Financial Services Authority

# FINAL NOTICE

To: **Citigroup Global Markets Limited**

Of: **Citigroup Centre**
**Canada Square**
**Canary Wharf**
**London**
**E14 5LB**

Date: **28 June 2005**

**TAKE NOTICE: The Financial Services Authority of 25 The North Colonnade, Canary Wharf, London E14 5HS ("the FSA") gives you final notice about a requirement to pay a financial penalty.**

## 1. Action

1.1. The FSA gave you a Decision Notice on 23 June 2005 which notified you that pursuant to section 206 of the Financial Services and Markets Act 2000 ("the Act"), the FSA had decided to impose a financial penalty on Citigroup Global Markets Limited ("CGML") in respect of a breach of Principles 2 and 3 of the FSA's Principles for Businesses. This consists of two elements:

1.1.1. a relinquishment of profits in the amount of £9,960,860; and

1.1.2. an additional penalty of £4 million.

1.2. Accordingly, for the reasons set out below the FSA imposes on CGML a financial penalty as set out at 1.1.1 and 1.1.2 above.

## REASONS FOR THE ACTION

## 2. Summary

2.1. On 2 August 2004 CGML executed a trading strategy on the European government bond markets which involved the building up and rapid exit from very substantial long positions. The centre-piece of the strategy was the simultaneous execution of a large number of trades on the MTS platform using specially configured technology.

2.2. In contravention of Principle 2 of the FSA's Principles for Businesses CGML failed to conduct its business with due skill, care and diligence in that in planning, authorising and executing the strategy, CGML:

2.2.1. did not have due regard to the inherent risks including the likely consequences the execution of the trading strategy could have for the efficient and orderly operation of the MTS platform.

2.2.2. did not ensure that clear parameters for the size of the trade were understood, communicated and reviewed.

2.3. In contravention of Principle 3 of the FSA's Principles for Businesses, CGML failed to take reasonable care to organise and control its affairs responsibly and effectively and to implement adequate risk management systems in that:

2.3.1. There was a failure within CGML to escalate the detailed trading strategy on 2 August 2004 adequately and in advance to senior management, and a failure to consult with applicable control functions.

2.3.2. There were inadequate systems for the supervision of traders.

2.4. The effect of the trade was to cause short term disruption to volumes of bonds quoted and traded on the MTS platform, and sharp drops in prices.

**3. Relevant Statutory Provisions and Guidance**

3.1. Section 206 of the Act provides:

*"If the [FSA] considers that an authorised person has contravened a requirement imposed on him by or under this Act, it may impose on him a penalty, in respect of the contravention, of such amount as it considers appropriate."*

3.2. The FSA's Principles for Businesses, as set out in the FSA's Handbook of Rules and Guidance[1] ("the Handbook"), represent high level standards of business. The Principles constitute requirements imposed on authorised persons under the Act.

3.3. Principle 2 of the FSA's Principles for Businesses provides:

"*A firm must conduct its business with due skill, care and diligence*"

3.4. Principle 3 of the FSA's Principles for Businesses provides:

*"A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems."*

3.5. Guidance on Principle 3 is contained in the Handbook. In particular, the Senior Management Arrangements, Systems and Controls sourcebook ("SYSC") provides:

[1] See the section of the FSA Handbook entitled Principles for Businesses ("PRIN")

*"A firm must take reasonable care to establish and maintain such systems and controls as are appropriate for its business" SYSC 3.1.1*

*"A firm must take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system and for countering the risk that the firm might be used to further financial crime." SYSC 3.2.6*

## 4. Background Facts

<u>*Introduction: The Eurozone Government Bond Market*</u>

4.1. Trading in bonds issued by governments within the Eurozone is undertaken principally in two closely inter-related markets – the cash market and the futures market. Dealing in the cash market is conducted partly through the use of voice brokers and inter-dealer brokers and partly over electronic platforms such as MTS - a European electronic inter-dealer system for the trading of fixed-income securities, operated as local trading sectors by affiliated MTS companies in various European domestic markets.

