

# **Explanatory Note on the Error Correction Facility**

## **ERROR CORRECTION FACILITY**

### **Explanatory Note**

#### **1. Introduction**

- 1.1 By accepting a client order for a LIFFE contract, a member agrees to attempt to procure the execution of a contract in the pit.
- 1.2 Various factors serve to protect the client's interests, including:
- (i) the advice/service provided by the member;
  - (ii) the application of Rules and Trading Procedures designed to manage conflicts of interest (e.g. ensuring client order priority) and to provide a competitive and transparent price discovery mechanism (e.g. open outcry pit trading); and
  - (iii) the general requirement that the client's order must directly interact with such mechanism, as the member may only enter into a LIFFE contract with the client once he has procured a matching contract **in the pit**, the price of which **must** be disclosed to the client.
- 1.3 The client has a direct interest in the matching pit contract procured by the member and, unless the member and the (fully informed) client expressly agree otherwise, the member should yield up to the client the price achieved when executing the client's order in the pit.
- 1.4 Although errors inevitably complicate the picture, the same principles continue to apply, as explained in the remainder of this Note. In particular, clients should always be offered the benefit of any improvements that arise, since these improvements are related to the client order. In this respect, it should be noted that special provisions apply to certain wrong month/wrong exercise price errors, whereby the loss on the wrong month/wrong exercise price trade may be offset against the improvement on the client trade.
- 1.5 When resolving errors it is best practice to do so promptly.

#### **2. Use of Error Correction Facility**

- 2.1 Where a client has been advised that all or part of his order has been completed, yet an error in the execution and/or reporting process is subsequently identified, the Exchange will make available to the member the error correction facility to satisfy the client order and resolve the error, provided that certain conditions are met.
- 2.2 Members should note that the error correction facility is designed only for the resolution of errors by members in the execution of client business **on the market**. This means that the error must relate to a mistake by a member in respect of instructions received from a client, the execution of business within

the pit, the reporting of business to a client by a member, or to similar communication errors between members where orders are passed from one member to another for execution.

#### Who may use the facility

- 2.3 Where more than one member is involved, either the instructing member or the executing member may seek authorisation of an error correction, subject to the normal conditions for authorisation. However, the instructing member would additionally need the requisite TRS/CPS capacity, whereas the executing member would additionally need to obtain from the instructing member the relevant client order details and confirmation of any relevant client consent.
- 2.4 Whilst the Error Correction Declaration Form would normally be submitted for authorisation on the market floor, where necessary the Declaration Form may be completed by the member in his office and faxed to the Trading Operations Department of the Exchange for authorisation.

#### Conditions of use

- 2.5 As set out in the Trading Procedures, in order to obtain authorisation of an error correction, the member must demonstrate to the satisfaction of the Exchange Official that:
- (i) a client order was received and an attempt made, or intention existed, to execute the order in the pit; and
  - (ii) a “fill”, which was in retrospect an error, was reported to the client (i.e. **either** there was a mistaken belief that a trade had been executed **or** a trade had been executed but the price or quantity differed from that mistakenly reported to the client).
- 2.6 In particular, the member must provide to the Exchange Official:
- (i) either the relevant completed trader card or other evidence that the trade reported to the client could reasonably have been executed in the pit;
  - (ii) the relevant completed client order slip; and
  - (iii) an Error Correction Declaration Form signed by a representative of the member, duly authorised for this purpose, confirming that there was an error and, where applicable, that the client has been offered the improvement.

### **3. Types of error**

- 3.1 If the correct number of lots has been executed in the pit in the correct contract, but the price achieved for part or all of the order is different from that reported to the client, then the following principles apply:

- (i) where a better price (i.e. an improvement) than that reported to the client has been achieved, that improvement must be offered in full to the client. If the client declines that improvement, in part or in full, the error correction facility may be used to reflect this; and
  - (ii) where a worse price than that reported to the client has been achieved, then the member may **either** use the error correction facility to satisfy the client order and simply assign the pit trade to his own account **or** discuss the error with the client. Where the member has discussed the error with the client and the client has agreed to share the loss, the error correction facility may be used to reflect this.
- 3.2 Errors relating to price may alternatively be corrected by means of a separate cash payment, subject to the member's obligation to disclose to the client the price traded in the market.

