Reference number: FS/2010/0024

FINANCIAL SERVICES – FSMA s 123 – financial penalty - FSMA s 118(5) – whether conduct of Applicant constituted market abuse – FSMA s 56 - prohibition order - whether Applicant a fit and proper person

UPPER TRIBUNAL (TAX AND CHANCERY CHAMBER)
FINANCIAL SERVICES

DAVID JOHN HOBBS	**Applicant**
- and -	
THE FINANCIAL SERVICES AUTHORITY	**Respondent**

TRIBUNAL: JUDGE ROGER BERNER
SANDI O'NEILL (Tribunal Member)
PETER BURDON (Tribunal Member)

Sitting in public at 45 Bedford Square, London WC1 on 25 June 2012 (reading day), 26 – 29 June 2012 and 23 July 2012

The Applicant, Mr Hobbs, in person

Andrew Hunter QC, instructed by the Financial Services Authority, for the Respondents

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DECISION

Introduction

5 1. This reference, made by reference notice dated 18 August 2010, concerns whether the conduct of the Applicant, David Hobbs ("Mr Hobbs"), in his trading in certain coffee futures on 15 August 2007, constituted market abuse.

2. Mr Hobbs disputes a Decision Notice dated 23 July 2010 by which the Financial Services Authority ("the Authority") decided:

10 (1) that conduct by Mr Hobbs on 15 August 2007 constituted market abuse under s 118 of the Financial Services and Markets Act 2000 ("FSMA"), and that a financial penalty of £175,000 should be imposed on Mr Hobbs in respect of this conduct pursuant to s 123 FSMA; and

(2) to impose a Prohibition Order on Mr Hobbs pursuant to s 56 FSMA on the
15 ground that he is not a fit and proper person.

3. We shall consider the evidence in detail, but we think it will be helpful if we just set the scene with a few introductory facts.

4. In August 2007 Mr Hobbs was a proprietary trader employed by Mizuho International plc ("Mizuho"), the London-based securities and investment banking
20 arm of one of Japan's largest banking groups. He was approved by the Authority as an investment advisor under CF21. Mr Hobbs conducted proprietary trading for Mizuho in LIFFE (London International Financial Futures and Options Exchange) coffee futures and associated derivatives, such as call and put options.

5. The conduct of Mr Hobbs that falls to be considered in this reference is that
25 before 12.30pm on the afternoon of 15 August 2007. At that time the September 2007 coffee future call and put options "expired", meaning that the options could no longer be traded after that time. Shortly thereafter, and by reference to trading in futures in the minute between 12.29pm and 12.30pm, a reference price, namely the coffee options reference price ("CORP"), was set. The CORP determined whether, in
30 the absence of countervailing instruction prior to 1.15pm, options would be automatically exercised or allowed to lapse; those "in the money" (ITM) by reference to the CORP would be exercised, and those "out of the money" (OTM) by the same measure would be abandoned.

6. At the material time Mr Hobbs held 2050 September 2007 coffee future put
35 options with a strike price of US$1750. At 12.26pm on 15 August 2007, the September 2007 coffee futures price had a bid-offer range of US$1744-US$1746, below US$1750, meaning that, at that stage, the put options were ITM. This pricing of the futures was consistent with the trading range in a two and a half hour period prior to that, when the September 2007 coffee future had traded in a narrow range
40 (US$1743 to US$1747), although trading earlier in the day (before 9.45am) had been consistently at prices above US$1750.

7. At 12.26pm Mr Hobbs instructed a broker, Mr Andrew Kerr ("Mr Kerr") of Sucden Ltd, to place a limit buy order, up to US$1757, for 600 lots of coffee futures, "on the close", shortly before 12.30pm. The trade ("the Trade") was executed by Mr Kerr in the two seconds prior to 12.30pm.

5 8. The effect of the trade was to increase the price of September 2007 coffee futures from US$1745 (at 12.29.57) to US$1757 (at 12.30.00). This in turn increased the volume weighted price of the September 2007 coffee futures traded in the minute between 12.29 and 12.30 to US$1752, and thus resulted in the CORP being set at that level, and thus above the US$1750 exercise price for the September 2007 US$1750 10 put and call options rather than, as would have been the case absent the Trade, below US$1750.

9. This accordingly had the effect that the default positions (as to exercise and abandonment) of those put and call options were effectively reversed as a consequence of the Trade; the call options became ITM, and would be exercised at 15 1.15pm in the absence of a countervailing instruction and the latter became OTM and would be abandoned, unless contrary instruction were given.

The law

10. Section 118 FSMA defines market abuse as behaviour (whether by one person alone or by two or more persons jointly or in concert) which, amongst others, occurs 20 in relation to qualifying investments admitted to trading on a prescribed market, and which falls within one of the types of behaviour set out in s 118. There is no dispute that coffee futures and coffee futures options are qualifying investments admitted to trading on a prescribed market[1]. The Authority's case on market abuse is brought under s 118(5), which defines as the fourth type of market abuse behaviour:

25 > "… where the behaviour consists of effecting transactions or orders to trade (otherwise than for legitimate reasons and in conformity with accepted market practices on the relevant market) which –
>
> (a) give, or are likely to give, a false or misleading impression as to the supply of, or demand for, or as to the price of, one or more 30 qualifying investments, or
>
> (b) secure the price of one or more such investments at an abnormal or artificial level."

11. The power to impose penalties in cases of market abuse is conferred by s 123 FSMA:

35 > "(1) If the Authority is satisfied that a person ('A') –
>
> (a) is or has engaged in market abuse, or

[1] Under the Financial Services and Markets Act 2000 (Prescribed Markets and Qualifying Investments) Order 2001, made under s 118(3) FSMA, commodity derivatives traded in LIFFE are qualifying investments traded on a prescribed market.

(b) by taking or refraining from taking any action has required or encouraged another person or persons to engage in behaviour which, if engaged in by A, would amount to market abuse,

it may impose on him a penalty of such amount as it considers appropriate.

(2) But the Authority may not impose a penalty on a person if, having considered any representations made to it in response to a warning notice, there are reasonable grounds for it being satisfied that –

(a) he believed, on reasonable grounds, that his behaviour did not fall within paragraph (a) or (b) of subsection (1), or

(b) he took all reasonable precautions and exercised all due diligence to avoid behaving in a way which fell within paragraph (a) or (b) of that subsection.

…"

12. The Authority's decision to impose a prohibition order on Mr Hobbs prohibiting him from performing any function in relation to any regulated activity carried on by any authorised or exempt person or exempt professional firm was made under s 56 FSMA:

(1) Subsection (2) applies if it appears to the Authority that an individual is not a fit and proper person to perform functions in relation to a regulated activity carried on by an authorised person.

(2) The Authority may make an order ('a prohibition order') prohibiting the individual from performing a specified function, any function falling within a specified description or any function.

(3) A prohibition order may relate to –

(a) a specified regulated activity, any regulated activity falling within a specified description or all regulated activities;

(b) authorised persons generally or any person within a specified class of authorised person.

…

(8) This section applies to the performance of functions in relation to a regulated activity carried on by –

(a) a person who is an exempt person in relation to that activity, and

(b) a person to whom, as a result of Part XX [provision of financial services by members of the professions], the general prohibition does not apply in relation to that activity,

as it applies to the performance of functions in relation to a regulated activity carried on by an authorised person.

(9) 'Specified' means specified in the prohibition order."

13. Under s 133 FSMA, the power of the Tribunal on a reference of this nature is to determine what (if any) is the appropriate action for the Authority to take in relation

to the matter referred to it and remit the matter to the Authority with such directions (if any) as the Tribunal considers appropriate for giving effect to its determination.

14. It is common ground that the burden in each of these respects (market abuse, penalty and prohibition) is on the Authority, the standard being the ordinary balance of probabilities. We turn therefore to consider the Authority's case.

The Authority's statement of case on market abuse

15. The Authority says that the effect of the Trade on the price of the September 2007 futures, and the consequent setting of the CORP at above US$1750, so that the September puts expired unexpectedly OTM and the September calls expired unexpectedly ITM, is that Mr Hobbs effected an order to trade which gave a false and misleading impression as to the price of September futures (and the CORP) within the scope of s 118(5)(a) FSMA, and that he effected an order to trade which secured the price of September futures (and the CORP) at an abnormal and artificial level, within the scope of s 118(5)(b).

16. The Authority says that the trading was not for legitimate reasons and was not in conformity with accepted market practices. The Authority's case in this respect is that the Trade was made with a view to increasing the September futures price and hence the CORP. The Authority says that Mr Hobbs intended to manipulate the September futures price above US$1750 in order to achieve a CORP above US$1750. It is said that Mr Hobbs' intent in effecting his order in the size and at the precise time that he did was to mislead, and thereby influence the behaviour of, other market participants in order that he might profit thereby.

17. The Authority makes the point that, although Mr Hobbs was successful in driving the September futures price up through the US$1750 strike price for the September options, the other market participants did not react to what the Authority describes as Mr Hobbs' manipulation of the market in the way Mr Hobbs is said to have had envisaged, and accordingly Mr Hobbs does not appear to have made a profit. Nonetheless, the Authority's case is that if Mr Hobbs' alleged plan had worked he could have made substantial profits.

18. Mr Hobbs on the other hand says that when instructing Mr Kerr to buy the 600 September futures he was motivated solely by a desire to reduce his short position. In explanation of the content of various telephone conversations between Mr Hobbs and Mr Kerr, which we shall consider in detail, Mr Hobbs' position is that he was concealing his position, and the limits to which he was subject, from Mr Kerr, because he believed that Mr Kerr might reveal that position to one or more other market participants. The Authority says that this explanation is untrue.

The evidence

19. We heard witness evidence from the following witnesses for the Authority, each of whom was subject to cross-examination by Mr Hobbs:

(1) Marc Petrocochino, who at the relevant time was a managing director and member of the executive committee of Mizuho. Mr Petrocochino's evidence covered the recruitment of Mr Hobbs to Mizuho, the limits to which Mr Hobbs' trading was subject, Mizuho's approach to limits, the disciplinary meeting on 12 December 2007, which arose out of concerns about the Trade, and the decision to dismiss Mr Hobbs.

(2) Darren Sherman, chief risk officer and head of risk management for Mizuho. Mr Sherman's evidence also dealt with the approach of Mizuho to limits, and covered Mr Hobbs' risk position on 15 August 2007. He also commented on the concerns he had in relation to the Trade.