4.2. The futures market is primarily conducted on Eurex, the German exchange on which the 'Bund' (German federal government 10 year bonds) and 'Bobl' (German federal government 5 year bonds) are traded along with other bond futures contracts.

4.3. The pricing of the cash and futures markets is very closely correlated. CGML, in common with other banks operating in the same markets, calculates a real-time market price of cash bonds derived from a price feed from Eurex. Eurex, MTS and other trading platforms can be viewed as different means by which the Eurozone government bond market can be accessed.

4.4. MTS has a finite number of participants and is a quote driven trading platform. All market making participants are required by the rules of MTS to provide bid and offer quotes (in terms of price and volume) for certain specified minimum periods each day in respect of certain specified bonds. As a result of these quotation obligations on MTS, there is at any given time a large quantity of visible firm bids and offers.

4.5. This quoting requirement is in contrast to the position in many other markets, including Eurex and the LSE's SETS system, which are order-driven. Participating members on those markets have no obligation to provide quotes, rather they will input buy or sell orders in sizes and prices determined by them, which may be accepted by other participants, or matched automatically with other orders already in the system.

<u>*CGML's Trading Strategy*</u>

4.6. During July 2004, the European Government bond trading desk (the "Desk") was encouraged by CGML to increase profits by taking more proprietary market risk and developing new trading strategies.

4.7. One of the traders on the Desk subsequently identified a trading opportunity which resulted from being able to calculate the aggregate firm bids and offers on other cash markets including the MTS electronic trading platform.

4.8. He observed that the visible liquidity in MTS (i.e. the visible firm bids and offers) had grown significantly and that bid/offer spreads had narrowed over recent months, making MTS more liquid, provided that the quoted bids and offers could be accepted ("hit") rapidly. It was also noted that there was an increasing correlation between Eurex and the cash markets, making trading across these markets seamless.

4.9. In the two weeks before 2 August 2004, four traders on the Desk[2] (the "Traders"), developed a strategy based on their observations. As part of the strategy, CGML devised a means of submitting a large number of orders simultaneously to hit the live bids on MTS**,** by reconfiguring the existing functionality on their trading software (MarketView). This used a "bulk aggress view" within MarketView to indicate the aggregate of all the firm bids or offers quoted on MTS across all sectors and bonds. This reconfigured software would enable them to submit multiple orders to be submitted across all MTS platforms, to capture all the bids within a specified price range almost instantaneously. This was in contrast to the normal system of submitting orders where individual orders would have to be manually input sequentially. The reconfigured software became known as the "spreadsheet". The functionality of the spreadsheet would enable CGML to sell a very large quantity of bonds rapidly and close to the mid-market price. In an electronic message sent between the Traders the trading strategy, utilising the spreadsheet, was nick-named "Dr Evil" after a fictional character.

4.10. Against this background, the Traders devised a trading strategy involving the following stages:

4.10.1. Firstly, creating over a period of days a "basis position" by which the Traders becomes long in cash bonds and short in futures;

4.10.2. On a chosen day (a day when the Traders expected the futures market to be rising but otherwise free of economic data announcements that may affect the price), close out the short futures position by buying futures contracts, leaving a long cash position; and

4.10.3. The rapid sale of the long cash position on MTS using the spreadsheet to capture all firm bids for a large number of bonds within a specified price range.

4.11. The basic strategy was set out in an e-mail on 20 July 2004, sent by the trader mentioned in paragraph 4.7 above[3], but not circulated or seen by some of the other Traders or their management prior to the execution of the trade on 2 August 2004. This trader was not part of the team which executed the 2 August 2004 trade.

