as possible, provide information regarding the stated circumstances on its website. An announcement shall be disclosed as soon as possible, regarding the cease of quoting prices.

This provision means that the market maker's undertaking to quote bid and ask prices applies **under normal conditions** related to the market or the issuer's technical system. MSI's technical problems affected the normal conditions under which MSI undertook to provide a market for the certificates and therefore MSI's decision to change to only providing bid prices was in compliance with the Exchange's rules.

Item 4.14 of the Nasdaq Nordic Market Model states:

> Sold-Out Buy-Back is an optional functionality for Market Makers in Warrants, Certificates and Exchange Traded Notes. The aim of the functionality is to protect investors in situations where the Market Maker is no longer able to maintain orders on the sell side due to the instrument being sold out or where **due to unforeseen and exceptional circumstances, it is unreasonable to expect the Market Maker/issuer to maintain two-sided prices in the order book**.

The technical problems were unforeseen and of an exceptional nature and the SOBB code was therefore applicable. MSI sought advice from the Exchange as to which code was to be used in order to prevent continued sales of the certificates.

It is correct that a significant reduction of the prices was made on February 16. This was due to the fact that MSI suspected technical errors in the pricing system and it appeared to be obvious that this was due to a delay in the price reporting (which was subsequently confirmed). By referring to the arbitrage scenario, MSI implied that it was very likely that it was a technical problem.

Taking into consideration the volatility in the underlying assets, the high leverage effect which follows from the nature of the certificates, and the technical problems affecting MSI, MSI denies that the price was reduced in order to influence the price at which Flow Trader would be able to sell them back. The prices which were set during the SOBB period were correct. The volatility, combined with the time delay for entry of the price of the underlying product, as well as the leverage effect, led to MSI realizing that a 9% price adjustment was correct. On October 15 and 16, the 60-day historical volatility for the underlying product was 31.189, which corresponds to a 2% daily movement in the underlying product. The adjusted price corresponds to the prevailing market value based on the movement spread in the underlying product multiplied by the leverage effect. The price also had a protective effect for MSI in that it made it possible for MSI to hedge the risk in the underlying asset product. Under normal conditions, a correct risk management technique is based on the pricing system ensuring that the positions which MSI takes on the market are well hedged. When the underlying products are incorrectly priced, the hedge also becomes incorrect.

The reference to the guidelines for cancellation of transactions was only intended to verify that the price adjustment could be deemed reasonable in light of the cancellation rule, i.e. a final check before a reasonable price was set.

On February 22, MSI finally concluded that the delay in the pricing of the underlying product was six seconds. MSI also wishes to point out that no guidance was received from the Exchange as to how the situation should be handled. There were two alternatives: either go into SOBB status or lower the bid price. MSI chose to prevent a situation where investors purchased certificates only to subsequently incur losses on the sale of the certificates based on the wide spread. This was also in better compliance with the rules.

Considerations

Item 4.6.1.i.a, of the NMR states:

"Orders placed in the Order Book, Automatically Matched Trades and manual Trades must reflect the current market value of the Instrument in question and constitute genuine Orders and trades..."

Item 4.6.2. i.a., of the NMR states:

The Member may not place Orders, enter into Trades or enter into any other behaviour which, individually or together:

- give or are likely to give false or misleading signals to the supply, demand or price of relevant instruments;
- secure or are likely to secure the price of relevant instruments at an abnormal or artificial level;
- affect or are likely to affect the price of one or several certificates and where the activity is part of a fictitious device, or any other form of deception of contrivance; or

- are intended to delay or prevent access to the Trading System by other Members.

The above general rule means, for example, that it is prohibited to

- Secure a dominant position over the supply of or demand for an instrument and where such activity has or is likely to have the effect of fixing, directly or indirectly, purchase or sale prices or creates, or is likely to create, other unfair trading conditions;

Item 4.14 of the Nasdaq Nordic Market Model 2016:05 states:

Sold-Out Buy-Back is an optional functionality for Market Makers in Warrants, Certificates and Exchange Traded Notes. The aim of the functionality is to protect investors in situations where the Market Maker is no longer able to maintain orders on the sell side due to the instrument being sold out or where due to unforeseen and exceptional circumstances, it is unreasonable to expect the Market Maker/issuer to maintain two-sided prices in the order book.

Please refer to Appendix T for further information.

The aforementioned appendix T, pages 119 and 120, governs both the Buy-Back function as well as the Sold-Out-Buy-Back function.

There is, in principle, no disagreement regarding the actual chain of events. Even if there are differences between the Buy-Back and Sold-Out-Buy-Back functions, both appear to be capable of being applied when unforeseen and exceptional circumstances occur which render it unreasonable for a market maker to maintain two-sided prices in the order book. As the Disciplinary Committee has understood it, the Exchange and MSI are in agreement that the SOBB function has been applied.

The Disciplinary Committee notes that there was cause for MSI to suspect that the reporting of the pricing for the reference asset might be exposed to delay and that this circumstance indicated technical problems which could not have been foreseen and which were of such a nature that item 4.14 of the Nasdaq Nordic Market Model was applicable. In the opinion of the Committee, conditions existed at that time to apply the SOBB code. When this code is applied, only a bid price is to be quoted. The Disciplinary Committee has not found that the Exchange, over the denial of MSI, can be deemed to have proven that the purpose of the reduction in the bid price was solely to stop Flow Trader from getting out of its positions.

The question is then whether the bid price, after the reduction by 9%, can be deemed to correspond to the prevailing market value. In the opinion of the Committee, the spread in the certificates before the SOBB code was introduced, together with the fact that no change in the underlying asset could be discerned prior to the introduction of the SOBB code, argues against the notion that the bid price, after a reduction by 9%, corresponded to the prevailing market value. In the opinion of the Committee, a brief reduction of the bid price may be appropriate for maintaining the market without counterparties being given the opportunity for arbitrage until the technical problems have been identified and remedied.

The responsibility for ensuring that the technical systems are secure and effective lies with MSI. In consideration of this responsibility and in light of the fact that one can strongly question whether the bid price, after a reduction of 9%, corresponded to the prevailing market value during the five days in which this price was applied, serious criticism must be directed against MSI. The Disciplinary Committee thus finds that MSI violated items 4.6.1 and 4.6.2 of the NMR and that the violations are serious. The Committee notes that there were deficiencies in the communications on the part of the Exchange in conjunction with MSI's contacts with the Exchange when MSI sought guidance in the situation which had arisen. Consequently, despite the seriousness of the violations, a warning is deemed sufficient as sanction.

On behalf of the Disciplinary Committee

Marianne Lundius

Former Justice of the Supreme Court Marianne Lundius, company director Stefan Erneholm, company director Carl Johan Högbom, company director Jack Junel and *advokat* Wilhelm Lüning participated in the Committee's decision.