SFC takes action disciplinary action against Mr Bjorn Magnus Eriksson

22 Dec 2000

The Securities and Futures Commission ("SFC") today announced that it had taken disciplinary action against Mr. Bjorn Magnus Eriksson ("Mr. Eriksson") for misconduct under section 56 of the Securities Ordinance and section 36 of the Commodities Trading Ordinance for his role in dealings through the following companies by the Indosuez W. I. Carr Group ("the Group") namely:

> Indosuez W. I. Carr Securities Limited formerly known as W.I. Carr (Far East) Limited ("Carr FE Securities");
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> Indosuez W.I. Carr Securities (Hong Kong) Limited formerly known as W.I. Carr Hong Kong Limited ("Carr HK Securities"); and
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> Indosuez Carr Futures Limited formerly known as W.I. Carr (Futures) Ltd. ("Carr Futures").

Details of the disciplinary action and the SFC's findings are given in the attached Annex 1.

The SFC has publicly reprimanded Mr. Eriksson as a person concerned in the management of Carr FE Securities, Carr HK Securities and Carr Futures. The SFC was concerned by an apparent intention, in collaborating in the formulation of and implementing the November Expiry Strategy, to seek to influence the closing price of the Hang Seng Index on the expiry date of the November HSI futures and options and the cash settlement price of these contracts. The SFC was also concerned that disturbance which the implementation of the Strategy caused in the Hong Kong markets, was potentially prejudicial to the interests of members of the investing public. The SFC's action took into account that since his departure from the Group in late 1996, when his registration as a dealer of Carr HK Securities, Carr FE Securities and Carr Futures lapsed by operation of law, Mr. Eriksson had not held any registrations with the SFC.

SFC's Findings

The disciplinary action resulted from extensive inquiries by the SFC in 1997 into dealings through Carr FE Securities, Carr HK Securities and Carr Futures by the Indosuez W.I. Carr Group ("the Group") between the 19th and 28th November 1996 on the Stock Exchange of Hong Kong Limited ("SEHK") and the Hong Kong Futures Exchange Limited ("HKFE"). The activity by these entities was executed by the Group's proprietary trading desk ("the Trading Desk"). Mr. Eriksson was the head of the trading team that carried out the proprietary trading for the Group and had overall responsibility for executing the proprietary trading in particular the trading on 28 November 1996. This activity involved the Group's actual capital and no customer funds or accounts were implicated.

The SFC's powers under section 56 of the Securities Ordinance (Cap 333) and section 36 of the Commodities Ordinance (Cap 250) enable the SFC to sanction conduct which is or may be prejudicial to members of the investing public.

Background: the trading activity

The Group held proprietary positions in the cash, futures and options markets during November 1996. Between 21st and 26th November 1996 the Trading Desk gave instructions to futures brokers to close the Group's existing short positions in November Hang Seng Index Futures Contracts ("HSI futures") and to purchase long contracts in November HSI futures. By the close of business on 27th November, the day before the expiry day of the November HSI futures contracts and Hang Seng Index Futures Options ("HSI Options"), the Trading Desk's book had gone from 4579 short November

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HSI futures on 18 November to 4180 long November HSI futures. In the same period the Trading Desk bought November long HSI call options traded on HKFE. On 18th November it held 595 such options but at the close of trading on 27th November held 7623 options. In addition they held over the counter November long HSI call options equivalent to 300 HSI options traded on HKFE. These contracts and options were to be cash settled by reference to the final settlement price of the HSI on 28th November 1996. These trades would be profitable if the HSI rose on expiry day.

On 28th November 1996, the expiry date of the November HSI futures contracts and options contracts, the Trading Desk went to an expiry in relation to its position in respect of its long November HSI futures contracts. It placed orders with Carr FE Securities and 7 other independent brokers to purchase parcels of 33 individual securities ("the constituent stocks") that make up the Hang Seng Index equivalent to about 4800 November HSI futures contracts, worth approximately HKD3.3 billion. Analysis of the securities trading in the constituent stocks on behalf of the Trading Desk showed that:

- Initial bids, higher than the previous closing price, were entered resulting in successful opening bids for 8 of the 33 constituent stocks. This is possible because there is no upward limit placed on the first or "opening bid" under SEHK trading rules.
- Where the initial bids were unsuccessful, "sweeping" occurred. Sweeping refers to the clearing of the "ask" queues in a particular stock. The bidding rules of SEHK limit price movements. The only way a trader attempting to set the price of a stock could achieve this result is by purchasing all the stocks on offer and then inputting his higher bids i.e. "sweeping". Once the ask queues had been cleared, bids at a higher level were input. The brokers succeeded in clearing the queues and inputting higher bids in another 6 of the constituent stocks.