4.12. The e-mail briefly described the way the market had developed in the recent past, and, then, how the opportunity might be exploited. The e-mail described the way in which the available liquidity in the MTS and other cash markets could be calculated and converted to a futures contract equivalent. It went on to state that when a liquidity

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[2] The two 5-year bond traders and the two 10-year bond traders

[3] One of two 30 year bond traders on the Desk. This trader held the position of Vice President. The other 30 year bond trader held the position of Director and had no involvement at all in the events which are the subject of the Notice.

imbalance existed (i.e. when the liquidity offered within, for example, 2 cents of the mid-market price for 10 year cash bonds, was greater than that required to move the futures price by 10 cents) the traders should "drive up" the futures and then "hit out all the cash" on MTS. The e-mail concluded with a list of what the author viewed as the potential benefits and side effects which execution of the strategy might have, aside from profitability to CGML, such as imposing a cost on competitors for offering liquidity on MTS, reducing the attractiveness of using the Bund future to hedge, widening cash market bid-offer spreads, an increase in the likelihood of competitors carrying out "copycat trades" and helping remove some of the smaller primary dealers from the cash market. The e-mail was not seen by all of the Traders and not all of the Traders agreed with the author's assessment of the possible side effects and benefits and the strategy evolved in the days leading up to 2 August 2004.

4.13. The strategy was developed and refined by the Traders over a period of around 2 weeks from 16 July 2004. The spreadsheet was developed from 20 July 2004 onwards. During that period the spreadsheet was tested in a test environment and with a small number of trades in a live environment.

4.14. The Traders discussed the strategy with the head of the Desk[4] (the "Head of Desk"). Following this discussion the Head of Desk on 28 or 29 July 2004 sought approval from the European Head of Interest Rate Trading, (the "European Head of Interest Rate Trading"), based on a proposed long futures position of around 25 – 40,000 Bund futures contracts equivalent. The European Head of Interest Rate Trading authorised the trade on that basis. However, there was not a common understanding between the Traders, the Head of Desk and the European Head of Interest Rate Trading as to the parameters of the size of the trade. CGML did not therefore ensure parameters for the size of the trade were clear, understood and communicated.

4.15. On 30 July 2004 the Traders came close to executing the strategy for the first time. They built up a long futures position in contemplation of executing the spreadsheet, but in the end decided to unwind that position on the futures market due to the speed of the rise in prices on the futures market.

## 5. Trading on Monday 2 August 2004

*Execution*

5.1. On the next trading day, following further discussions with management, the Traders decided the right market conditions were in place to make another attempt to execute the strategy. Between 09:12 and 10:29 am the traders purchased a total of 66,214 futures contracts on Eurex, the majority of which were 41,390 Bund contracts and 24,284 Bobl contracts. This equated to approximately a 55,000 Bund futures equivalent.

5.2. During the trading period, approximately 360,000 Bund and Bobl contracts were traded on Eurex by all market participants.

[4] On 27 July 2004 another person was appointed co-Head of Desk, but the latter played no significant part in trading strategy

5.3. The price of the Bund rose over the trading period from around €114.25 to around €114.61, and the Bobl from €111.06 to €111.21. As the price of cash bonds is closely linked to the futures price, the prices of cash bonds also rose. For example, the BTP 01/02/13 4.75% rose from €104.10 to €104.38; the OLO 43 09/14 4.25% rose from €99.66 to €99.97; and the DSL 15/07/14 3.75% rose from €95.86 to €96.15.

5.4. At the end of the buying period, the Desk had a risk position of just under €5 million DV01[5]. To put this into context, this was more than four times the level at which the Desk was authorised to hold a position overnight although there are no intra-day limits and trades frequently exceed end of day limits during the day. The Desk's overnight risk limit was US $1.25 million DV01 (equivalent to €1.04 million at the relevant time), and their normal end of day risk level was between US $0.5 million and US $1 million DV01 (equivalent to €0.42 million and €0.83 million respectively at the relevant time). CGML did not ensure parameters for the size of the trade were clear, understood and communicated.

5.5. In a period between 10:28 and 10:29 am, the Traders executed a sale in the cash market on MTS using the spreadsheet. The sale was executed in separate tranches for 5-year and 10-year bonds. Additionally, the Traders carried out some sales on other domestic platforms (HDAT and SENAF).