(3) Florent Lambert, who leads the LIFFE grain options market making team at Marex Financial Ltd. At the material time, in the absence of Mr Charles Lesser (who was the person in charge of Marex's options market making desk), Mr Lambert was responsible for managing Marex's options positions. Mr Lambert's evidence included comments on the relevance of the CORP to market participants, his experience of the setting of the CORP on 15 August 2007, and the complaint to LIFFE that he made following the release by LIFFE of the CORP at 12.48pm on that day.

(4) James Hearn, the joint head of the agriculture division at Marex Financial Ltd. Mr Hearn too gave evidence on the relevance of the CORP to market participants and the setting of the CORP on 15 August 2007. Although Mr Hearn's witness statement also included a brief section on Mr Hobbs' trading on that day, it became clear in oral evidence that he had not had sufficient information on which to form a view; accordingly we placed no reliance on that part of his evidence.

(5) Simon Hardy, an independent commodities day trader who, in August 2007, was the manager of the commodities trading desk at the commodity broking firm TRX. During 2007 Mr Hardy was Mr Hobbs' main contact when Mr Hobbs traded coffee futures through TRX. Mr Hardy gave evidence relating to Mr Hobbs' trading on 15 August 2007, including of a telephone conversation with Mr Hobbs at12.35pm on that day. He also gave evidence of the impact of the CORP finishing above US$1750 on his own trading.

(6) Ellis Batchelor, an independent consultant to the financial services industry, specialising in compliance and regulatory issues. At the material time, Mr Batchelor was a manager in the Audit, Investigations & Membership ("AIM") department at LIFFE, reporting to Andrew Fenlon, Head of AIM. Mr Batchelor gave evidence on the LIFFE investigation into Sucden, a meeting on 18 December 2007 with Mr Hobbs and other representatives from Mizuho attended by Mr Batchelor, Mr Fenlon and a Mr Martin Carbin of LIFFE and a subsequent email to Simon Dixon of the Authority's markets division. Although in his witness statement Mr Batchelor commented on the question of the liquidity of the coffee futures market as the time of option expiry approaches, it became clear that Mr Batchelor was not qualified to express any expert opinion on that matter, and his evidence in that respect was disregarded.

(7) Anthony Algeo, a director in the Compliance Department at Mizuho International plc. Mr Algeo gave evidence of the training Mr Hobbs had received from Mizuho, in particular in relation to market abuse, Mr Hobbs' methods of trading, the initial query from LIFFE, and his own internal enquiries, including meetings with Mr Hobbs. The evidence covered the contents of an email to Mr Hobbs of 29 August 2007, in which Mr Algeo raised a number of questions with Mr Hobbs, the response of Mr Hobbs on 30 August and the response to LIFFE, as well as further correspondence. Mr Algeo also gave evidence of a briefing note on the matter to the executive committee of Mizuho. Finally, Mr Algeo's evidence covered Mr Hobbs' position limits and surrounding issues.

(8) An expert report was provided by William Beagles, an experienced derivatives trader across a wide range of asset classes, including commodities. Mr Beagles explained to us that he had traded coffee futures and options, although he had never been a market maker in that respect. He had, however, for the past eight years or so run LIFFE's education for their clients in the commodity business on commodity options and futures. Mr Beagles' report was comprehensive, including a technical description of the market in coffee futures and options, which was largely, if not wholly, uncontroversial. We shall draw on that extensively in our description of the general operation of the market. Mr Beagles also offered an opinion on Mr Hobbs' own Trade, which was controversial. We shall examine that in detail in our discussion of the issues.

20. Mr Hobbs was the only witness on his own behalf. He was cross-examined by Mr Hunter for the Authority.

21. At the outset of the hearing Mr Hobbs renewed the application he had made earlier to the Tribunal for witness summonses to compel the attendance of two further witnesses, namely Ms Olivia Dickson (a voting member of the Regulatory Decisions Committee ("RDC") panel which had issued the Authority's decision) and Andrew Fenlon of LIFFE. The original application had been considered by the Tribunal judge, Sir Stephen Oliver QC in chambers on the papers, and he had refused the application in both respects in his decision released on 2 September 2011. We refused the renewed application for the same reasons as those given by Judge Oliver.

The coffee futures and options market

22. As Mr Hunter submitted, the central issue for the Tribunal is to ascertain the trading rationale for the Trade, in other word the purpose of Mr Hobbs in effecting it, at the time that he did so. We shall examine in detail the Trade itself, and the events leading up to it, but before doing so it is necessary to summarise the workings of the market so as to appreciate whether the Trade was, as Mr Hobbs submits, for legitimate reasons and in conformity with accepted market practices on that market, or, as the Authority argues, was a manipulative scheme to make Mr Hobbs a profit, and as such was not a legitimate trade of this nature.

Coffee futures contracts

23. Futures contracts ("futures") are agreements to buy and sell a commodity ("the underlying") on a fixed date in the future ("expiration" or "expiry"), with the price agreed at the time of trading. Futures are contracts; they are not physical transactions of the commodity, although a physical transaction will result if a position is still held in the futures upon expiry.

24. LIFFE coffee futures are agreements to buy or sell suitable grade Robusta coffee on a fixed date in the future. One LIFFE coffee future now equates to 10 tonnes of such coffee. At August 2007, one coffee future equated to five tonnes. LIFFE lists a range of delivery months for trading: January, March, May, July, September and November, such that 10 delivery months are available for trading at any particular time.

25. LIFFE coffee futures are priced in US dollars per tonne. The minimum price movement is US$1 per tonne. The price accordingly moves in increments and multiples of US$1 per tonne.

26. LIFFE coffee futures may be traded at all times until expiry.

Coffee futures option contracts

27. Option contracts ("options") convey the right but not the obligation to buy (in the case of calls) or sell (in the case of puts) the underlying at a given price ("the strike price") on or before a given date in the future ("expiration" or "expiry"). We should note at this point that "expiry" is also used to denote the time at which the options themselves cease trading. This expiry in relation to the September 2007 put and call options took place at 12.30pm on 15 August 2007. The options remained exercisable, however, for a further 45 minutes; accordingly 1.15pm on that date was the expiry or expiration of the options in that respect.

28. LIFFE coffee options are agreements that convey the right but not the obligation to buy (in the case of calls) or sell (in the case of puts) LIFFE coffee futures at a given price on or before a fixed future date. One LIFFE coffee option equates to one LIFFE coffee future.

29. As with coffee futures, LIFFE lists the same range of option delivery months for trading. Thus, 10 delivery months are available for trading at any particular time.

30. Owners ("longs") of options have the right to exercise the options that they own. The exercise of a call will result in a long underlying position for the long. This is because the owner will acquire futures as a result of the exercise. The exercise of a put will result in a short underlying position; the owner will sell futures.

31. Sellers ("shorts") of options may be "assigned" on the options they have sold. Assignment is merely the mirror image of exercise. If the owner of an option exercises it, the counterparty to that option (the seller) is assigned on the option. Assignment on a short call position will result in a short underlying position (the

seller will have to sell futures). Assignment on a short put position will result in a long underlying position (the seller will buy futures). When an option is sold, the option seller receives a payment (the option "premium") and takes on in return the risk that the option will be exercised.

5 32. On LIFFE the exercise of one September coffee call will result in a position of long one September coffee future. The exercise of one September coffee put will result in a position of short one September coffee future. Conversely, the assignment of one September coffee call will result in a position of short one September coffee future. The assignment of one September coffee put will result in a position of long 10 one September coffee future.

33. LIFFE coffee options are American-style; they may be exercised at any time up to expiry (that is, not the expiry of trading in the option, but the latest date for exercise).

34. We have already briefly referred to options being in the money (ITM) or out of 15 the money (OTM). There is also an expression "at the money" (ATM):

> ATM is the expression used to describe an option with a strike price adjacent to the prevailing underlying price.
>
> ITM is a term used to describe an option with an intrinsic value. A call option will be ITM where the strike price is lower than the market price, so that a profit 20 can be made on a call; conversely, a put option will be ITM when the strike price is higher than the market price; a profit will be made on exercising the put.
>
> OTM is the term used to describe an option with no intrinsic value. A call option will be OTM where the strike price is higher than the market price, and a put option will be OTM where the strike price is lower than the market price.

25 35. It can be seen from this description that where the market price is relatively close to the strike price, any movement of the market price through the strike price will have the effect of converting ITM options to OTM and vice versa.

36. Mr Beagles' report described ITM options as those that would be exercised if expiring at that time, and OTM options as those that would not be exercised. Whilst 30 this is an explanation that might hold good as a matter of simple economics if the only consideration was the making of a profit on the option itself, it is not so straightforward where delta trading is concerned. We shall describe delta trading shortly. In those circumstances, there may be cases where options will be exercised even though they are OTM, and abandoned even though they are ITM.

35 *Relationship between LIFFE coffee futures and LIFFE coffee options*

37. LIFFE coffee futures and LIFFE coffee options are distinct contracts and trade independently of one another. However, they are linked, as the underlying of a coffee option is a coffee future.

38. One of the key determinants of the price of LIFFE coffee options is the LIFFE coffee futures price. The other key determinants are time, volatility and interest rates. Since the price of coffee options is linked so closely to the coffee futures price, coffee options are often traded against coffee futures or physical coffee (the underlying of coffee futures).

39. For example, option market makers (specialist market participants who provide two-way prices in options) will usually hedge option positions with the corresponding future. This hedge is designed to reduce directional exposure to the futures price and is known as "delta hedging".

Delta and delta hedging

40. The delta of an option quantifies the extent to which an option price is expected to change in response to a change in the underlying futures price, other things (such as time, volatility and interest rates) being equal. Delta hedging is common practice across all option markets including LIFFE. LIFFE recognises this fundamental inter-relationship between futures and options by allowing futures and corresponding options to be traded simultaneously, a combination known as a "volatility trade".

41. Delta may be quoted as a decimal or percentage. For example, an ATM call has a delta of 0.50 or 50%. Delta is positive for calls (because calls tend to increase in value as the underlying increases) and is negative for puts (because puts tend to decrease in value as the underlying rises). An ATM call has a delta of +0.50 or +50%. An ATM put has a delta of -0.50 or -50%.

42. Mr Beagles gives the example of an ATM call which has a delta of +0.50 or +50%. Other things being equal, for every one tick that the underlying rises, the value of the call will rise by 0.50 of one tick. If the underlying rises by 10, then the value of the call should rise by 5. If the underlying falls by 30, then the value of the call should fall by 15.

