complaint

Mr S's complaint is that Saxo Capital Markets UK Limited (SCML) acted wrongly when it changed the price of his trades in EURCHF options. This resulted in his account moving into a very substantial deficit.

background

At 9.30am on 15 January 2015, the Swiss National Bank ('SNB') announced it would no longer guarantee a 'floor' in the EUR/CHF exchange rate at a level of 1.20. This caused a sharp move higher in the value of the Swiss franc.

Mr S had EUR/CHF put options open on his account. At 09.30.52 on the above date, he received trade confirmations that his positions had been closed at 1.1860, leaving his account at £41,789.10. At 11.52am, he was sent an email saying that owing to market movement in CHF crosses, all executed trades would be amended, which might result in a worse execution rate than was originally confirmed to him. Around 9pm that day, SCML revisited Mr S's trades and amended the closing price to 0.9625. This meant that his account entered a negative balance of £739,140.88, which represented a sum owed to SCML.

SCML requested the amount owed to be paid by 23 January 2015. Mr S wrote to SCML, asking for additional information and evidence in order to satisfy himself as to whether it was entitled to make the price adjustments, and whether the final price he received was correct. Dissatisfied with SCML's response on the matter, he referred his complaint to our service for independent review.

In summary our adjudicator concluded:

- No evidence had been presented showing that the original price of Mr S's trade had been manifestly wrong or that there had been a lack of liquidity in the market.
- The evidence showed that at the time of Mr S's trade there was in fact reasonable liquidity in the market.
- The evidence also showed that the price of Mr S's original trade was within the market range at the time.
- Mr S's contract with SCML only specified that he would trade with SCML as principal. The contract made no mention of matching trades with Saxo Bank or with any other counterparty.
- The contract between Mr S contained no provision for SCML to pass on to Mr S losses (or profits) arising from Saxo Bank's hedging activities.

The adjudicator's view was that Mr S's trade should be reinstated at its original closing price.

SCML didn't agree with the adjudicator. In reply it made the following main points:

- SCML had acted fairly throughout and in the best interest of all its clients

- Mr S was a very experienced investor who wouldn't reasonably have assumed his trades wouldn't be changed.

- The manifest error clause relied on didn't only require a *price* to be manifestly wrong. It said any '*ingredient of a transaction'* may be manifestly wrong. SCML has said the price was based on 'erroneous' information or assumption.

- The particular assumption that was wrong was that there was adequate liquidity in the market at the time of Mr S's trade.
- It had provided trading data from Saxo Bank (SCML's parent company) that showed the absence of liquidity. Between 9.30 and 9.32 Saxo Bank was only able to execute 11% of the order size it tried to execute with its liquidity providers.
- The prices that SCML received from Saxo Bank were '*ghost prices'* that didn't have any liquidity behind them.
- It was fair to use the prices that Saxo Bank was itself able to achieve trading on EBS.

my provisional decision

I issued a provisional decision on 22 September 2016 upholding Mr S's complaint. My main provisional findings were:

- The terms and conditions of Mr S's account didn't allow SCML to aggregate Mr S's trade.
- At the time of Mr S's trade there was still ample liquidity being quoted to Saxo Bank by its liquidity providers.
- The manifest error clause wasn't reasonably applicable on the grounds of either price or liquidity.
- Having considered the circumstances of Mr S's trade, I concluded that what had happened was the transfer to Mr S of losses suffered by Saxo Bank. I saw no fair or reasonable basis for this.

The fair compensation I proposed was broadly that SCML should reinstate the terms of Mr S's original trade and refund the additional loss applied to his account. I also proposed interest to be payable as well as compensation for the upset caused to Mr S by SCML's actions.

responses to my provisional decision

SCML asked me to re-consider my finding regarding the occurrence of a 'manifest error', saying that its view was supported by an advisory opinion given by the Danish Maritime and Commercial High Court on 18 October 2016.

SCML pointed to what it described as an important distinction between (a) available liquidity which Saxo Bank's liquidity providers posted to Saxo Bank and (b) available liquidity capable of execution.

SCML said the opinion of the Danish Court was clear on this point:

> *"In the opinion of the expert lay assessors, whose opinion the legal judges of the Court accept, there was no liquidity in the market for the EURCHF currency pair on 15 January 2015 at 10:30:48 (CET). Consequently, it was not practically possible to*

> *execute transactions at the prices appearing from the notifications from Saxo Bank…"*

SCML said its view, as evidenced by the Danish case, was that liquidity issues were so significant as to allow them to rely on the manifest error clause.