5.6. The majority of the bonds sold were on MTS with 188 orders being submitted in 18 seconds. 119 different government bonds were targeted across 11 MTS platforms.

5.7. The purpose of the sale of cash bonds was to close out CGML's long cash bond position, and to return to a flat position, where the risk position was zero. To do this the Traders needed to sell €8 to €9 billion nominal value of bonds.

5.8. In setting the parameters for the sale orders, the Traders aimed to err on the side of selling short i.e. the Traders wanted to ensure that *no less* than €8 to €9 billion nominal value of bonds were sold. The Traders set the price limit instruction at 3.0 cents (for 10-year bonds) and 1.5 cents (for 5-year bonds) below mid-market price, whilst the figures inserted in the size fields were €300 million (for 10-year bonds) and €500 million (for 5-year bonds). This ensured that price, and not size, was the sole determining factor.

5.9. The spreadsheet allowed the Traders to see that, given the above parameters, they were likely to sell around €11 - €12 billion worth of bonds if all the bids within those parameters would be hit. This would have resulted in the Traders selling around 20-30% in excess of the €8 to €9 billion worth of bonds they needed to sell to return to a flat position. However, the Traders' calculations assumed that there would be a failure rate of 20% - 30% i.e. that 20% - 30% of the orders submitted would fail. These estimations for the failure rate were not considered by management as part of the authorisation process. In the event there was no failure rate.

5.10. Within about the first 20 seconds of the spreadsheet being deployed, the Traders were unaware that CGML had received sale confirmations of the trades from MTS and the Traders became concerned that the spreadsheet had not worked and that CGML

[5] "Dollar Value of 0.01%" – a standard measure of risk reflecting the approximate change in price of the holding of a security for a one basis point change in yield (0.01%)

continued to retain a significant risk position. Accordingly, the spreadsheet was activated again with sell orders being re-submitted for the 5-year bonds targeted. Additionally, the Traders sold around 10,000 futures contracts.

5.11. Thereafter, the Traders started to receive sale confirmations. Once the Traders had received back all the sales confirmations, it became apparent that all or virtually all of the visible liquidity, plus some hidden liquidity, on MTS had been caught. The second hit of the spreadsheet had also caught additional trades in 5-year bonds as participants had added new bids into the market following execution.

5.12. Overall, on MTS, 158 of the 188 orders submitted were filled representing a sale of around €11.3 billion nominal value of bonds, the equivalent of an average day's volume of trading being sold on MTS in 18 seconds. In addition, around €1.5 billion nominal value of bonds was sold on other domestic cash markets. This, together with the selling of further futures contracts, resulted in CGML selling a total of €12.9 billion bonds (rather than €8 to €9 billion as anticipated) and incurring an unexpectedly large short position of around €3.8 billion nominal value of bonds, equating to a risk position of around €3 million DV01.

5.13. In response to this unexpected short position, the Traders began as rapidly as possible to try to reduce CGML's risk by purchasing futures and cash bonds. The spreadsheet had originally been configured only to sell bonds and had to be reconfigured to work in reverse (i.e. buy bonds). At 11:25 am the reconfigured spreadsheet was executed, which enabled the traders to close out their unexpected short position by buying €3.8 billion nominal value of bonds on MTS, returning the Desk to a virtually flat and risk neutral position. At the same time, CGML closed out some of its market risk by buying back at a lower price some of the bonds they had previously sold at the top of the market. This realised additional profit.

*Trading Profits*

5.14. The Desk made a profit of $18.2 million (£9,960.860[6]) on 2 August 2004 as a result of the sale of the long cash position and subsequent buy-back of cash bonds.