43. Sophisticated option users such as market makers understand these relationships and (unless they want a directional futures position) will hedge the directional exposure of their options positions with futures. Mr Beagles provided the following simplified example:

> A broker asks a coffee option market maker for a quote in some ATM (at the money) calls. The market maker gives the broker a two-way quote (i.e. a bid and an offer). The broker buys 100 lots of the ATM calls from the market maker at the offer price. As a result, the market maker is short of 100 ATM calls. The market maker did not actively seek this position; rather the market maker simply provided a two-way quote to a broker who decided to "hit" the market maker's offer. The market maker now has directional exposure; exposure to the underlying coffee futures price moving. Specifically, since the market maker is short of calls, he or she will tend to make money if the coffee futures price falls and lose money if the coffee futures price rises (because the calls that the market maker is short will tend to decrease

in value if the coffee futures price falls and rise if the coffee futures price rises).

The market maker does not necessarily *want* this directional exposure (profit to the downside and loss to the upside) and therefore "*delta hedges*" this exposure with futures. The market maker needs a hedge that will show a profit to the upside (the area of exposure from the short calls); the market maker needs to buy futures. And since the market maker has sold 100 at the money calls with a delta of 0.50 or 50%, the market maker needs to buy 50 futures (i.e. 100 lots x 0.50 delta) as a delta hedge.

The market maker's combined futures and options position is as follows:

Short 100 lots of ATM calls (with a delta of 50%)
Long 50 lots of the underlying futures

The combined position is "delta neutral"; directional exposure has been hedged.

For example, all things being equal, if the underlying future rises by 8 ticks, then the calls that the market maker is short should rise in value by about 4 ticks each (i.e. 8 tick rise in future x 0.50 delta) causing the market maker a loss of 400 ticks (i.e. the rise of 4 ticks per short call x 100 lots). At the same time, as the underlying future rises by 8 ticks, the *futures* that the market maker is long (the delta hedge) will give the market maker a profit of 400 ticks (i.e. the 8 tick rise in the future x 50 lots).

The loss of 400 ticks sustained on the short calls is cancelled out by the profit on the futures delta hedge. The position is "delta neutral"; directional exposure has been negated.

44. Delta reflects the likelihood of an option being exercised. The more likely an option is to be exercised, the closer its delta approaches 1.0 or 100%; the less likely it is to be exercised then the delta will approach zero (0). The delta reflects the number of futures that the option represents. Traders will assign deltas to their positions depending on their view of the market, including volatility. An adjustment to delta will then give rise to possible adjustment to a trader's position, depending on the extent to which that trader wishes to delta hedge to avoid directional exposure, or needs to adjust his position to remain within his own trading limits.

45. On expiry (meaning the latest date on which the options can be exercised), the options become binary. In other words, the delta attaching to the option will either be 0 or 100% (1.0) reflecting the likelihood of exercise or non-exercise; the likelihood of an option converting effectively into the underlying futures.

The Coffee Options Reference Price ("CORP")

46. LIFFE coffee options expire (that is cease to be traded) at 12.30pm on the third Wednesday of the calendar month preceding the expiry month. The September 2007 coffee options accordingly expired at 12.30pm on 15 August 2007.

47. LIFFE coffee futures do not expire until the last business day of the delivery month.

48. LIFFE coffee futures are open for trading from 9am to 5.30 pm. As the options expire at 12.30 pm on the expiry date, a futures reference price (the CORP) is
5 established by reference to that time in order that the expiring options may be characterised as ITM or OTM.

49. On the basis of this classification the Clearing House automatically exercises ITM options unless given instructions to the contrary by the owners of the options in question. The Clearing House automatically allows OTM options to expire worthless
10 (in other words it does not exercise the options) unless given instructions to the contrary by the owners in question. Following option expiry, instructions relating to exercise must be given no later than 45 minutes after the latest trading time for the option (i.e. 1.15 pm in the case of coffee options).

50. Longs of options thus have 45 minutes (during which the futures market
15 continues to trade, and the futures price may fluctuate) in which to decide whether or not to exercise their options. The positions of shorts of options will be affected by the decisions taken by the longs in that respect, and decisions of the shorts to adjust their own positions will therefore be based on their own judgements as to the number of options that are likely to be exercised or abandoned.

20 51. The CORP is calculated with reference to the volume weighted average price (VWAP) of the relevant coffee future in the minute preceding 12.30pm on option expiry. The September 2007 CORP was the VWAP of September 2007 coffee futures from 12.29 pm to 12.30 pm on 15 August 2007. Ordinarily, the CORP would be expected to be released to the market by LIFFE within two or three minutes after
25 12.30pm.

The facts

52. From the oral and documentary evidence before us, we find the following material facts.

Mr Hobbs' trading limits

30 53. Mr Hobbs was subject to trading limits set by Mizuho. Limits were set by Mizuho's parent company and by the risk committee. A breach of risk committee limits could result in a desk's position being liquidated and the desk being shut down. Breaches of risk committee limits were serious and would likely result in disciplinary action. Those limits were not relevant to Mr Hobbs' position at the material time.
35 Those that were relevant were "front office" limits set by Mizuho's risk department.

54. In relation to front office limits, it was not uncommon for traders at Mizuho to breach those limits; indeed, as Mr Petrocochino described it, they were violated on a weekly basis. The purpose of the limits was to trigger a discussion between the trader

and the risk management department about the particular trading position that had given rise to the breach, in order that it might be checked and approved.

Mr Hobbs' position at close of trading on 14 August 2007 / opening of trading on 15 August 2007

55. At the close of trading on 14 August 2007 and the start of trading on 15 August 2007, Mr Hobbs' position on the LIFFE coffee futures and options markets was:

(1) He was short coffee futures (across various months) in a total amount of 564 lots.

(2) He held various put options, including 2000 September 2007 put options with a strike price of US$1750.

(3) He held various call options, including 150 September 2007 call options with a strike price of US$1750.

56. In consequence, Mr Hobbs' overall position in coffee futures at the opening of trading on 15 August 2007 was substantially short.

57. The September coffee futures price at the close of trading on 14 August 2007 and the start of trading on the following day was around US$1760; that was the price of the opening trade on 15 August 2007. That meant that Mr Hobbs' put options were OTM and his call options were ITM.

58. At this stage, Mr Hobbs was in breach of his front office limits (both single commodity and across all commodities). His breach of limits was a subject of a recorded telephone conversation between Mr Hobbs and an unknown member of Mizuho's risk department at 5.28pm on 14 August 2007. As against a front office limit of 4 million, Mr Hobbs was 6.6 million short. When, in the course of the conversation, it was suggested that he might be 8.4 million short ("double the limit" as Mr Hobbs replies), Mr Hobbs is recorded as saying "It doesn't excite me".

Discussions between Mr Hobbs and Mr Kerr on the evening of 14 August 2007

59. At 5.57pm on 14 August 2007 Mr Hobbs and Mr Kerr had a telephone call in which they discussed the next day's trading and in particular the expiry of the September 2007 coffee options. There was discussion of calling options early, with some evident confusion as to whether the options were European style options (which could only be exercised on expiry) or (as is the case) American style options that could be exercised at any time up to expiry.

60. Mr Hobbs suggests a sale of a one lot "iceberg" from the opening at "50 or something like that" for "maybe 500 lots", meaning a sale of futures in tranches, a large part of which would be hidden so as to conceal the true size of the order, at a price of US$1750. He comments: "… that'll throw a bit of [unclear] panic [unclear] won't it?" He then goes on: "You can't get pulled up for offering one lot", before suggesting that it could be done for November rather than September.

61. Mr Hobbs and Mr Kerr discuss their views of the possible positions of other market traders. They joke that everyone in the market knows who is holding the positions. Mr Hobbs suggests that he might "take the options on" on the basis that he considers that the counterparties would not be allowed to carry a position, so on
5 exercise of the put option, the shorts of that option would have to sell futures.

62. The discussion then turns to the impact of delta hedging on the traders who are considered to be the counterparties to the September put options held by Mr Hobbs. Mr Kerr remarks that those traders would have to sell if the market falls on the following day. The conversation then continues:

10 KERR: But it would definitely tip down if they get called.

HOBBS: Well, that's where the beauty of it is, isn't it really?

KERR: And then you've got the next strike as well, which all of a sudden comes into play.

HOBBS: But that's where the beauty of it is in terms of … in terms of
15 after 12.30.

KERR: Mm.

HOBBS: Because they'll expect it to go off worthless.

KERR: Yeah.

HOBBS: And someone calls it.

20 KERR: It ain't worthless.

HOBBS: 'Cos they'll have covered all their futures.

KERR: Yeah.

HOBBS: You'd have to sell about 2,000 lots.

KERR: Yeah.

25 HOBBS: Yeah, yes, that might be well worth doing. I don't know. I haven't decided. I need to sleep on it.

KERR: You should be the prime minister.

HOBBS: I could have had, I should have had 4 or 5,000 lots on, really, then it would make it a lot easier.

30 KERR: Yeah. Well then, you can call at least 2½ thousand lots.

HOBBS: Yeah. Exactly. But then you'd make it proper market moving stuff, whereas 2,000 lots, is it really? I don't know. I'm not sure.

KERR: Well I think it will move it.

35 HOBBS: Alright, okay, very good.

KERR: Alright, mate.

HOBBS: Right, we'll speak about it again tomorrow.

Mr Hobbs' initial trading on the morning of 15 August 2007

63. Trading in coffee futures on 15 August 2007 commenced at 9.40am. The first September 2007 futures trade conducted (at 9.40am) was at a price of US$1760. Mr Hobbs' first trade was a 150 lot sell order, effected through Mr Kerr at 9.40am, at 5 prices between US$1762 and US$1756. Then, on his own account, he sold 111 September futures at between 9.46am and 9.47am at prices between US$1746 and US$1749, followed, at 9.51am by a sale of a single lot at US$1736.

64. Mr Hobbs' trades constituted a significant proportion of the volume of trades in September 2007 futures. By 9.45.28am the price had fallen to US$1750; immediately 10 thereafter it fell below US$1750.

Telephone call between Mr Hobbs and Mr Kerr at 9.51am, 15 August 2007

65. At 9.51am on 15 August 2007 Mr Hobbs telephoned Mr Kerr. During this call, at 9.52am Mr Hobbs commenced a strategy of buying futures through Mr Kerr, using "iceberg" orders. He also conducted trading on his own account, in smaller 15 quantities, including both buys and sells, but with a net buy of 16 lots.

66. During this telephone call the following exchange took place:

> KERR: Be nice if you bought about a thousand lots down here and you can have it back up through 1750 and they will have to cover and you could sell them all out at 60.
>
> 20 HOBBS: Yes. Or it finishes in the money and I just don't exercise anything.
>
> KERR: Yes [laughter]
>
> HOBBS: Which is probably what I [UNCLEAR] give myself another option do you know what I mean?

