

Market surveillance & enforcement in addition to mechanisms to manage extreme volatility and preserve orderly trading

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- the **self-regulatory organization (SRO)** of **B3**, the Brazilian trading venue (former BM&FBOVESPA)
- subject to **direct oversight of CVM**, the Brazilian Securities Commission
- responsible for the **surveillance** of trading in the Brazilian Equities, Futures and over-the-counter markets

1. Market structure

Single trading venue for equities & futures: B3

2. Mechanisms

- (a) Volatility based → wide-market circuit breaker (equities market)
- (b) Volatility based → price/volume bands (rejection/auctions)
- (c) Automatic rejection of certain orders without temporarily halting the market → B3 Line 5.0 System

3. Regulatory framework

Regulatory Authority: CVM regulation n° 168/1991

Establishes the obligation for trading venues to adopt special trading proceedings in case of extreme volatility (price or volume)

Trading Venue: B3 trading regulations

Establishes the mechanisms described in **item 2**

EQUITIES MARKET

1. Trigger: if BOVESPA INDEX decreases 10% from the closing index of the previous day → 30' halt (wide-market)
2. Trading resumed, new trigger: if BOVESPA INDEX decreases 15% from the closing index of the previous day → 60' halt (wide-market)
3. Trading resumed, new trigger: if BOVESPA INDEX decreases 20% from the closing index of the previous day → halt (wide-market) for a period of time to be determined at the trading venue's own discretion

BOVESPA INDEX

- Tracks the current quotation of a theoretical stock portfolio constituted on January 2nd, 1968
 - It serves as an average indicator of market behavior
 - The portfolio's configuration intends to be as close as possible to the real configuration of trading in the equities market
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FUTURES MARKET

No circuit breaker

1. Trading is permitted within a pre-determined price threshold (ex.: Future contracts of IBOVESPA INDEX → 10% of the previous day's settlement price)
2. Price threshold varies according to the security and is determined according to the previous day's settlement price
3. Price threshold: mechanism to manage extreme volatility and to control liquidity and credit risks related to cash settlements

DISCIPLINARY ADMINISTRATIVE PROCEEDING

Context:

- (a) Subprime crisis in September 2008
- (b) Bovespa Index (“Ibovespa”)
- (c) Future contracts of Bovespa Index (“Ibovespa Derivative”)
- (d) Internalization prohibited in Brazil (CVM regulation n° 461/2007)

Situation:

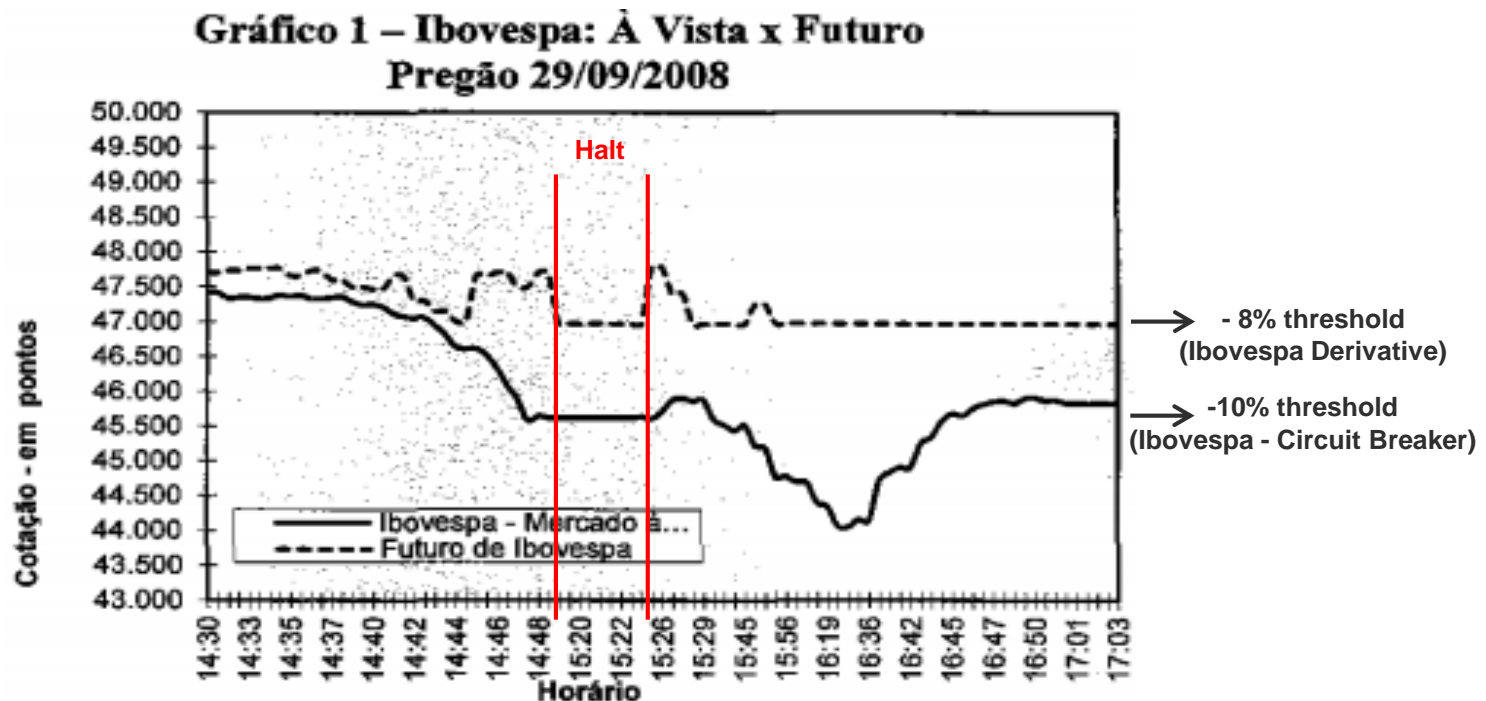
1. September 29th, 2008: extreme volatility in the equities market (Ibovespa price decreased more than 10% from the closing index of the previous day)
2. Circuit breaker triggered in the **equities market** at 14h49 → 30' halt
3. Trading of the Ibovespa Derivative continued within its price threshold (8%) until the end of the session

4. At the time:

Ibovespa circuit breaker threshold \rightarrow -10% of the previous day's closing index

Ibovespa Derivative price threshold \rightarrow $\pm 8\%$ of the previous day's settlement price

5. Price "detachment" (Ibovespa Derivative x Ibovespa)



6. Reaction: a brokerage firm created an internal dark “parallel market” to trade Ibovespa Derivative at a price inferior of that of the lit market
7. Trades were registered in the lit market at the permitted price band
8. After market: day-trades to compensate the difference between the price traded in the dark market and the lit market → artificial market conditions

Example of a day-trade executed in the after-hours

<i>N° Trading</i>	<i>Time</i>	<i>Broker</i>	<i>Client</i>	<i>Buy/Sell</i>	<i>Qty. Future Contracts</i>	<i>Price</i>	<i>Financial</i>	<i>Client Contourparty</i>
4320	17:32	THR	Client A	B	985	45.250,00	-3.752.850,00	Client B
4427	17:33	THR	Client A	S	985	45.150,00	3.851.350,00	Client B
Result							BRL\$98.500,00	

9. Items 6, 7, 8 combined → Brokerage firm allowed its clients to trade Ibovespa Derivative at a price ≠ than the lit market price → competitive advantage

10. BSM market surveillance detected the \$ transfer (day-trades)



Data bases → data mining and market supervision solutions → filters and alerts → analysis → **enforcement**

Internalization
(trading outside the organized market)
+
creation of artificial market conditions (\$ transfer)

Broker's responsibilities:

- Brokers are forbidden to intermediate securities outside the organized market
→ CVM regulation n° 461/2007
- Brokers are forbidden to create artificial conditions of securities' demand, supply and price (artificial market conditions)
→ CVM regulation n° 8/1979 and B3 trading regulations

Charges / Results:

- (a) Brokerage Firm's Director: allowed internalization in the firm and the creation of artificial market conditions → settlement BRL\$ 250k
- (b) Broker 1: intermediated trades outside the organized market, without a public price formation → penalized with a fine of BRL\$ 20k → acquitted after appeal
- (c) Broker 2: intermediated day-trades that created artificial market conditions → penalized with a fine of BRL\$ 20k

Brokerage Firm not accused → ceased to exist

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