*Impact on prices*

5.15. The sale of cash bonds by CGML resulted in a fall in prices of the cash bonds as demonstrated by the samples in the table below. On futures, the Bund similarly fell from €114.60 to €114.33(0.2%); and the Bobl fell from €111.20 to €111.06 (0.12%).

| **Bond Type** | **Last bid price before CGML sale €** | **Time of last bid price before CGML sale (BST)** | **First bid price after CGML sale €** | **Time of first bid price after CGML sale (BST)** | **Price Difference (basis points)** | **Price Difference %** |
|---|---|---|---|---|---|---|

[6] Dollar / Sterling exchange rate of $1.8271 to £1 as at 2 August 2004, Bloomberg.

| | | | | | | |
|---|---|---|---|---|---|---|
| BTP 01/02/13 4.75% | 104.38 | 10:28:57 | 103.99 | 10:33:28 | 39 | 0.37 |
| DBR 04/07/14 4.25% | 100.61 | 10:28:59 | 100.44 | 10:31:46 | 17 | 0.16 |
| DSL 15/07/14 3.75% | 96.15 | 10:28:33 | 95.95 | 10:46:55 | 20 | 0.21 |
| OAT 25/04/14 4.00% | 98.5 | 10:28:30 | 98.33 | 10:38:27 | 17 | 0.17 |
| OBLE 30/07/14 4.75% | 104.47 | 10:28:32 | 104.30 | 10:38:26 | 17 | 0.16 |
| OT 16/06/14 4.375% | 100.89 | 10:28:37 | 100.74 | 10:39:37 | 15 | 0.15 |
| OLO 43 09/14 4.25% | 99.97 | 10:28:33 | 99.82 | 10:39:44 | 15 | 0.15 |

5.16. Although the average daily price volatility for the cash bonds and futures contracts traded were lower on 2 August 2004 than for the average of the year to date in each market, the price movement on the cash market was notable for the extent of the drop over a very short period. Although price fluctuations of this degree do occur on the Euro government bond markets, it is rare for them to do so in the absence of an extraneous market event (e.g. the release of economic data). It is uncommon for such volatility to be caused by the trading of one participant on the cash market alone.

5.17. The price impact on the cash market was relatively short lived. Prices quickly regained some of their fall, and most regained about 50% of their fall within an hour, to reach a trading level equivalent to, or above, their opening level at the beginning of the day (although this rebound to previous levels may have been partly due to CGML's €3.8 billion purchase at 11:24 am). The futures market showed a similar reaction.

*Liquidity*

5.18. On MTS, all bids within 3 cents of the market midpoint in the 10 year sector and 1.5 cents in the 5 year sector for the 119 bonds targeted were sold. This had the immediate effect of causing a hiatus in visible quotes on the MTS platform.

5.19. In the immediate aftermath of the execution of the spreadsheet, some MTS participants temporarily withdrew from the market.

5.20. For example, on a sample of seven bonds in which CGML sold significant quantities, the number of participants providing quotes and displaying visible quotations on the MTS system reacted as follows:

| | **10:25 (BST)** | | **10:35 (BST)** | | **10:55 (BST)** | |
|---|---|---|---|---|---|---|
| **Bond Type** | **No. of quoting participants** | **Total volume quoted € million** | **No. of quoting participants** | **Total volume quoted € million** | **No. of quoting participants** | **Total volume quoted € million** |

| | | | | | | |
|---|---|---|---|---|---|---|
| BTP 01/08/14 4.25% | 23 | 160 | 4 | 20 | 7 | 40 |
| DBR 04/07/14 4.25% | 19 | 165 | 2 | 10 | 3 | 35 |
| DSL 15/07/14 3.75% | 13 | 120 | 0 | 0 | 3 | 10 |
| OAT 25/04/14 4.00% | 22 | 190 | 0 | 0 | 3 | 30 |
| OBLE 30/07/14 4.75% | 16 | 160 | 0 | 0 | 2 | 20 |
| OT 16/06/14 4.375% | 15 | 140 | 0 | 0 | 2 | 20 |
| OLO 43 09/14 4.25% | 20 | 190 | 0 | 0 | 4 | 40 |

5.21. There is a similar picture for the other cash bonds targeted by CGML, with the total available liquidity for those 119 bonds falling from around €12.4 billion at 10.25 am to €195 million at 10.35 am and then to €2.1 billion at 10.55 am.