For his part, Mr S confirmed his agreement with my provisional decision. His other points, briefly summarised, were:

- The retrospective aggregation was only for SCML's benefit.
- The Danish Court case was irrelevant. SCML hadn't properly explained its background and context. And SCML had chosen to remain silent about the case until I'd made my provisional decision.
- The equivalent of the Financial Ombudsman Service in New Zealand had considered a case involving CMC Markets NZ Ltd and one of its clients on the same subject matter and had concluded:

  "I accept there was market volatility, however I am not satisfied on the evidence that by 9:30:51 CMC Markets' platform was unable to provide valid, tradable prices. I consider that the prices generated on CMC Markets' platform at 9:30:51 were close to underlying market conditions and that there were not yet 'Circumstances Outside of Our Control'."

More recently, SCML has submitted for my consideration the final judgment dated 22 December 2016 of the Danish Court in the Danish case. The final judgment is in broadly the same terms as the advisory opinion.

At the same time, SCML also submitted for my consideration a decision dated 14 December 2016 of the Danish Complaint Board of Banking Services in a complaint brought by a customer (not Mr S) against Saxo Bank. The case concerned the *"execution of the complainant's stop-loss order in the context of a sudden sharp appreciation of the Swiss franc"* and the *"adjustment of [the] automatically generated settlement rate"*.

The Danish Complaint Board's findings include these (according to a translation kindly supplied by SCML):

> *"In accordance with the assessment in the reprimand issued by the Danish Financial Supervisory Authority on 7 July 2015 to Saxo Bank, the Complaint Board takes for its basis that the method applied by the bank for determining the adjusted settlement rates contributed to equal treatment of the bank's clients and was not biased towards the interests of the bank. On that basis, the Complaint Board finds that it must be applied* [sic] *that, by the method applied, the bank sought to achieve the best outcome for the complainant under the circumstances.*
>
> *"Accordingly, the Complaint Board does not find that the complainant is entitled to settlement of the foreign exchange trades at the stop-loss rate/the rate automatically generated, but must accept that the bank adjusted the settlement rate as described in the reprimand issued by the Danish Financial Supervisory Authority on 7 July 2015. Accordingly, the Complaint Board cannot order the*

> *bank to reduce its claim against the complainant resulting from the adjusted settlement rate."*

my findings

I've considered all the available evidence and arguments to decide what's fair and reasonable in the circumstances of this complaint.

A number of currency pegs over the years have been abandoned and extreme volatility generally results. The scale of the move was I understand unprecedented, being one of, if not the largest one day move in a major currency.

In such a situation some dislocation and breakdown in trading systems is to be expected. I don't consider that what happened on 15 January 2015 should be treated as a normal day. In considering the actions of SCML that day and how its systems coped with trading conditions, this needs to be borne in mind.

The Swiss National Bank announcement was made at 9.30am. It took around 20 seconds for the market to react and the pace of the fall in the EURCHF pair accelerated as the value of the Swiss franc rose sharply.

Owing to the sharp fall in the value of the EURCHF pair Mr S's account went into margin deficit. This caused a close out order to be generated. This order was executed at 9.30.52 at a price of 1.1860. An email confirmation was sent to Mr S.

SCML later re-priced the trade to reflect prices achieved by SCML's parent company (Saxo Bank) trading on a currency trading platform (EBS) from 9.33 onwards. The trade was later re-priced to 0.9660.

the nature of Mr S's trading with SCML

The terms and conditions of the account define an 'OTC' trade in the following way:

'OTC shall mean any contract concerning a commodity, security, currency or other financial instrument or property including any option, future, or CFD which is not traded on a regulated exchange but 'over the counter' by us whether as a market maker…'

Based on SCML's definition I'm satisfied the product that Mr S was trading, as it wasn't a product trading on a regulated exchange, was an OTC product.

The terms (section 5.5) also confirm that when SCML trades OTC products the following applies:

'When carrying out OTC, options and futures transactions, we act as principal and therefore carry out transactions in our own name. When carrying out exchange contracts (with the exception of options and futures contracts) we will act as agent on an undisclosed principal basis and therefore carry out transactions on our own name but on your behalf and you will be directly responsible for the transaction.'