#### Under-trading

- 3.3 If a member has under-traded (i.e. bought or sold too few or traded none of the correct contract) then, unless the client expressly agrees to cancel the balance of the order, he may either:
- (i) trade the balance and apply the principles stated above<sup>1</sup>; or
  - (ii) for **loss-making** situations only, use the error correction facility to satisfy the client order without trading the balance in the pit.
- 3.4 Special provisions apply where the member has bought or sold in accordance with the instruction in the order to buy or, as the case may be, to sell but has traded the wrong month/wrong exercise price of the relevant contract (see below).

#### Over-trading

- 3.5 Where a member has over-traded the client order, then the excess number of lots should be treated as a proprietary position<sup>2</sup>.

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<sup>1</sup> Where the market is closed, different procedures necessarily apply (see below).

<sup>2</sup> It is important to note that it is not always possible to identify the order in which trades have been executed in an attempt to complete a client order. In such circumstances, the trades executed at the best prices must be given to the client.

Market Open/Closed

- 3.6 A key element of the authorisation process in respect of error corrections is the applicable reference price to assess whether a profit or loss is involved. Where the market is open, the reference price shall be the prevailing best bid or offer, as relevant to the client order, at the time that the error correction is submitted for authorisation.
- 3.7 Where the market is closed, the reference price shall be:
- (i) the Daily Settlement Price (both for contracts without after-hours trading, as well as for error corrections authorised during the interval between trading sessions for contracts with after-hours trading); or
  - (ii) the Official Closing Price (for error corrections authorised following the close of after-hours trading for contracts with after-hours trading).
- 3.8 As noted above, the requirement to trade where an improvement can be achieved necessarily cannot apply when the market is closed. Rather, where the reference price gives rise to a notional improvement, the member must offer that notional improvement to the client.

Wrong Month/Wrong Exercise Price errors

- 3.9 Where the member has bought or sold in accordance with the client instruction in the order to buy or, as the case may be, to sell but has traded the wrong month/wrong exercise price of the relevant contract, then the member may offset any loss arising from that trade against any improvement achieved for the client in the course of correctly satisfying the client order. In these circumstances, the net improvement, if any, must be offered to the client. Further details of these special provisions are provided in section 4.6 below.

**4. Examples**

**4.1 Over-trade**

*Order:* Pay 130.50 for 100 March BTPs  
*Trade:* Paid 130.50 for 110 March BTPs

In the above example, the member has purchased 10 excess lots. The 10 excess lots are a proprietary position of the member, since the 100 lot client order has already been satisfied.

*Order:* Pay 130.50 for 100 March BTPs  
*Trades:* Paid 130.46 for 10 March BTPs  
 Paid 130.50 for 100 March BTPs

In the above example, there is again a 10 lot excess. The first 100 lots traded are the client's and thus, if it is clear that the 10 lots at 130.46 were part of the first 100 lots traded, the client must be given 10 lots at 130.46 and 90 lots at 130.50. If it is clear that the 10 lots at 130.46 were traded last, then these lots are the

member's. If it is not clear, then the benefit of the doubt goes to the client, and thus the 10 lots at 130.46 are the client's.

In either of these examples, if a profit arises from the member's 10 lot long position, then that profit is the member's and not the client's.

#### 4.2 Under-trade/no trade

*Order:* Pay 130.50 for 100 March BTPs  
*Reported:* Paid 130.50 for 100 March BTPs  
*Trade:* Paid 130.50 for 90 March BTPs

In the above example, the method for resolving the error will depend upon: (a) whether the market is open or closed; (b) the current market price (or other reference price if the market is closed); and (c) any agreement reached with the client.

##### Scenario 1: market open/current market price worse than reported price

The market price is now 130.54. The member may buy the outstanding 10 lots at this price and seek an error correction at the reported price level. The member may seek an error correction at 130.50 **before** trading the outstanding 10 lots, which would also be permitted. Alternatively, the member could contact the client who may be willing to accept to share the loss (in which case an error correction could be used to facilitate this).

##### Scenario 2: market open/current market price better than reported price

The market price is now 130.46. The member must trade the balance of the order in the pit at the prevailing market price. This trade is the client's and the improvement must be offered **in full** to the client. Should the client decline all or part of the improvement, the member may use the error correction facility to reflect this.

##### Scenario 3: market open/market price equal to reported price

The market price is (still) 130.50. The member must trade the balance of the order in the pit at the prevailing market price.

##### Scenario 4: market closed/reference price<sup>3</sup> worse than reported price

The market closed at the price of 130.54. The member may seek an error correction at 130.50. This will satisfy the client order and result in a 10 lot short position for the member.