5.22. MTS's customary visible quotes returned across the platforms at different rates with quotes apparently returning for the more liquid bonds before those of the less liquid bonds. For the most liquid and heavily traded bonds, it returned to normal levels (considering the time of day) after around two to two and a half hours (i.e. between 01.00 pm and 01.30 pm). However, some MTS participants withdrew their quotes for up to three days.

*Market Reaction*

5.23. Some market participants ceased quoting for varying periods of time.

5.24. MTS considered it necessary to introduce emergency measures to restore confidence in the market following CGML's trading. A new rule was brought into effect on 4 August 2004 limiting the volume of trades that could be effected to no more than €1 billion in any two minute period, or to 20% of the average trade over the past 10 days, whichever was the greater. The rule was revoked on 10 September 2004.

## 6. Contravention of Principle 3 – Failures in Systems and Controls

6.1. CGML's systems and controls in relation to the Desk on 2 August 2004 were inadequate in a number of material respects. Specifically:

6.1.1. There was inadequate communication of CGML's policies and procedures on escalation and/or inadequate compliance training on escalation matters which gave rise to the failure described at paragraph 6.1.2 below to escalate the trading to appropriate levels within CGML and/or the failure to consult with applicable control functions.

6.1.2. Although escalation of the trading strategy to management did occur, there were inadequate systems and controls in place to ensure that the details of the strategy were escalated adequately and in advance to senior management. There was also a failure to consult with applicable control functions. As a result, the trading strategy was not considered by Compliance, Legal or independent Risk Management before it was executed on 30 July 2004 (in part) and on 2 August 2004. Accordingly, insufficient weight and attention was given to:

- the franchise risk to which the trading gave rise;

- the execution risk arising from, amongst other things, the use of a spreadsheet that was not fully testable;

- the market impact risk i.e. that the trade might have an adverse effect on price and on quotation levels on MTS and the effect this might have on market confidence; and

- legal and regulatory risk resulting from the above.

CGML's escalation policies have since been enhanced as set out in section 9 below.

6.1.3. There were inadequate systems for the supervision of traders on the Desk. In particular:

- In the absence of clear, understood and communicated parameters, the Traders purchased 66,214 futures contracts (55,000 bund future equivalent) in total on Eurex on 2 August 2004. This was significantly in excess of the number which had been considered by the European Head of Interest Rate Trading;

- the unexpected over-selling of cash bonds on 2 August 2004, resulted in an unexpectedly large short position of around €3.8 billion nominal value of bonds which the traders had to work to cover. Neither the Traders nor the Head of Desk became aware that this position had been incurred until around 10:40 am.

6.1.4. There was a failure by CGML to register one of the traders on the Desk with Eurex which led to unauthorised trading being conducted on Eurex.

6.1.5. The Desk was inadequately trained in respect of observing proper standards of market conduct. In particular:

- market abuse training was only provided to CGML employees on the introduction of the market abuse regime on 1 December 2001, a date known as "N2" and not thereafter;

- the Traders employed at the time did not attend the market abuse training provided on N2;

- although the Desk did receive some compliance training, and written material in respect of observing proper standards of market conduct was available within CGML, the email dated 20 July 2004, referred to at paragraph 4.11 / 4.12 above, contained language which suggested that the author had been inadequately trained on market conduct issues;

- CGML has since provided further training in relation to market conduct to its employees as set out in section 9 below.

6.2. By reason of the failings set out at paragraph 6.1 above, the FSA considers that CGML has contravened Principle 3.

## 7. Contravention of Principle 2 – Failure to act with due skill, care and diligence

7.1. The FSA considers that CGML's conduct in relation to the trade of 2 August 2004 :to be a very serious instance of failure to conduct its business with due skill, care and diligence in that in planning, authorising and executing the strategy, CGML :

7.1.1. did not have due regard to the inherent risks including the likely consequences the execution of the trading strategy could have for the efficient and orderly operation of the MTS platform;

7.1.2. did not ensure that clear parameters for the size of the trade were understood, communicated and reviewed.