I am therefore satisfied that Mr S was trading with SCML and that it was acting as principal when it traded with him.

The order execution policy says the following about OTC trades in which SCML act as principal.

'SCML uses automated systems to route and execute client orders; therefore we are dependent on the technology provided by Saxo Bank A/S for routing the orders to the appropriate execution venue. <u>When your order is received by us and if we effect your order as principal for an Over-the-Counter ("OTC") transaction with SCML as the counterparty, SCML act as the sole execution venue of your orders</u>. However, if we effect your order as agent it is automatically routed to an execution venue determined by Saxo Bank A/S to achieve the best execution according to this policy...'
(my emphasis)

Mr S's trade as originally executed was between him and the counterparty to the trade SCML. The original trade wasn't aggregated with any other clients either of SCML or Saxo Bank.

Late in the evening of 15 January SCML retrospectively changed the terms of Mr S's trade. It aggregated Mr S's trade both with other SCML clients as well as with clients of Saxo Bank. It then re-priced Mr S's trade based on the outcome of Saxo Bank's trading in the underlying market.

The terms and conditions of the account say the following about aggregation:

'The client's orders may at the discretion of SCML, be aggregated with SCML's own orders, orders of any of SCML's associates and/or other clients. Furthermore, SCML may split the client's orders as well as aggregate orders before executing such. Orders will only be aggregated or split where:

It is unlikely that the aggregating of orders and transactions will work overall to the disadvantage of any client whose order is to be aggregated and

It is disclosed to each client whose order is to be aggregated that the effect of aggregation may work to its disadvantage in relation to a particular order.'

Whilst the terms allow for aggregation they make no provision for the retrospective aggregation of client trades. Mr S's order was aggregated not only with other SCML clients but also with clients of Saxo Bank. The terms make no reference to this type of aggregation taking place. The terms also only allow for aggregation where it is unlikely to work to the disadvantage of *any* client whose order is aggregated. However, when the retrospective aggregation of Mr S's order took place SCML knew that it would work to Mr S's disadvantage (his order was re-priced from 1.1860 to 0.96).

The above clause mirrors the regulatory restrictions on aggregation which are set out in COBS 11.3.

I'm therefore satisfied that the terms and conditions don't allow SCML to take the action it did in aggregating Mr S's trade. So when deciding whether Mr S's trade was properly executed I will only consider the trade as originally executed at 9.30.52 (i.e. unaggregated).

what justification does SCML have for re-pricing the trade?

SCML says it was reasonable for it to re-price Mr S's trade as '*the transaction was based on a manifest error*'.

Section 7.9 of the terms and conditions covers manifest errors and says the following:

'We reserve the right to void or to amend the terms of any transactions that we reasonably believe at our sole discretion to contain or be based on <u>an obvious or palpable error</u> *(a manifest error). In deciding whether an error is a manifest error we may take into account any relevant information including the state of the market at the time of the error and any error within or lack of clarity of any information source or pronouncement.'*
(my emphasis)

It should be noted that while the above wording refers to SCML's 'sole discretion', it also refers to SCML *reasonably* believing something to be the case.

SCML's principal objection to the trade is the lack of liquidity.

liquidity

SCML has provided data from Saxo Bank showing the liquidity provided by liquidity providers to Saxo Bank.

In addition to the above chart of available liquidity Saxo Bank has provided data about the actual volumes that were traded with the liquidity providers. This shows that in the first minute following the SNB announcement Saxo Bank executed just under 18m EURCHF. This was just over half the trade volume requested. So whilst there was a significant reduction in liquidity, it's not in my view correct to say there was no liquidity. I therefore don't accept that *"there was no liquidity in the market for the EURCHF currency pair on 15 January 2015 at 10:30:48 (CET)"* (the Danish case).

SCML has also provided the following chart which shows liquidity on the EBS trading system. EBS is probably the closest to a reference venue for foreign exchange trading.

It's clear from the above charts that at the time of Mr S's trade (9.30.52) there was still ample liquidity being quoted to Saxo by its liquidity providers. It's equally clear that liquidity very quickly dried up: by 9.33 it was substantially reduced and by 9.35 it had all but disappeared.

This conclusion is consistent with data from other market participants.