25 *Mr Hobbs' morning trading*

67. Between 9.52am and 12.23am Mr Hobbs bought 802 lots of September 2007 futures, largely through Mr Kerr on an iceberg basis, at prices between US$1736 and US$1744. All these buy orders were filled. There was a 40 minute break in trading by Mr Hobbs between 11.09 and 11.49. In that period Mr Hobbs' explanation was 30 that he was engaged in an administrative element of trading which required all individual trades executed through a broker to be manually input by his Bloomberg terminal throughout the morning. He also explained that he was trading in other commodities markets.

68. During this period the telephone transcripts show that Mr Hobbs was discussing 35 with Mr Kerr the timing of options expiry. After checking, Mr Kerr confirmed to Mr Hobbs that the expiry time was 12.30pm.

69. Mr Hobbs' evidence was that he had buy orders in throughout the morning. However, these were not at market price.

70. Mr Hobbs also received a number of offers to buy his September 2007 put options at a premium to their value by reference to the market price. At 9.43am there was an offer of US$5 to US$10, which Mr Hobbs declined, he was looking for US$15. He also declined offers of US$10 or more at 9.44am, an enquiry from Marex at 9.48am and an offer at US$10 at 11.25am. Mr Hobbs did not enquire at what volume these purchase offers were made.

71. At 11.03am Mr Hobbs increased his short position in September 2007 US$1750 put options by buying a further 50 such options at US$13 from Natexis. This was at a premium of US$9 by reference to the market price, which at that time was US$1746.

Telephone calls between Mr Hobbs and Mr Kerr at 11.15am and 11.35am

72. Mr Hobbs and Mr Kerr spoke again by telephone at 11.25am and 11.35am. Those calls occurred during the period of 40 minutes when Mr Hobbs carried out no trading in coffee futures. Mr Hobbs and Mr Kerr discuss the timing of option expiry, and Mr Kerr says that this is "exciting, something for you to do". Mr Hobbs replies:

> "I don't know really, I've got about fifty things going through my head what I want to do with them and I haven't decided on any of them."

73. Mr Hobbs then asks for a recap on his trading activity, followed by a discussion of what appears to be an offer by Mr Hobbs to sell 100 put options at US$18, in respect of which a bid of US$10 has been received, as against another trade bid at US$15, so that the US$10 bid was out of the market. At 11.35am, Mr Hobbs cancelled his offer at US$18 and instructed Mr Hobbs instead to offer 400 of the September puts at US$25. This causes some surprise to Mr Kerr, and the following exchange takes place:

> KERR: OK. Do you want me to show them?
>
> HOBBS: Yes.
>
> KERR: OK. Why, are you just playing with them?
>
> HOBBS: Yes. Well if someone pays 25 then I don't mind doing it, it's alright.
>
> KERR: But no one's going to pay 25 are they? Who would possibly pay 25?
>
> KERR: It depends. It's a matter of sophistication.

74. There is an interruption in the call, but when reconnected the conversation of Mr Hobbs and Mr Kerr proceeds as follows:

> HOBBS: The other thing I was thinking about and obviously this goes no further. At 732.
>
> KERR: Right, sorry?
>
> HOBBS: At sorry, at so it's 30 and 10 seconds.
>
> KERR: Yes.

> HOBBS: You've got 30 and 10 seconds. I see that someone's actually, I was going to say if I lifted all the offers.
>
> KERR: Well then they'd have to, they then, if you did it before 30 then …
>
> HOBBS: No not before, before 30 … after 30 … So basically let's say it finishes in the money, yes.
>
> KERR: And then you push it up to 55 and you don't exercise.
>
> HOBBS: Yes.
>
> KERR: They will have to buy 2000 lots back or whatever …
>
> HOBBS: … Yes exactly.
>
> KERR: … Or whatever they've sold yes.
>
> HOBBS: Anyway, just going through my head dunno.
>
> KERR: Alright mate.
>
> HOBBS: What …
>
> KERR: … Let me speak to, I want to just get everything clear in my head. I'm going to call the exchange and …
>
> HOBBS: Yeah I need to know basically …
>
> KERR: Yes exactly of course. OK mate, cheers.

Checking the position on options expiry, and other conversations

75. At 11.39am Mr Kerr telephoned LIFFE to check exactly when and how the CORP would be determined and the rules for option holders. LIFFE confirmed to him that the options expired at exactly 12.30pm, that option holders would have 45 minutes to decide whether to exercise the options, and that if they did not direct otherwise then ITM options would be exercised and OTM options abandoned.

76. Whilst holding the line waiting to speak to LIFFE, the tape records Mr Kerr explaining to another broker or trader (unidentified) what appears to be an attempted description of what Mr Kerr has just discussed with Mr Hobbs. Mr Kerr says:

> "Exercise then all the jobbers, all the market makers that sold him the put have sold him the put have sold the futures against it so they're gonna have to buy the futures so if he buys shit loads here … Then they're gonna have to buy 2000 lots back [UNCLEAR] yeah but he's long, he's long a thousand lots outright so if the market goes more than 20 bucks [UNCLEAR] then he makes a hundred thousand [UNCLEAR].

77. At 11.47am Mr Kerr called Mr Hobbs to inform him of the conversation he had had with LIFFE. Mr Hobbs is at this point concerned with the position if the options are ITM on expiry, so that they will be automatically exercised, unless he instructs the clearing house otherwise. His concern is evidently to enable him to ensure that the put options are not exercised if he does not want them to be.

78. On hearing Mr Hobbs singing, Mr Kerr asks him whether he is enjoying himself. The conversation continues:

> HOBBS: Not really. I knew exactly what I wanted to happen so, I thought it might come off quicker so.
>
> KERR: Yes. I was thinking with it down here, you see this is the crux now it's either, if you start [expletive] not taking them it will probably fly this afternoon but then it will be a nice opportunity to sell it up towards 1760, 1770. Or 1800 odd on Nov. But if you don't take, if you do take them then I think we're just going to drift lower. The ball is in your court mate, at last you are the market mover. You have a direct personal impact on the market today.
>
> HOBBS: How wonderful.
>
> KERR: Isn't that fun.
>
> [SINGING]
>
> HOBBS: Sounds funny because I was sort going into the day, really now, I'm you know, still don't have any …
>
> KERR: Any options cover …
>
> HOBBS: No.
>
> KERR: So you either need it to dump or you abandon the options and watch it fly.
>
> HOBBS: I better call this guy tell him to widen their parameters.
>
> KERR: Yes cool.

79. Immediately after that call with Mr Kerr, Mr Hobbs telephoned Mizuho's back office to discuss how to prevent an automatic exercise of ITM options. He explained that he might not wish to "take them on", meaning exercise them, even though they were in the money. At that stage, according to the conversation, the September coffee futures were trading at US$1744, meaning that Mr Hobbs put options were US$6 in the money. Mr Hobbs explains that he might not want to exercise the options because of his delta position. It is then explained to him that he does not need to adjust any parameters; each position would be handled individually. Mr Hobbs checks again that he can abandon the options, and is reassured that this can be done with no problem.

The 12.06 telephone call: the Trade

80. The order for the Trade was placed by Mr Hobbs during a telephone call with Mr Kerr which commenced at 12.06pm and ended just after 12.30pm. We need to refer to a number of passages in the transcript of this call. Shortly after the start of the call the following exchange is recorded:

> HOBBS: … idea of just slapping London myself now. That would throw a spanner in the works.
>
> KERR: Yes it would definitely.

HOBBS: Be quite nice, you still got, basically they go off at half past.

KERR: Yes.

HOBBS: But you still got another 45 minutes of trading to …

KERR: Yes.

5 HOBBS: …Go around with it, make a decision. Funny. [Yawn] Tiredness, tiredness, so much bloody tiredness. What's the depth like above 1750?

KERR: Above [UNCLEAR] well there's um 70 at 50, 20 at 51, 30 52, 20 at 53, 20 at 54, 60, 55 …

10 HOBBS: [UNCLEAR]

KERR: Huh?

HOBBS: What about above 54?

KERR: 60 at 55 then nothing for 60, nothing really no and nothing really much.

15 HOBBS: OK. [Pause] Cause you could do the ultimate here [UNCLEAR]

KERR: Sorry?

HOBBS: Basically on the close, hopefully pick up some more yeah.

KERR: Yes.

20 HOBBS: On the close just before the close, lift everything.

KERR: Right.

HOBBS: Then everyone covers.

KERR: Yes.

HOBBS: Sell into it and exercise the options.

25 KERR: Yes [laughter].

HOBBS: See what I mean?

KERR: Yes, yeah, yeah I do yeah.

HOBBS: Or is that just trying to be too clever?

KERR: It's probably trying to be too clever but it's still not a bad …

30 HOBBS: But we do it at 29 minutes past.

KERR: Yes [*said with uncertainty*]

HOBBS: There's not much Nov selling either is there?

KERR: No. No above there isn't.

HOBBS: Come on give me some more 43s so we can do that then,
35 that's probably what I might do … Whoa no maybe not. [Pause] See, you know by lifting some of the offers if there's people actually need to cover or not.

KERR: Yes you would.

> HOBBS: Really. You find out. You glean some information.
>
> KERR: Yes.
>
> HOBBS: I reckon someone's bidding Nov instead you see.
>
> KERR: Yes. Probably. There's a bit of roaster buying around in Nov. I do know that, I've got some, had some.

81. Following this exchange, Mr Hobbs placed several iceberg orders at or just below the market price. All the orders were filled without difficulty.

82. As regards the iceberg orders being placed by Mr Hobbs, these were placed in random batch sizes, the size of each batch being determined by a random number generator. Mr Hobbs comments that he likes the way it randomly changes. The exchange then continues:

> KERR: It's good isn't it that random, one at it sort of does 13s and you put the maximum that you want to put in which I put as 20 as the maximum. So it might do a 20 or a 7 or a 9, it's quite good. Keep them guessing mate keep them guessing. Always good to keep them guessing.
>
> HOBBS: But we can't, we cannot afford to have any F-ups on the timing today OK.
>
> KERR: I know mate.
>
> HOBBS: Alright.
>
> KERR: That's the fun thing.
>
> HOBBS: So this is going to be down to yourself.
>
> KERR: Alright.
>
> HOBBS: … Getting it bang on.
>
> KERR: Alright we will get Tiny Tim on. [Note: It is accepted that this is a reference to the speaking clock.] So have you extended the …
>
> HOBBS: No they don't, they said they don't have to do it.
>
> KERR: Well they do. I've spoken to LIFFE.
>
> HOBBS: They're saying they don't, they don't go with LIFFE's rules on TRS.
>
> KERR: Sorry.
>
> HOBBS: With the US company.
>
> KERR: I hope they're right for your sake mate.