7.2. The centre-piece of the trading strategy was the deployment of the spreadsheet which was designed to execute the simultaneous sale of a very large number of bonds on MTS. From its inception, the trading strategy was clearly careless in view of the ordinary levels of trading volume on MTS and the amount of visible quotes on that platform. It was foreseeable that the execution of the trading strategy ran the significant risk of disrupting visible quotes and therefore the efficient and orderly operation of the MTS platform.

7.3. The FSA considers that, to the extent that the risks inherent in the trading strategy were considered by CGML in the planning and authorisation of this trade, that exercise was carried out with insufficient skill, care and diligence.

7.4. The testing of the spreadsheet carried out by CGML was not capable of creating a reasonable or statistically meaningful basis for assessing what would happen if a very large number of orders were submitted on MTS simultaneously. The Traders' estimates of what would happen, including their assessment of the likely failure rate in respect of trades submitted, were therefore made without any scientific basis and resulted in CGML selling in excess of the number of cash bonds it needed to sell in order to return to a flat position.

7.5. The FSA further considers that CGML's execution of the trading strategy based on presumptions about the spreadsheet's functioning that were not supported by scientific analysis constituted a serious failure of skill, care and diligence.

7.6. CGML failed to take care to ensure that in planning and authorising the trade, clear parameters for the size of the trades were defined, communicated and understood and reviewed during execution. This further contributed to the excessive scale of the trading and increased the risks to the MTS platform.

7.7. The average daily volume of trading on MTS at the relevant time was around €13.5 billion. In the event, CGML sold bonds close to the average total daily volume on MTS. Moreover, these sales were executed by the Traders in the space of 18 seconds.

7.8. By reason of the failings set out at paragraphs 7.2 to 7.7 above, the FSA considers that CGML has contravened Principle 2.

## 8. Effect of the Trade

8.1. The effect of simultaneously capturing all the bids on MTS was to cause a hiatus in visible quotes and volumes traded on the platform. In addition, prices dropped sharply. The resulting confusion on the MTS platform caused some market participants to withdraw their quotes for up to three days.

## 9. Mitigation

9.1. The FSA acknowledges that it has received from CGML very good co-operation during the course of the investigation.

9.2. CGML has publicly stated that it regrets having executed the trade and that it fell short of its own standards.

9.3. CGML has taken action to remedy the Principle 2 and 3 contraventions identified above. Specifically:

9.3.1. CGML's escalation policies have been enhanced. The Chief Executive of Citigroup has personally emphasised to all staff the expectations of the bank as to the compliance standard required of all employees, and the need, in case of any doubt, to contact Compliance, Legal and Risk Management directly. Senior management within the Fixed Income Division have similarly taken steps to reinforce the same message to all their staff. Further, CGML is in the course of rolling out a web-based training module specifically focused on escalation.

9.3.2. In relation to training, refresher training in relation to market conduct has been provided to all Fixed Income and Equity, Research and Investment Banking staff. This had in fact been planned and developed prior to the 2 August 2004 trade and has now been fully rolled out. Further enhanced web-based compliance training (again planned and developed before the 2 August 2004 trade) has been fully implemented and made available. All staff also now receive an annual refresher training course.

9.3.3. CGML has invested in the purchase of third party surveillance software which is in the course of being rolled out. This will enhance the monitoring and surveillance capabilities of CGML, including in relation to the Fixed Income Division.

9.4. CGML has enhanced and strengthened its Compliance resource by increasing head count, and by focusing more of the available resource onto Fixed Income. It has relocated all Fixed Income Sales and Trading Compliance professionals to the trading floor in order to improve the liaison with the Fixed Income Division including the Desk.

9.5. The FSA is satisfied that senior management within the bank have taken the matters raised by this trade, and the concerns raised by its regulators including the FSA, extremely seriously and have been fully engaged in seeking to resolve the matter and ensuring the correct remedial actions are taken.