FXCM, a major CFD and currency firm, has published on its website an account of its experience on 15 January. It has said the following:

FXCM executed approximately 200 million in total volume before 4:30:56 in the 1.17 to 1.20 range. At 4:30:57, FXCM's circuit breakers engaged and would not execute the remaining approximately 1 Billion until the market began to function with stable pricing. FXCM's system circuit breakers deploy to halt new quotes and trading, and are designed to protect clients against erroneous quotes and off-market trades.
(the time represents US time).

FXCM operates on a matched principal basis and trade volumes and prices represent trades executed by FXCM with external liquidity providers on behalf of its clients i.e. they represent trades in the underlying market.

were price/liquidity issues sufficient to engage the manifest error clause?

A manifest price error may be determined by comparing the disputed price with an accepted reference price and then deciding whether any deviation from the reference price is sufficient to reasonably conclude the price is or was manifestly wrong. From the perspective of the unbiased observer it ought to be obvious that the price of the trade was wrong. Given the speed of the move in the Swiss franc and the wide range of prices being quoted by market participants, I don't consider that such an observer would have reasonably concluded that the price of Mr S's trade was manifestly wrong.

For the manifest error clause to be applicable by reason of a lack of liquidity I think it would have had to be reasonably obvious to an unbiased observer that the trade Mr S executed with SCML couldn't have been replicated in the underlying market because of a lack of liquidity.

I don't accept this was the case. It's clear that at the time of Mr S's original trade (9.30.52) very substantial volumes of Swiss francs were being traded. I accept that trading wasn't normal and that not all market participants were able to execute all of the trades they wanted to. I also accept that, a short time after Mr S's trade, liquidity had very significantly reduced. However, I don't consider that at the time of Mr S's trade the level of disruption to normal trading was sufficient to invoke the manifest error clause. I'm not satisfied it would have been obvious that Mr S's trade couldn't have been executed in the underlying market because of a lack of liquidity. It follows that, on the facts, I don't accept SCML's distinction between 'posted liquidity' and 'liquidity which was actually capable of execution' – not least because Saxo Bank was demonstrably able to carry out some trades at the time.

My conclusion therefore is that the manifest error clause isn't reasonably applicable on grounds of either price or liquidity.

SCML's business model

In spread betting /CFD trading there are two business models. The first is where the firm trades with the client as principal. In this model the firm is exposed to the risks of market movements (principal risk). Firms will generally look to hedge their exposure by trading in the underlying market but this is an issue for the firm to manage. Any gains or losses that arise from hedging activities are the responsibility of the firm.

The second model is where the firm trades on what is known as a matched principal basis. In this model the firm will execute a trade with a client and simultaneously execute a matching trade with a counterparty. This trading model has the effect of removing market risk from the firm. The risk of the trade will then rest with the end counterparty.

The SCML trading model doesn't correspond directly with the matched principal model described above (it involves four trading entities rather than three). It's also not how the trading is described in the terms and conditions of the account or the order execution policy. These only say that, in trading with Mr S, SCML will be acting as principal (not matched principal) and that SCML will be the sole execution venue for the trade.

The terms and conditions and the order execution policy therefore describe the first business model. On that basis the risk that the principal takes on when trading with clients is their responsibility and not that of their clients. However, SCML has said that this is not in effect how it trades with clients. It has said that in practice it operates on a matched principal basis. It has described (in its final response to Mr S) its trading model in the following way:

'SCML is not a market maker that takes risk on its books. All client trades are entered into only when an equal and opposite trade is executed into by SCML with our liquidity provider. This is normally a straight through process that happens seamlessly and almost instantly. However, there are situations where this does not happen for a number of reasons, in this case it was due to SCML's price feeds showing prices with no liquidity behind them.'

The above description is accurate as far as it goes. Mr S entered into a trade with SCML. Simultaneously SCML executed an identical trade with its liquidity provider. In this case the liquidity provider was Saxo Bank. Saxo Bank is the sole liquidity provider/counterparty to SCML. Having taken on the risk of Mr S's trade from SCML, Saxo bank then looked to hedge this risk in the underlying market. This didn't take place simultaneously with the SCML trade but took place a short time afterwards.

When Saxo Bank tried to hedge its position with its own liquidity providers the price at which it was able to sell EURCHF was markedly lower than the price at which Mr S had traded with SCML.