83. There followed a further period of trading by Mr Hobbs through Mr Kerr. He placed another order, in random batches, for 150 lots at US$1743. In all, between 12.01pm and 12.23pm Mr Hobbs bought, through Mr Kerr, 184 lots of September 2007 futures at prices between US$1743 and US$1744.

84. The exchange then continues:

HOBBS: Yes cancel the stuff below, you know the …

KERR: The …

HOBBS: … iceberg shit.

KERR: Oh the 56, 56, 56.

5 HOBBS: Yes. How long?

KERR: Five minutes just over.

HOBBS: What's the depth like up to 60?

KERR: Hold on I'm just cancelling this shit for you.

HOBBS: What's the depth like up to 1760?

10 KERR: And you're cancelling the thousand lots as well below yes?

HOBBS: Hmm.

KERR: OK. The depth like up to 60 is you've got 324 lots showing on Sep and that would be up to 75/80, you've got couple hundred Nov.

HOBBS: OK. You ready?

15 KERR: Yes.

HOBBS: I want you to tee up to buy, if I want this thing to finish through 50, how many lots do I need to buy?

KERR: At the moment you need to buy 200 and, hold on there's more because it says 140, 150, 150 Nov plus 180 Sep so 330 lots, and
20 you've got four minutes.

HOBBS: OK I want you to on the close, and this is the idea that it finishes obviously higher than 1750. I want you to buy 600 lots of September up to 1757.

KERR: Up to 1757, 600 lots OK. OK we've got three and a half
25 minutes.

HOBBS: I'm getting mildly nervous myself I don't know why.

KERR: Getting nervous yes.

HOBBS: Let's get the clock on myself.

KERR: But it will go off before it expires if you do it right now so I'm
30 just going to wait until 27 and 10 seconds then I'm going to put it on.

HOBBS: Right it's 12.27 already

[TALKING CLOCK]

HOBBS: Right you've got in on there yourself. I can listen to it from there then I'm absolutely fine you letting it go light.

35 KERR: Sorry?

HOBBS: I'm fine if you let it go light I just want to make sure you buy them. Yes?

KERR: Sorry you want to do it before rather than after?

HOBBS: Yes.

KERR: Which way it doesn't really matter.

HOBBS: Yes it does actually, I just want it to finish above 1750.

KERR: OK so 600 lots to buy up to 57 as close to 30 as possible beforehand preferably.

5 HOBBS: Yes. Well no it has to be beforehand otherwise …

KERR: Sorry?

HOBBS: It has to be beforehand.

KERR: OK. [Pause] I'm just going to do it again 1, 2, 3. I've had it before it's cut off beforehand. I'm going to go about three seconds

10 before OK?

HOBBS: Yeh.

KERR: Yes.

HOBBS: [UNCLEAR] it goes the beep.

KERR: Sorry?

15 HOBBS: When it says it will be 5.30 at 230 and …

KERR: Yes then I'll do it before the beeps. [Pause] Here we go. Shit someone's offered to down there to 50. The last print was 1757 though.

HOBBS: OK. Alright.

20 KERR: OK mate.

HOBBS: OK so how many did we do?

KERR: 600.

HOBBS: OK very good.

KERR: Alright mate.

25 HOBBS: OK

KERR: Cheers.

85. At this point the call ended. The order for 600 lots of the September 2007 futures was entered on the market at 12.29.58pm. At that time the price was US$1744 (bid for 27 lots) – US$1746 (offer for 6 lots). The 600 lot buy was filled at

30 12.29.59pm at various prices between US$1746 and US$1757.

86. The LIFFE trading data shows that the Trade caused the price of the September 2007 future to increase from US$1745 at 12.29.57pm to US$1757 at 12.30.00. There was no further trading on the market until 12.32.41pm when 20 lots were traded at US$1750. This was followed by a single lot trade at 12.32.43pm at US$1754, and

35 some small trades at 12.33.57pm at US$1748. Within seven minutes of 12.30pm, the price had fallen back to its pre-12.30pm level of US$1745.

Summary of Mr Hobbs' trading

87. We summarise here, from Mr Beagles' report, the trading in the September 2007 futures carried out by Mr Hobbs from the close on 14 August 2007 and opening on 15 August 2007 up to 1.16pm on that date.

5 88. During the relevant period, Mr Hobbs bought a total of 1,402 lots (including the 600 lot purchase by means of the Trade) and sold a total of 326 lots. Mr Hobbs therefore bought 1,076 lots net during that period. Overall, therefore, the effect was to reduce Mr Hobbs' short position by that amount.

89. The effect of sales and purchases of the futures themselves is clear. The
10 position for options is less so. As Mr Beagles' report notes, for a delta trader such as Mr Hobbs, the directional exposure of option positions is not static. The exposure of the option position is affected not only by purchases and sales, but by the mere fluctuation of the underlying futures price. This is but one of the variables that can affect the prices and deltas of options. The others are time, volatility and interest
15 rates. As each of these variables fluctuates, both the prices and deltas of options also fluctuate.

90. Mr Hobbs owned more than 2,000 lots of the September 2007 US$1750 options (calls and puts). As the market price of the September future rose during the relevant period, Mr Hobbs' overall position was becoming longer (or less short). As the
20 September future price fell, as it did during the morning of 15 August 2007, Mr Hobbs' overall position was becoming shorter. As Mr Beagles' described it, this was due to the effect of (long) gamma, the fact that option deltas change as the underlying futures price fluctuates.

91. At 1.01pm on 15 August 2007, Mr Hobbs exercised 1,147 of the US$1750 put
25 options that he owned. By reference to the CORP (US$1752), those options were OTM and thus would have expired at 1.15pm but for specific instruction given by Mr Hobbs to the clearers. The effect of that exercise was to increase his short position, and nullify to that extent the effect of his earlier net purchases of futures on that day. However, at that time the future had settled below US$1750, and was trading at
30 around US$1745-1746. The options had therefore moved from OTM (by reference to the CORP) to ITM (by reference to market value).

The effect on the market

92. We heard evidence from Mr Hearn, Mr Lambert and Mr Hardy as to what happened in the market as a consequence of the Trade and its effect on the CORP.

35 93. Mr Hearn's evidence in his witness statement was that his view at the time, based on the price at which the underlying futures had been trading in the run-up to 12.30pm, was that the level at which the CORP had been set was surprising. In light of the automatic exercise and abandonment of options, Mr Hearn recalled thinking at the time that the fact of the CORP having been set unexpectedly (and seemingly
40 artificially) above the US$1750 strike price for the September US$1750 options could have a negative impact on the profit and loss account of Marex's clients.

94. The CORP was released at around 12.50pm, and Mr Hearn and his colleagues sought in the 25 minutes leading to 1.15pm to contact the clients with open options at the US$1750 strike price to inform them of the CORP so as to enable them to decide whether to instruct clearers to declare or abandon the options. Mr Hearn and his team also contacted Marex's major clients to inform them of the level at which the CORP had been set and of the view that this was potentially market-moving. Marex's own delta position was adjusted to reflect the unexpected level of the CORP. Notwithstanding those adjustments Mr Hearn's evidence was that Marex suffered a small loss by reason of it having to buy futures at a higher than expected price.

95. In giving evidence to the Tribunal, Mr Hearn clarified his statement. He explained that the issue around the CORP was not the level at which it had been set, but the fact that it had been released by the exchange considerably later than was usual. The fact that the CORP itself had increased by a few dollars was not a problem.

96. Mr Hearn was asked about the price increase occasioned by the Trade. He explained that, to use his own language, a price increase might be categorised as a big spike, a little spike, or simply a spike. This price increase was none of these; Mr Hearn described it as "nothing", or, questioned by the Tribunal, as a "twitch".

97. As regards the options, Mr Hearn told us that it was very common for options to be exercised unexpectedly. There was inherent uncertainty, especially if the options were at the money or close to ATM. Mr Hearn explained that being "right on a strike" did not mean precisely ATM, but within US$1 to US$3. In those circumstances, where there was a "big open interest" (which there was in this case, there being around 3,500 relevant options outstanding), the longs of the various options would be having conversations with the clearers as to whether or not to exercise the options. The shorts to the options (such as a counterparty to a put option) would have no control over what the long would do. The shorts would simply have to make assumptions.

98. Mr Hearn also confirmed that options were different from the futures themselves, in that notwithstanding that the option might be ITM or OTM, it may well be exercised (or not) because the market participant wanted a particular position in the futures themselves.

99. At the time in question, Mr Hearn told us that Marex had a client, a "roaster" (an industry participant interested in acquiring the actual commodity, namely coffee) who was a big short of the puts (about 2,000 lots). Even though roasters would typically not be affected by whether options were exercised or not (because they were interested in the coffee itself, and could take a long-term view, unlike market-makers and other traders who would be looking to balance their positions), an open position of this size was material. Although the roaster could do nothing itself (as it was the short), Marex needed to advise it of the likelihood of the roaster being assigned the options and thus having to acquire the actual futures.

100. Mr Lambert in his witness statement referred to what he described as aggressive bidding in the final seconds before 12.30pm on 15 August 2012, as a result of which the CORP was unexpectedly set at $1752. He made a complaint to LIFFE. He explained that he had two reasons for doing so. The first was that the CORP had not been released by LIFFE until 12.48pm. Mr Lambert had not experienced such a delay before. The clearers would normally expect their customers to inform them by 1pm if they wished to countermand the automatic exercise or abandonment of the options which would take place at 1.15pm. Mr Lambert was not satisfied that LIFFE had taken 18 minutes to make a decision, leaving only 12 minutes for market participants to act.

101. The second reason, set out in Mr Lambert's statement was that he suspected that a market participant had manipulated the price of the underlying futures in the seconds leading up to 12.30pm, and that a market participant potentially might have tried to influence LIFFE officials after 12.30pm in order for the CORP to be set above US$1750. We do not understand this latter concern. The CORP is arrived at purely arithmetically, and no such influence would have been possible.

102. In evidence before us, Mr Lambert confirmed, in agreement with Mr Hearn, that the price increase was nothing more than an irritation. His motivation for calling LIFFE had not been due to Marex's position. The market remained open, and Marex had time between 12.30pm and probably 1.30pm, when they would know what had happened as regards exercise and abandonment of the options, to cover whatever exposure they had. No significant profit or loss arose; Mr Lambert did not feel it necessary to report the matter to his own boss, Mr Charles Lesser, who was away from the office on that day.