## 10. Penalty

10.1. In consequence of the above, CGML is in contravention of Principles 2 and 3 of the Principles for Businesses. The FSA therefore proposes to impose a penalty pursuant to section 206 of the Act in respect of this contravention.

10.2. The matter of regulatory concern is the serious corporate failings of CGML. The FSA is not taking action against any of the individuals concerned.

10.3. The FSA's policy in relation to the imposition of financial penalties is set out in Chapter 13 of the Enforcement Manual ("ENF") which forms part of the FSA's Handbook. The primary purpose of imposing a financial penalty is to promote high standards of regulatory conduct by deterring firms who have breached regulatory requirements from committing further contraventions, helping to deter other firms from committing contraventions and demonstrating generally to firms the benefit of compliant behaviour.

10.4. The severity of the penalty should reflect the degree of wrongdoing in each case and be proportionate to the breach in question. The level of financial penalty should also take into account all the relevant circumstances of the case (ENF 13.1.2). In setting the level of penalty in this case, the FSA has had particular regard to the points of mitigation set out in section 9 above. It has also taken into account the following particular matters.

*Seriousness*

10.5. CGML is part of the largest financial institution in the world. CGML has the financial resources at its disposal to ensure that its internal arrangements are compliant. CGML's financial resources allow it to trade in large volumes and take significant risks. The FSA therefore expects high standards of a firm of CGML's size. It behoves a firm such as CGML to take particular care when trading on a platform such as MTS to consider all the risks associated with its trading for the efficient and orderly operation of the platform.

10.6. The FSA considers that CGML's conduct on this occasion constituted a serious breach of the FSA's principles for authorised firms.

*Whether conduct deliberate or reckless*

10.7. The FSA has regard to the extent to which it considers the conduct was deliberate or reckless. (ENF 13.3.2 (b)).

10.8. In this regard the FSA notes that the main issue of regulatory concern was the failure by CGML to take due care to consider the impact the trade would be likely to have (and indeed did have) on MTS. However, the FSA notes that CGML did not deliberately set out to disrupt the efficient and orderly operation of the MTS platform. The success of the trading strategy did not depend on price positioning or other distortive behaviour.

10.9. Whilst the FSA does consider that CGML was careless in its failure to pay proper regard to the market impact of its trading strategy, it does not consider CGML's conduct to have been reckless in all the circumstances.

*Profits accrued*

10.10. The FSA notes that CGML made considerable profits, amounting to $18.2m (£9,960.860) out of the trading strategy as a whole, and in determining what action to take is guided by the principle that a person should not benefit from a contravention of FSA's Principles.

*Losses caused*

10.11. In considering the seriousness of the contravention, the FSA takes into account the losses caused to other market participants as a result of the contravention. However, it also recognises that the counterparties to the trades conducted by CGML are professional market counterparties who can be expected to understand the nature of their commitments when providing quotations on MTS.

## 11. IMPORTANT

This Final Notice is given to CGML in accordance with section 390 of the Act.

**Manner of and time for Payment**

The financial penalty must be paid in full by CGML to the FSA no later than 12 July 2005.

**If the financial penalty is not paid**

If all or any of the financial penalty is outstanding on 13 July 2005, the FSA may recover the outstanding amount as a debt owed by CGML and due to the FSA.

**Publicity**

Sections 391(4), 391(6) and 391(7) of the Act apply to the publication of information about the matter to which this notice relates. Under those provisions, the FSA must publish such information about the matter to which this notice relates as the FSA considers appropriate. The information may be published in such manner as the FSA considers appropriate. However, the FSA may not publish information if such publication would, in the opinion of the FSA, be unfair to you or prejudicial to the interests of consumers.

The FSA intends to publish such information about the matter to which this Final Notice relates as it considers appropriate.

**FSA contacts**

For more information concerning this matter generally, you should contact Jamie Symington at the FSA (direct line 020 7066 1256 / fax: 020 7066 1257).

Carlos Conceicao
**Enforcement Division**
**The Financial Services Authority**