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<sup>3</sup> Daily Settlement Price or Official Closing Price, as applicable.

Scenario 5: market closed/reference price better than reported price

The market closed at the price of 130.46. As the market is closed, the member cannot realise the (notional) improvement by trading in the pit. An error correction will be authorised at closing/reference price. Alternatively, if the (notional) improvement has been declined in part or in full by the client, the error correction facility may be used to reflect this.

Scenario 6: market closed/reference price equal to reported price

The market closed at the price of 130.50. In situations where the reference price is the same as that reported to the client, the error correction facility will be made available to complete the client's order at that level.

4.3 Incorrect Price

*Order:* Pay 130.50 for 100 March BTPs  
*Reported:* Paid 130.50 for 100 March BTPs  
*Trade:* Paid 130.54 for 100 March BTPs

An error correction will be authorised at 130.50. Alternatively, the member could contact the client who may be willing to accept to share the loss (in which case an error correction could be used to facilitate this).

*Order:* Pay 130.50 for 100 March BTPs  
*Reported:* Paid 130.50 for 100 March BTPs  
*Trade:* Paid 130.46 for 100 March BTPs

The improvement should be offered in full to the client. If the client declines all or part of the improvement, the error correction facility may be used to reflect this.

4.4 Strategy Trades

4.4.1 Any client order to trade an Exchange recognised or authorised strategy is subject to the same principles in respect of the error correction facility as for outright orders. Where an error occurs in the execution of a permitted, but not expressly recognised, options strategy order, the error correction principles as for outright orders shall apply in respect of the strategy as a whole. It is the responsibility of the member to have assessed whether such an error gives rise to an overall loss or improvement for the client and, where applicable, to have obtained appropriate client consent.

4.5 “Legging into” a strategy order

4.5.1 It is recognised that from time to time members may seek to execute a client order for a strategy by trading the individual legs of that strategy separately, with the aim of achieving best execution for the client. In such circumstances, the same principles with regard to the offering of improvements and the use of the error correction facility apply. However, the following additional factors are noteworthy:

- (a) when executing a strategy order in this manner, the member must observe his fiduciary duties to the client throughout the execution of that order (e.g. act in the best interests of the client). However, where the member has decided **unilaterally** to execute the order in this manner, each executed trade will be the client's, but only if the member completes the strategy order. If the order cannot be completed, yet the member has observed his fiduciary duties to the client, then any executed trade shall be the member's;
- (b) where the client has expressly indicated that the strategy order should be executed in this manner (i.e. by trading the individual legs separately), then the client has implicitly accepted that all legs executed will be for his benefit. However, the member has an overriding obligation to complete the entire order, which may result in the client receiving a worse differential than the differential that could have been achieved had the order been executed as a strategy trade. In certain circumstances, rather than complete the order at any price, it may be in the interests of the client for the member to offer the traded leg alone to the client.

*Order:* Pay +10 for 100 lots of the March/June BTP spread  
 Member elects unilaterally to "leg into" the spread

*Price levels:* March 130.90  
 June 130.80

*Trade:* Member pays 130.90 for 100 March BTPs

#### Scenario 1

The market level in the March contract then moves to 130.92 and the market level in the June contract then moves to 130.84. Although the spread quote has improved to +8, the member must complete his "legging" method by selling 100 lots of the June contract at 130.84 and achieve a spread of +6. The member may not execute a spread trade in order to complete the client order and treat the March trade as his position. This improvement (i.e. a differential of +6) must be offered in full to the client.

#### Scenario 2

If the market moves against the member (e.g. the June contract moves to 130.76), he may either trade the outstanding leg and seek an error correction, or alternatively treat the original leg as a proprietary error and trade the spread (i.e. provided that there is a +10, or better, differential).

### 4.6 Wrong Month/Wrong Exercise Price Errors

- 4.6.1 Where the member has bought or sold in accordance with the client instruction in the order to buy or, as the case may be, to sell but has traded the wrong month/wrong exercise price of the relevant contract, then the member may offset any loss arising from that trade against any improvement achieved for the client in the course of correctly satisfying the client order. In these circumstances, the net improvement, if any, must be offered to the client.