103. Mr Lambert referred to the fact that between 27% and 28% of the US$1750 puts were abandoned, despite the market having moved below that strike price before 1.15pm. He suggested that this meant that 27% of the longs in respect of those put options had not reacted to the fact that the price had gone down, shifting the options from OTM to ITM. However, in questions from the Tribunal, Mr Lambert conceded that it was impossible, without interrogating each individual long, to say what percentage might have simply failed to react, as opposed to those who deliberately allowed their options to lapse (as Mr Hobbs did in relation to a proportion of his options).

104. Mr Hardy gave evidence that the fact that the CORP finished above US$1750 on 15 August 2007 influenced his trading on that day and resulted in him losing money. He said that the fact that the CORP finished at US$1752 gave him confidence that somebody wanted to keep the price up. He was long coffee futures at that time, and as a result of the CORP he held on to contracts that he would otherwise have sold, in the expectation that the price was going to keep rising. The price actually fell and Mr Hardy ended up selling the contracts at a greater loss than would otherwise have been the case had the CORP been set at or around the price it was trading in the final minutes leading up to 12.30pm.

105. It became clear in Mr Hardy's oral evidence that the CORP was not relevant to his own trading. He had no options position. His confidence, as he then described it, was derived, not from the CORP, but from the Trade itself, being one of 600 lots. This confirmed Mr Hardy in what was already a bullish view of the market.

106. At 12.29pm, Mr Hardy was long in the September 2007 futures. The price at that time was US$1745. Mr Hardy was not a seller at that stage. The Trade caused the price to rise to US$1757, temporarily, before it fell back to below US$1750. Mr Hardy did not increase his long position as a result of the Trade. If the Trade had not taken place, Mr Hardy would not have had an opportunity to sell at a price greater than US$1750. We do not therefore accept that he made a loss as a result of the Trade, of the increase in market price, or (in particular) the fact that the CORP was fixed at US$1752. Any loss which Mr Hardy incurred was by reason of his own bullish view of the market, which preceded the Trade, and his failure to sell at a time when the price began to fall back towards the pre-12.30pm price.

107. Mr Hobbs telephoned Mr Hardy at 12.35pm. By that time the price of the September futures had fallen below US$1750; the last trade before the call was at US$1746 (at 12.34.48). Mr Hardy is likely to have been aware of that, as he explained to us that his trading screen showed what trades were going through, although at that time the CORP had not been announced. Mr Hardy was aware of the Trade (although he mistakenly thought it had been for 500 lots), but he did not know who had made it.

108. In this call Mr Hardy expresses his frustration at not having any selling in the market. He said: "I think they're trying to get the buck – the settlement price to 55 or something." Mr Hardy explained that he meant that it felt like someone was trying to set the CORP above US$1750. He regarded the timing of the Trade as "suspicious". Mr Hobbs told Mr Hardy that: "I do know what's going to go on but I'm not going to tell you." Although Mr Hardy replies: "I don't really care to be honest", in evidence to us he said that he did care, but it was not worth pursuing the matter as Mr Hobbs would not give him the information.

109. Mr Hardy's suspicions concerning the Trade sit uneasily with his professed reliance upon it in his own trading. The inconsistencies in his evidence, which we should note related to events some five years earlier, lead us nevertheless to place little reliance on Mr Hardy's evidence in this respect.

110. Mr Hardy had a further telephone conversation on 15 August 2007, this time with Mr Kerr, timed at 1pm. In that conversation, as was admitted, Mr Hardy and Mr Kerr discuss the Trade. Mr Kerr admits that he was the broker who had executed the Trade. Mr Hardy appears to be complaining to Mr Kerr that he could have sold once the price had reached US$1757. There is also a discussion of what Mr Hardy, with Mr Kerr, would have done if they had been in Mr Hobbs' shoes.

111. Asked about this conversation in evidence, Mr Hardy said that this was the one occasion on which he had discussed a client (Mr Hobbs was also a client of Mr Hardy in his broker capacity). He nevertheless also confirmed a general culture in the

market of participants seeking to ascertain what the big players in the market were doing so as to get the best picture of the then current state of play in the market. He said that "like anybody", he has two or three people he would call to try and gauge what is happening in the market. This is certainly, in our view, borne out by the evidence of telephone transcripts we have seen, although these are of course nothing more than a snapshot of market behaviour as a whole.

Telephone conversations of Mr Hobbs after 12.30pm

112. Mr Hobbs called Mr Kerr at 12.38pm to obtain information on his net buying of the September 2007 futures on the day. At this stage Mr Hobbs is anxious to have the CORP confirmed, so that he can consider what he needs to do. Mr Kerr confirms the CORP at US$1752 to Mr Hobbs at 12.48pm. Mr Kerr also confirms that (by reference to the CORP) the September US$1750 put options are OTM, and appears to suggest that in that event those options must be abandoned worthless.

113. As a result, Mr Hobbs placed an internal call within Mizuho to someone called Robert, who dealt in options expiries. He informs Robert that, notwithstanding that the CORP was at US$1752, he wants to exercise some of his options. During this call, Mr Hobbs is interrupted by a call from Mr Hearn advising him, as a client, of the CORP. When he returns to the call with Robert, Mr Hobbs is told that he will have to give the countermanding instructions before 1.15pm. In a call starting at 12.57pm Mr Hobbs gives Robert instructions that he wants to exercise 1147 of the September put options. His initial instruction is for the exercise of 997 lots, but he increases this to 1147 to take account of the automatic exercise of the 150 September call options he had a long position in (by reason of being ITM by reference to the CORP). At this stage, the actual market price of the September 2007 futures was between US$1744 and US$1746; accordingly, Mr Hobbs' put options were in fact ITM, and the call options were OTM.

114. Mr Hobbs telephoned Mr Kerr at 1.03pm. He begins the conversation by saying that he is happy, and asks Mr Kerr what everyone is talking about. Mr Kerr explains that he had received calls from two traders wanting to know the effect of the CORP on exercise of options. Mr Kerr then asks Mr Hobbs why he had not left the put options to expire below their strike price, and then left it until the latest time not to exercise. On being told by Mr Hobbs that the put options could still be exercised, Mr Kerr appears to be confused, thinking (wrongly) that the put options could not be exercised at all if they were OTM by reference to the CORP. Mr Hobbs, on the other hand, is clear at this stage on the way the market operates in this respect; he is also aware that the put options are, by that time, back ITM.

115. The conversation then continues:

> HOBBS: There you go … I basically just wanted to see what the market was going to do. I mean I wasn't going to make that much money out of them anyway so
>
> KERR: No exactly.

HOBBS: So I had a free play in terms of taking out some of the selling that was there, just to see how the market reacted.

KERR: Yeah.

HOBBS: And now everyone probably won't know what to do.

KERR: Mmm

HOBBS: In terms of …

KERR: Cover or not cover or give up or not give up.

HOBBS: Yeah but if market still stays down here after what's gonna happen then its rubbish.

KERR: Yeah, it's not good is it?

HOBBS: That's all I need to know really.

KERR: Yeah exactly.

HOBBS: It's just an exercise in, an exercise for that reason only.

KERR: Sure.

HOBBS: Just gives me a lot more information than just sitting there and just saying right.

KERR: Take and don't take you know yeah, information is power my friend, information is power yeah.

HOBBS: Plus I was seventy short in the day, overnight so effectively I didn't really change the book that much at all.

KERR: No.

HOBBS: So I am still short.

KERR: Cool.

HOBBS: But there's a lot of people scratching their heads now I guess going what the [expletive] going on?

KERR: Yeah working it all out.

HOBBS: Yeah.

116. At 1.19pm Mr Hobbs called Mr Hearn. They discussed, somewhat disingenuously in the case of Mr Hobbs, what was going on in the market. Mr Hearn refers in this conversation to the difficulties caused when, against expectations, the CORP finishes above the strike price, referring to the automatic exercise and abandonment process involving the clearing house. He says that this "… could of just screwed everyone up." Mr Hearn also offers the view that "… a big short of the put didn't want to be made long" (of futures). Marex, having had an internal meeting, had put it down to "shenanigans". Mr Hearn's view was that the option expiry had supported the market. He also confirmed that Marex had been short of the September futures, but had been delta'd. However, the big short had not been Marex but had been the roasters who were not delta'd, but who were unconcerned.

117. Mr Hobbs telephoned Mr Kerr again at 2.11pm. At this time the market in September 2007 futures had dipped to between US$1726 and US$1729. This

explains the opening remarks of the conversation to the effect that the market was looking bad. Mr Hobbs says, alluding, we infer, to his own need that morning to address his short position, that he "could've done with this this morning …"

118. This conversation then continues:

5 KERR: It's just sod's law isn't … you should've just exercised the lot and not hedged anything.

HOBBS: Yeah.

KERR: Yeah right.

HOBBS: That would have been an interesting trade.

10 KERR: It would have been an interesting one to explain to your bosses if it had of gone up. Why the [expletive] are you sitting there 3000 lots short?

HOBBS: Exactly.

KERR: Well umm I had a hunch (laughs)

15 HOBBS: (laughs)

KERR: I thought it might go down this afternoon.

HOBBS: A hunch went wrong. So can you see what I did though?

KERR: Yeah.

HOBBS: I created a false impression … coz em … which is worth
20 doing I think for the overall book.

KERR: How many did you exercise between you and I.

HOBBS: Over a thousand.

KERR: Over a thousand … and do you choose which broker to execute or which …?

25 HOBBS: No.

KERR: OK.

HOBBS: (sighs) Oh well I think it worked well enough but …

KERR: Could have made more on it but …

HOBBS: Nothing's perfect.

30 KERR: No.

HOBBS: The market might have done this anyway.

KERR: Maybe.

Events subsequent to 15 August 2007

119. On 23 August 2007 LIFFE contacted Mizuho for an explanation of the Trade.
35 This led Mizuho compliance to investigate. On 28 August 2007 Mr Algeo and his colleague, Paul Varoujian had two meetings with Mr Hobbs, one at 9am and the other

at 4pm. Mr Varoujian made a note of each meeting, which Mr Algeo reviewed and approved.

120. At the 9am meeting Mr Hobbs described his coffee positions on 15 August 2007 and indicated that as the coffee price had fallen on that morning he had bought September 2007 futures to profit from his short position and to improve the delta on his coffee option position. Mr Hobbs indicated that there were more offers in the coffee futures market as the option expiry time (12.30pm) approached and it suited him to take some of these offers. Mr Hobbs did not refer to having been in breach of his position limits.