The SFC considers that such trading activities by the Trading Desk were consistent with an intention to push the HSI higher.

The Hang Seng Index opened 142 points or some 1.04% higher at 13,672 points. The SFC was concerned that this was as a result of these activities. During the first 15 minutes of trading the Hang Seng Index rose a further 72 points to the days high of 13,744 points before falling back to close the morning session at 13,499 points.

The Index used to calculate the final settlement price of the expiring HSI futures and HSI options is based on the average of the prices of the 33 constituent stocks on the last trading day of the particular contract. In order to ascertain the average of the prices of the constituent stocks, the actual prices are sampled 47 times during the day at 5-minute intervals. These samples are often referred to as "snapshots". It was observed in early trading that the price of a number of the constituent stocks moved more than 3% higher than their price in the preceding minute. As a result, and in accordance with a predefined formula used for calculating the final settlement price of the expiring HSI futures and HSI options, the snapshots for the first 10 minutes of trading were automatically disregarded from the calculations.

The SFC found a particular pattern of trading by the Trading Desk on 28th November 1996 involving aggressive buying activity of the 33 constituent stocks throughout the remainder of the day on behalf of the Group. It is possible for a trader to improve his chance of having his price selected for the "snapshots" by breaking down an order for a substantial quantity of stocks into many small orders of one board lot and then executing the transactions in rapid succession around the time of the "snapshot". This involves repeated tapping of the key on his keyboard used for accessing the SEHK's computerized trading system and is accordingly known as "tapping". The SFC found that "tapping" occurred frequently at the current ask price and if the "ask" queue was cleared then the "ask" was tapped at one spread higher or at the next "ask" price.

During the morning session of the expiry day, the Hang Seng Index rose to a high of 13,744 points before selling pressure caused it to lose momentum and then to fall below the previous day's close of 13,530 points before finally closing at 13,310 points. The buying activity and the tapping, particularly during the morning session, affected the samplings for the final settlement price. The final settlement price of the expiring HSI futures and HSI options was calculated at some 178 points higher than the close of the Hang Seng Index on expiry day.

Background: the approved strategy

The SFC's inquiry found that senior management had, on two occassions between 21st November 1996 and 27th November 1996, approved in writing the following strategy referred to as "the November Expiry Strategy". Mr. Eriksson had collaborated in the formulation of this Strategy before approval was sought. Per this strategy, the futures contracts would be allowed to expire and a corresponding quantity of physical stock would be purchased to replace the futures contracts. The strategy only required approval because the Trading Desk would need to increase the Group's trading limits so that it could purchase long November HSI futures contracts. These futures contracts would be allowed to expire and a corresponding quantity of physical stock would be purchased to replace the futures contracts.

Mr. Eriksson and the Trading Desk expected that their trading would contribute to an increase in the price of the 33 constituent stocks and with it the Hang Seng Index. If this happened, the Group would profit from the call options that it already had, and planned to buy. In the event, the implementation of the strategy was unsuccessful. Mr. Eriksson's trading team on behalf of the Trading Desk had bought shares at average prices higher than the final settlement price, and had over-purchased shares.

The actions of Mr. Eriksson in this case were of concern to the SFC for two principal reasons. The first was the apparent intention behind the November Expiry Strategy to potentially influence the closing price of the Hang Seng Index on the expiry date of the HSI futures and HSI options and the cash settlement price of these contracts. The second was the disturbance which the implementation of the November Expiry Strategy caused in the market, irrespective of the motives of the Group in formulating this strategy.

The SFC does not view the trading that occurred as arbitrage trading. Genuine index arbitrage seeks to profit from exploiting the price differentials that arise between the price at which the HSI futures contract is trading at a particular point in time and the price at which the equivalent basket of physical stocks is trading at the same time on the SEHK. The Group had an arbitrage book, an options book and held stock. These could have been used, under appropriate market conditions, to derive a profit from existing price differentials. However the SFC considers that the November Expiry Strategy was not based on the various proprietary books of the Group; rather the books themselves were based on the November Expiry Strategy. The SFC also does not view the purchase of the "call options" as a "directional play". There is no objection to market transactions based on the view that the securities purchased will rise in value. This happens every day. The position is different where the price is intentionally pushed up by one's own buying and a position is taken, as in this case with the long call options, to profit from that buying. The SFC recognises that the transactions in question involved real purchases with genuine counterparties and actual capital at risk. The SFC, however, considers that the object of the November Expiry Strategy was to improperly push up the price of shares to increase the Hang Seng Index, and that insufficient management consideration was given to the potential effect of the Group's actions or to the question as to whether such trading was in fact proper.

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