*Order:* Pay 130.50 for 100 March BTPs  
*Reported:* Paid 130.50 for 100 March BTPs  
*Trade:* Paid 130.60 for 100 June BTPs

### Scenario 1

The market price is now 130.48 bid, 130.49 offered in the March BTP, and 130.60 bid, 130.61 offered in the June BTP. The member may either trade a spread at 11 (recording this as paying 130.49 for 100 March BTPs and selling 100 June BTPs at 130.60), or trade the March and June legs as outrights, to complete the client order (with an improvement which must be offered to the client) and to close out the June error.

### Scenario 2

The market price is now 130.48 bid, 130.49 offered in the March BTP, and 130.59 bid, 130.60 offered in the June BTP. Once again, the member may either trade a spread at 10 (recording this as paying 130.49 for 100 March BTPs and selling 100 June BTPs at 130.59) or trade the March and June legs as outrights. However, the member may offset the loss of 100 ticks in the June contract against the improvement of 100 ticks in the March contract, and may seek an error correction in the March contract to facilitate this (i.e. at 130.50).

### Scenario 3

The market price is now 130.47 bid, 130.48 offered in the March BTP, and 130.59 bid, 130.60 offered in the June BTP. Once again, the member may either trade a spread at 11 (recording this as paying 130.48 for 100 March BTPs and selling 100 June BTPs at 130.59) or trade the March and June legs as outrights. Whilst the member may offset the loss of 100 ticks in the June contract against the improvement in the March contract, the latter improvement is 200 ticks and therefore the net improvement of 100 ticks must be offered to the client. The member may seek an error correction in the March contract at 130.49 or, if the client declines the net improvement, at 130.50.

## **5. Error Correction Declaration Form**

- 5.1 To obtain authorisation for an error correction, the attached Error Correction Declaration Form must be completed and then signed by a representative of the member. It is a matter for each member to decide which of its staff are authorised to sign/submit such forms, and to control the activities of its staff in this respect. Completed/signed forms must then be submitted, in the first instance, to the relevant Pit Observer for authorisation. Members will need to retain a signed copy of the form for their records and a copy will be retained by the Exchange.
- 5.2 Error Correction Declaration Forms will be available on the floor, from the TRS Enquiries Desk.

5.3 It is anticipated that Error Correction Declaration Forms will normally be completed/submitted on the market floor. However, where necessary, the form may be completed in members' front offices and faxed to the Trading Operations Department, on 0171 329 3978/9, for authorisation. A copy of the attached form may be used for this purpose. Once signed by an Exchange Official, a copy of the form will be faxed back to the member for his records.

6. **Additional Client Agreement Requirement**

6.1 The Exchange's current client agreement requirements are set out in General Notice No. 399, issued on 6 March 1992, and, in respect of the Euroyen Contract, in General Notice No. 807, issued on 29 March 1996.

6.2 The procedures on the Error Correction Facility and offering improvements have necessitated a supplementary Exchange-required clause which must be added to all client agreements (Refer to Volume 3 Annex A). This clause explains fully and clearly to clients the implications of the special provisions relating to wrong month/exercise price errors (given that these provisions vary the previous rights of clients both at law and under the Rules in respect of improvements).

6.3 Members should note that they may supplement client agreements using the clause as drafted, or may draft their own clause, provided that the purpose and legal effect of any such clause is no less than that achieved by the attached clause. Written client consent to this additional clause is required only from clients who are required under SFA's conduct of business rules to give written consent.

**ERROR CORRECTION DECLARATION FORM**

Date of error		Time of error	
Member mnemonic		Trader mnemonic	
Nature of error			
	Client order details	Trade reported to client	Pit trade (if applicable)
Buy/Sell			
Contract			
Month & Year			
Exercise price			
Price			
Volume			
Time/Time bracket			

Error Correction request	Buy	Sell
Trader mnemonic		
Contract		
Month & Year		
Exercise price		
Price		
Volume		
Account (H, L, N, S)/ Allocation		
Order reference		
Account reference		

<b>To be completed by the Exchange Official</b>	Time	
Current market price/reference price <sup>1</sup>		
Total improvement/loss <sup>1</sup>		
Exchange Official signature	Print Name	

I confirm that I am an authorised signatory of the aforementioned member for the purpose of making this declaration in respect of the Error Correction Facility. In accordance with the Rules and Trading Procedures, any applicable improvement has been offered in full to the client/the instructing member has confirmed that any applicable improvement has been offered in full to the client<sup>1</sup>. The above information is correct and the requirements of the relevant Rules and Trading Procedures have been met.

Amount of improvement waived/loss accepted by client <sup>1</sup>	
Authorised member signatory	Print Name

<sup>1</sup> Delete as applicable