121. The meeting at 4pm was called by Mr Algeo to clarify certain aspects, including why Mr Hobbs had on the morning of 15 August 2007, as well as buying coffee futures, also sold 300 lots. In that regard, Mr Hobbs explained that he had sold his position at the opening of the market as the market had been expected to move lower. He started buying futures back after the price fell. At this meeting Mr Hobbs was also asked why he had waited until the last two seconds before expiry to place the Trade. Mr Hobbs explained that he did not know until the close whether the put option would be ITM or OTM. He had a relatively large position in the September 2007 US$1750 put and wanted to exercise the option in respect of approximately 1,000 lots. He was short overall in futures and knew he needed to buy some futures as cover. He was worried about having a bigger short than he wanted with the market expected to go thin after expiry of the option (in other words, little liquidity in the future was expected after the option expiry). Mr Hobbs also drew Mr Algeo's attention to the fact that he had been buying earlier in the session.

122. Mr Hobbs went on to explain that the order for the Trade was put in when it was because that was when there was sufficient volume and depth in the market. The market price was US$1745 before the order and the average price for the fill was US$1751.68 (just above the option strike), that is 6 points above the previous market price. Mr Hobbs did not think that was a significant spike given coffee price volatility. The September 2007 future price moved around 50 points on the day.

123. Mr Hobbs was also asked to explain why he had not sold some of the 2,000 lots of September 2007 put options before expiry. He explained that there were only three market makers in the options thus making them relatively illiquid. Furthermore, the bid:offer spreads are, at best, around 10bp wide. Mr Hobbs had offered to sell 400 lots at 25, but the best offer he received was at 12. It was easier to trade around the futures than the options. Market makers generally do not want to trade the options unless it suits them.

124. The meeting note contains some confused discussion about the price at which the September 2007 US$1750 put options were exercised. Mr Hobbs' answer to this question was that they were exercised at US$1752. That price was of course the CORP, but it was not an exercise price. The put options would have been exercised at their strike price of US$1750; and as we have noted earlier, the market price on exercise was between US$1744 and US$1746.

125. At neither of these meetings is it recorded that Mr Hobbs referred to any strategy to confuse Mr Kerr.

E-mail exchange between Mr Hobbs and Mr Algeo

126. Mr Algeo sent Mr Hobbs an e-mail on 29 August 2007 asking further questions relating to the Trade. Mr Hobbs replied on 30 August.

127. In his replies Mr Hobbs did not refer to any strategy to confuse Mr Kerr, even though he was asked to explain why, in the 12.06pm conversation with Mr Kerr, Mr Hobbs had been insistent that the price had to finish above US$1750. In that respect Mr Hobbs said that "in hindsight" there was no reason for the market to settle above US$1750 relative to the book. The purchase suited Mr Hobbs' book at that specific time. Mr Hobbs explains that the economic rationale was reduction of book delta short exposure and closure of profitable open positions. Mr Hobbs admits that there was no actual profit and loss account benefit in the price ending above US$1750; in fact the impact on profit and loss account was negative as the book remained overall short after expiry. The only perceived benefit, according to Mr Hobbs, was knowledge of market sentiment between options expiry and options assignment. Mr Hobbs did not refer to any concerns over his trading limits.

128. To the question why the Trade was done only two seconds before options expiry, Mr Hobbs replied that this time frame provided optimum liquidity, in effect because of the options becoming binary. Mr Hobbs also said that the timing maximised the opportunity to pick up further delta purchases at lower levels.

129. Mr Hobbs expressed the view in this e-mail that any market impact of the Trade at the time it was placed would have been negligible. He volunteered that there could have been an element of delta short covering by option short holders depending on how they had managed their own holdings, but expressed the view that this would most likely happen after assignment. He explained that any market impact as against price would be less at this time as volumes would be higher on expiry. Since his book remained short he was anxious to minimise the slippage (the effective price increase generated by the Trade).

LIFFE questions and Mr Hobbs' response

130. LIFFE wrote to Mizuho by e-mail of 25 September 2007 with similar questions, and Mr Hobbs gave replies to Mr Algeo on 4 and 5 October 2007 which Mizuho passed on to LIFFE. The explanation given to the question why there had been an attempt to reduce a delta short exposure at the US$1750 strike level with a US$1757 limit buy order rather than abandoning the put options was that the Trade reduced the overall short exposure of the book. The book was short outright futures and long puts. The Trade was not therefore purely delta covering of options, it was to reduce the overall short exposure of the book at that time.

131. Mr Hobbs' explanations also cover the rationale in selecting US$1757 as the level to limit the buy order. He explains that a limit order was used to minimise price

slippage whilst covering the overall short exposure of the book. The slippage was one which Mr Hobbs was comfortable with to reduce in an efficient manner the overall short exposure of the book. A limit order rather than a market order had been chosen in case liquidity was less than anticipated. The depth of the market suggested that this level would be sufficient for the order to be executed with acceptable slippage.

132. In this e-mail exchange Mr Hobbs does not refer to the strategy of confusion, nor to any concerns over his trading limits.

Mizuho disciplinary meeting

133. On 12 December 2007 Mr Petrocochino conducted a disciplinary interview with Mr Hobbs. As Mr Petrocochino explained to us, his concern was to determine whether on 15 August 2007 Mr Hobbs had been acting in the best interests of Mizuho and whether he had been acting diligently and with skill and care. His concern arose out of the seemingly illogical nature of Mr Hobbs' trading given the short position of his book, and the rationale Mr Hobbs gave to Mr Kerr for his trading on 15 August 2007, which to Mr Petrocochino appeared potentially to constitute market abuse.

134. During the course of the meeting Mr Petrocochino sought to explore with Mr Hobbs his reason for buying the 600 lots of September futures at prices up to US$1757, which was above the strike price of his options. The concern was that Mr Hobbs' trading was inconsistent with his seeking to cover his short position in the most efficient manner. In particular, Mr Petrocochino could see no reason for Mr Hobbs to want the price of the futures to go up. He explained that the fundamental principle in trading is "buy low and sell high".

135. In the conversation Mr Hobbs is unable to explain his conversation with Mr Kerr leading up to the Trade. He agreed with Mr Petrocochino that it would have been better if the markets had been lower, and described his insistence that the market finish above US$1750 as illogical. He agreed that the telephone conversation was not "of a high standard"; what was said was "poor" and "illogical comments" and "not the best way of getting the information out of the broker". The comments, according to Mr Hobbs, "don't make sense" and are "stupid". Mr Hobbs nevertheless reiterates his point that his aim was to reduce risk on his book, which is a commercial gain, at an acceptable slippage, and done at a time when he considered there would be available liquidity.

136. Although Mr Petrocochino pressed Mr Hobbs for a rational explanation for the telephone conversation with Mr Kerr, and warned Mr Hobbs of the seriousness of the disciplinary proceedings, no such explanation was forthcoming. Mr Hobbs did not at that time make any reference to his strategy of confusion in lying to Mr Kerr due to concerns about his trading limits.

LIFFE interview with Mr Hobbs on 18 December 2007

137. On 18 December 2007, in the context of a preliminary investigation into Sucden, Mr Hobbs was interviewed by Andrew Fenlon, Mr Batchelor and Martin

Carbin of LIFFE's audit, investigations and membership department. Other representatives from Mizuho were also present. Mr Hobbs was advised at the outset that, depending on LIFFE's findings, the matter might be referred to the FSA.

138. During this interview the 12.06pm telephone call was played to Mr Hobbs. Mr Hobbs accepted that his statements about "doing the ultimate" and getting the price to "finish above 1750" were "not to a very high standard". He said that, notwithstanding what he had said in the phone calls, he placed the Trade to reduce risk.

139. In this interview Mr Hobbs did not refer to the strategy of confusion as an explanation for what was said on the 12.06pm call.

140. Mr Hobbs was asked about the sale of 150 September coffee futures that he made on 15 August 2007 prior to 12.30pm. Mr Hobbs stated that this was an error.

Kingsley Napley letter of 19 February 2008

141. Mr Hobbs was invited to attend a further interview with LIFFE. Mr Batchelor's evidence was that this was because those concerned at LIFFE felt that he had "stonewalled" at the first meeting.

142. On 19 February 2008, Stephen Pollard of Kingsley Napley, solicitors acting for Mr Hobbs, wrote to Mr Fenlon at LIFFE. Mr Pollard told Mr Fenlon that he had advised Mr Hobbs that it would be likely to be more helpful to LIFFE if Mr Hobbs, through Mr Pollard, submitted a clear explanation of the trading under investigation, rather than for Mr Hobbs to participate in a further interview.

143. The letter contains an explanation of the context and purpose behind the trading, which we shall not repeat here, as it essentially forms the basis of Mr Hobbs' case which we shall consider below. The letter does, however, contain the first indication of an explanation by Mr Hobbs for the telephone conversations with Mr Kerr. The letter says:

> "<u>Telephone Conversations</u>
>
> I am aware from the transcript of Mr Hobbs' interview of 18 December 2007 that you are concerned to understand some of the telephone exchanges between Mr Hobbs and third parties. As is apparent from that earlier interview, Mr Hobbs cannot now, some six months later, recall the precise reason for using specific words and phrases. By way of reconstruction however, he believes that he may have used certain phrases in an attempt to obscure his difficult risk position (and resulting lack of flexibility) from other market participants."

Authority interview with Mr Hobbs on 2 September 2008

144. On 2 September 2008, Mr Hobbs, who was accompanied by his solicitor Mr Pollard, took part in a voluntary interview under caution at the Authority. Those present from the Authority were Mike Prange, Kevin Batteh and Don Groves. A transcript was taken, and we have reviewed that as part of the documentary evidence.

145. There was considerable focus in the interview on the telephone conversations between Mr Hobbs and Mr Kerr. Mr Hobbs was asked to explain what was meant by various statements made during the conversations. At this time he consistently maintained that he was spinning a story for Mr Kerr, “different scenarios and stories”, to protect his position. He did not want anyone to know that he was unable to take on a particular size of position because of the risk limits he was subject to. However, when asked whether he had any reason to believe that Mr Kerr would pass to others details of the trades that Mr Hobbs was transacting through him, Mr Hobbs said that he had no reason to believe that he was doing so.

146. Mr Hobbs also describes certain of his statements to Mr Kerr as “trader bravado” or “flippant” or “larging it”. With reference to the following exchange at the beginning of the 12.06 call:

> HOBBS: On the close just before the close, lift everything.
>
> KERR: Right.
>
> HOBBS: Then everyone covers.
>
> KERR: Yes.
>
> HOBBS: Sell into it and exercise the options.

