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EDITS & COLUMNS

FSA order on Citigroup misguided

Does it mean a large trade can invite penalty, despite doing no wrong?

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Nearly a year ago, Citigroup stunned European bond markets with a daring series of profitable trades, exposing serious flaws in these markets. Last month, the Financial Services Authority (FSA), UK, imposed a $25 million fine on Citigroup for these trades. This order is precedent-setting not only for the FSA, but also probably for other regulators who may be tempted to follow suit. This article examines the order and concludes that it is totally wrong and misguided.

EuroMTS, the London-based FSA-regulated subsidiary of the Italian bond exchange MTS, handles more than half the total trading in Eurozone government bonds on its electronic platform. Unlike government bond markets elsewhere in the world, EuroMTS has rules that force market makers to quote artificially low spreads in government bonds. The market makers are large banks who accept these rules because European governments give them bond issuance based on their participation in EuroMTS.

In contrast, Eurex, the leading futures exchange for Eurozone government bonds, is an order-driven market where the visible liquidity is a real liquidity and not one artificially created by government regulation. The cash and futures markets are tightly integrated.

In July 2004, Citigroup Global Markets Limited (CGML), London, developed software allowing trade against all the quotes in EuroMTS within a short period, instead of manually hitting them individually. They then built up a long position of about 9 billion euro in cash bonds hedged by offsetting short positions in the futures markets.

On August 2, 2004, they put their strategy into effect by first buying futures to extinguish their short futures position. Cash and futures prices rose by about 0.3% in response to futures buying. Now, Citigroup had a naked long cash position. In about 18 seconds, Citigroup sold 11 billion euro (about one day's normal trading volume) of bonds by hitting existing quotes in EuroMTS. Hence, cash bond prices fell only after these trades had been executed. Citigroup made a profit of about $20 million that day.

The resulting outrage forced the FSA to act. But after investigation, it lacked either the evidence, or the courage to say Citigroup had manipulated the markets. Yet, it was unwilling to let them off without any penalty. So it imposed one under regulations that have no bearing on the case. This means it was imposed without having to prove any serious charges against Citigroup. FSA accused Citigroup of contravening two Principles of Business of the FSA: "A firm must conduct its business with due skill, care and diligence"; and "A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems."

On the face of it, it is difficult to see how Citigroup's trading violated either. On the contrary, it seems that its actions demonstrated a high degree of skill and sound risk containment systems.

• Citigroup's series of profitable trades stunned European bond markets
• Financial Services Authority has slapped a $25 million fine on these trades

FSA, however, argued that due skill and care were lacking because Citigroup did not consider the consequences the execution of the trading strategy could have on the efficient and orderly operation of the MTS platform. This is absolute nonsense. The strategy was predicated on a clear understanding of these consequences, which were highly beneficial to Citigroup. More importantly, Citigroup's understanding of these consequences was quite correct.

FSA also claimed 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" and "inadequate systems for the supervision of traders."

A perfectly valid argument, provided the FSA had first established that the trading strategy violated the rules of market conduct. The FSA did not, however, want to assert

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that the trading strategy was manipulative. If it does not do so, it is difficult to see why a trade, even if it is very large, needs clearance from senior management.

The FSA (and perhaps Citi-group too) has taken the easy route out. In the process, setting a dangerous precedent—that any large trade can invite a penalty, without there being any wrong-doing at all. One wishes other regulators would behave more responsibly than the FSA.

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