The negative adjustment that SCML applied to Mr S's account had the effect of transferring the loss suffered by Saxo Bank on the trade back on to Mr S. However, Saxo Bank wasn't a party to Mr S's trade. He traded with SCML. SCML successfully hedged their position by trading with Saxo Bank and didn't suffer a loss on it. In addition, in my view the loss that Saxo Bank suffered arose from delay. The speed at which markets and liquidity dried up meant that it was unable to replicate the trade it had executed with SCML and suffered a loss as a result.

I must decide the outcome of this complaint on the basis of what I consider to be fair and reasonable. Having considered the particular circumstances of Mr S's trade, including what was in my view the invalid application of the manifest error clause, my conclusion is that what has happened is the transfer to Mr S of losses suffered by Saxo Bank. I don't consider this to be a fair outcome and I see no reasonable basis for Saxo Bank's losses to be passed on to Mr S.

the Danish Complaint Board's findings

There are many differences between Mr S's complaint (which is against SCML) and the complaint considered by the Danish Complaint Board (which was against Saxo Bank).

The Complaint Board's decisions are based on a legal assessment which is different from the statutory remit of the UK Financial Ombudsman Service. I have a statutory duty to decide what, in my opinion, is fair and reasonable in all the circumstances of Mr S's complaint. In considering what is fair and reasonable in all the circumstances of the case, I'm required to take into account relevant law and regulations, regulators' rules, guidance and standards, codes of practice and, where appropriate, what I consider to have been good industry practice at the relevant time.

While I've carefully considered the judgment of the Danish Court and the findings of the Complaint Board, I'm not required to follow their findings. I have to exercise my own judgment, assess the evidence before me independently and reach my own findings of fact and my own final decision of what is fair and reasonable in the circumstances of Mr S's case.

In Mr S's case, having been through that process I've decided, for the reasons I've given, that SCML shouldn't have adjusted Mr S's trades.

fair compensation

It's therefore my final decision that this complaint should be upheld. In terms of putting things right, I require Saxo Capital Markets UK Limited to reinstate the terms of the original trades it executed with Mr S, refund the additional loss applied to Mr S's account and reinstate the original closing balance. Any interest on the negative balance should also be repaid to Mr S.

Simple interest at the rate of 8% per year should be added to the original closing balance from 16 January 2015 to the date of payment.

I've noted that Mr S asked for an 'additional declaration for an adjustment' when he responded to the provisional decision. I consider the wording above fairly compensates him.

When the position was originally closed Mr S's account was left with a substantial credit balance. After the adjustment the balance of the account showed a very substantial deficit. Like the adjudicator I'm satisfied this must have been very upsetting for Mr S. I agree with the adjudicator that the sum of £750 is an appropriate sum to compensate Mr S for this.

Mr S suggested I might increase his compensation to allow for the extra costs and inconvenience caused in the light of my provisional decision, as he needed to understand his options should SCML choose not to comply with my recommendation appearing below. However, I don't think that would be fair as the legal costs incurred by Mr S were to understand his legal options and this has nothing to do with SCML.

my final decision

Where I uphold a complaint, I can make a money award requiring a financial business to pay compensation of up to £150,000, plus any interest and/or costs that I consider appropriate. If I consider that fair compensation exceeds £150,000, I may recommend that Saxo Capital Markets UK Limited pays the balance.

determination and award: I uphold the complaint. I consider that fair compensation should be calculated as set out above. My final decision is that Saxo Capital Markets UK Limited should pay the amount set out above up to the maximum of £150,000 (including distress and/or inconvenience but excluding costs) plus any interest set out above.

recommendation: If the amount of fair compensation as calculated above exceeds £150,000, I recommend that Saxo Capital Markets UK Limited pays Mr S the balance plus any interest on the balance as set out above.

This recommendation isn't part of my determination or award. Saxo Capital Markets UK Limited doesn't have to do what I recommend. It's unlikely that Mr S can accept my final decision and go to court to ask for the balance. Following the provisional decision, we asked SCML if it would pay the recommendation in the event that the final decision was accepted by Mr S. I'm pleased to note that SCML has written to us to confirm that it will accept the ombudsman's recommendation to reinstate the original price of Mr S's close-out transaction and pay compensation exceeding £150,000.

Under the rules of the Financial Ombudsman Service, I'm required to ask Mr S to accept or reject my decision before 3 April 2017.

Roger Yeomans
ombudsman