Mr Hobbs first explains the technical meaning of the terms used, namely that those short in the market might buy futures back thereby covering their position, but refers to this as “a flippant sort of comment to Andy as a made-up scenario that might … potentially could happen”. He explains that this conversation, as with others, does not have any internal logic, and could not in any event apply to him because of his risk limits. He says that he was trying to protect the fact that he could not “take those options on” (exercise the put options). This is “another one of those scenarios, which is backed on partly trader bravado, I was talking about, you know, it’s a flippant comment, which had been on conversation for a long time, and it was never a real scenario that could have been done.”

147. Later the interview turns to that part of the telephone discussion between Mr Hobbs and Mr Kerr on the evening of 14 August 2007 to which we have referred at [62] above. Mr Hobbs explains that this was another scenario that could not be achieved because it was referring to a possible early exercise of options, and Mr Hobbs’ position would not have permitted him to do that. He says “It’s just – it’s just being – larging it I think.” He explains that this means making more out of something that one could ever have.

Written response to the Preliminary Investigation Report

148. On 16 July 2009, Mr Hobbs submitted a written response to the Authority’s Preliminary Investigation Report of 14 May 2009. In that response Mr Hobbs maintains that his explanation for the statements he made during his telephone conversations with Mr Kerr were that he was deliberately trying to mislead Mr Kerr as to his trading intentions and thereby disguise the state of his book. Mr Hobbs’

case, which he maintained before us, was that his intention was simply to buy September 2007 coffee futures to reduce his short position.

149. In his response Mr Hobbs also comments on two particular trades, apart from the Trade itself. The first is the sale of 150 futures at 9.40am on 15 August 2007. In his interview with LIFFE, Mr Hobbs had described this trade as an error. In the response to the Authority, Mr Hobbs explains that he was at that time misled into thinking that this was a trade shortly before 12.30pm, and that this misapprehension drew him into giving an unconsidered answer. In the interview with the Authority, Mr Hobbs, having now ascertained the timing of the trade, gave what he asserts is the correct explanation, namely that his book on entering the trading day was not dramatically short, but that it became significantly short as the price dropped; the sale of the 150 lots at 9.40am was not inconsistent with the trading strategy then required by the state of Mr Hobbs' book.

150. The second trade is the purchase of the 50 September US$1750 put options. This was not raised by the Authority in interview with Mr Hobbs, and not until the Preliminary Investigation Report. Mr Hobbs responds that he does not recollect the trade, and that he believes it may have been an error. In any event, as the response states, the relatively small size is not significant in the overall picture and did not detract from Mr Hobbs' strategy to reduce his overall short position.

The Authority's case

151. We have referred to the definition of market abuse relied upon in this case by the Authority, namely s 118(5) FSMA, and to the Authority's statement of case. Before us, Mr Hunter contended that Mr Hobbs' conduct in relation to the Trade was a paradigm case of this type of market abuse. He submitted that all the required elements were present:

(1) The Trade effected by Mr Hobbs was "otherwise than for legitimate reasons and in conformity with accepted market practices on the relevant market". Mr Hunter argues that the trading rationale was the illegitimate one described by Mr Hobbs in his telephone calls, namely the manipulation of the CORP in an attempt to provoke re-hedging and a false market rally.

(2) The Trade plainly satisfies the criteria for abuse by price manipulation set out in s 118(5)(b). It does so most obviously because it secured the price of the September 2007 coffee future at "an abnormal or artificial level", namely US$1757 at exactly 12.30pm, when the true trading range at that time (absent the Trade) was US$1744-1746 and when no price increase at all had previously happened on an options expiry. Furthermore, although Mr Hunter submitted that it is not necessary for the Tribunal to rule on this in the circumstances of this case, the Authority also contends that the CORP itself is a "price" for this purpose, and that Mr Hobbs' Trade secured the CORP at an abnormal or artificial level.

(3) In addition, to the extent it is necessary, the Authority contends that the Trade also satisfies the criteria for market abuse under s 118(5)(a). The Trade

created a "false or misleading impression" as to demand for September 2007 futures, both by causing a short-lived price increase and by interfering with the CORP, and interfering with the normal and orderly exercise of the US$1750 put and call options.

5 152. In support of the price manipulation argument, namely moving the price at a specific significant moment for a collateral purpose, Mr Hunter referred us to what he described as one of the paradigm examples of market abuse given at MAR 1.6.15E (2) (from Chapter 1.6 of the Authority's Handbook: The Code of Market Conduct; the version we were shown was as at 27 August 2008):

10 "a trader *buys* a large volume of *commodity futures*, which are *qualifying investments*, (whose price will be relevant to the calculation of the settlement value of a *derivatives* position he holds) just before the close of trading. His purpose is to position the price of the *commodity futures* at a false, misleading, abnormal or artificial level so
15 as to make a profit from his *derivatives* position"

153. We have formed the view that the central question for us is whether the Trade was for legitimate reasons and in conformity with accepted market practices on the coffee futures and options market. We reach this conclusion because, as it seems to us, if the Authority is right in its submission on this aspect, then it necessarily follows
20 that the level of the coffee future price was at both an abnormal and artificial level in the context of the trading absent the Trade, and that it was the Trade that secured that price level. It is not necessary therefore for us to consider the alternative submission in relation to s 118(5)(a).

The Legitimacy of the Trade

25 154. As Mr Hunter submitted, the core and determinative issue in this case is to determine Mr Hobbs' true purpose when ordering and executing the Trade. As Mr Hunter described it, the Authority's case on this core issue is simple. It is that Mr Hobbs' purpose is what he said it was at the time when he placed the Trade. It was to force the September coffee futures price above US$1750 at 12.30pm so as to produce
30 a last second change in the CORP, and that this was all to enable Mr Hobbs to try to "do the ultimate", in other words to create a large prolonged false market rally.

155. Mr Hunter argued that the careful timing of the Trade, its size, when compared with the size of previous trades on 15 August 2007, and Mr Hobbs' own previous trades, and its demonstrable immediate effect on the September 2007 coffee future
35 price at that specific time, and thereby on the CORP, are, on their own, powerful indicators that the rationale of the Trade was to manipulate the September 2007 coffee futures price at exactly 12.30pm, and thereby the CORP.

156. Mr Hunter submitted that we should reach the conclusion that this was indeed the trading rationale and that it should reject the case of Mr Hobbs that his own words
40 in his discussions with Mr Kerr were part of a strategy of confusion to mislead Mr Kerr as to the state of Mr Hobbs' book and to prevent him from understanding the constraints on Mr Hobbs ability to trade because of the limits imposed on him. Mr Hunter argued that this was not the case, and that the words spoken by Mr Hobbs

were unguarded contemporaneous statements which provide the true context for the Trade. They make clear, in so far as it is not already clear, in the circumstances, from the size and timing of the Trade, that the purpose of the Trade was to bring about the twin price effects which in fact occurred. They also, argued Mr Hunter, evidence in express terms the wider motive for the Trade, which was to try to provoke a reaction from market makers by suddenly shifting Mr Hobbs' 2050 September 2007 US$1750 put options from ITM to OTM, the hope being that they would be forced to buy to close short hedge positions, enabling Mr Hobbs to sell into the false market rally.

The significance of the CORP

157. Mr Hobbs submitted that the CORP is relatively unimportant in the market and has little practical relevance. He says that the evidence demonstrated that the significant period for those short of the options is that leading up to the exercise or abandonment of options by the long holders of those options.

158. Mr Hobbs relied in this respect on a report into the Authority's investigation into Mr Hobbs produced by Mr Ramesh Sundaresan, a trader specialising in volatility trading and making two-way markets in Robusta coffee options. Mr Sundaresan did not appear as a witness before us, and so Mr Hunter did not have the opportunity of cross-examining him, and the Tribunal were unable to ask him questions, but his report was produced to the witnesses for their own comments. As we shall describe, some agreed with what Mr Sundaresan said regarding the significance of the CORP; others disagreed.

159. In his report, Mr Sundaresan says the following:

> "It is well understood that the CORP as a number carries very little meaning with regard to exercising or abandoning of the option. Here, what is relevant to the trader is whether an option is exercised or not by the long holder of the option, and that decision is taken based on the need for the futures lots. Most times, even after a CORP is published, the traders who are long or short an option on the expiry strike weigh their reasoning and come up with a decision that is usually independent of what the CORP is. Apart from these reasons, the CORP has no influence on cash flows, the same way as Settlement price. As the market continues to trade after the publication of [the] CORP, the risk of a position is totally independent of what the CORP is and whether the CORP is above or below a certain magic number, which in the current matter is US$1750."

160. In his evidence Mr Hearn agreed with this element of Mr Sundaresan's report. He said that it does not matter what the CORP is; what matters is that traders know what the CORP is, because, having made their decision, they need to know whether the options are ITM or OTM by reference to the CORP, so that they can determine whether they can allow automatic exercise or abandonment, or whether they have to intervene to prevent the automatic effect. In answer to a question from the tribunal, Mr Hearn confirmed that a decision at or around 1.15pm on option expiry whether to exercise options or not would be made, not by reference to the CORP, but by reference to the market price at the relevant time. The market continues to move

between 12.30pm and 1.15pm, which makes that period a tense one, and a delay in obtaining information about the CORP makes this even more difficult.

161. As we have described, Mr Hardy confirmed that the CORP did not have any relevance to his own trading.

5 162. Mr Lambert, by contrast, gave evidence that the CORP is material because a trader, and a market maker, is trying to establish, between 12.30pm and the latest time when the options are exercised or abandoned, the probability of those who are long of the options exercising or abandoning the options. Those who are short the options cannot control what the longs will do; and there can be no trading out of the options 10 after 12.30pm.

163. Mr Lambert told us that if the market price goes up or down it will still be necessary for a delta trader to react and try to neutralise his position. He said that if the market were to go down rapidly after 12.30pm most players in the market would be aware that they would have to act against the automatic exercise set by the CORP; 15 they would exercise their puts if they were long, and, if they were short, expect those options to be exercised and assigned to them. The CORP and the price movement after 12.30pm was therefore very material in enabling a market participant to anticipate how many long orders will make the decision to exercise or not exercise the options. The CORP is relevant because it may affect the percentage of traders whose 20 options are exercised. Some traders may not react if the price changes; those traders will be fixed by the automatic exercise created by the CORP.

164. Mr Lambert told us that he disagreed with Mr Sundaresan on the relevance and significance of the CORP. He agreed, however, that it would be irrelevant for a market maker, and that it was irrelevant to him as to his decision to buy and sell 25 futures. The relevance and significance of the CORP was that it set the automatic exercise and assignments of the put and call options. As Mr Lambert explained the position, he and his colleagues at Marex would be quite reactive to price action before, at, and after 12.30pm. Even though after 12.30pm the options could no longer be traded, the delta could change very rapidly, according to the futures price.

30 165. According to Mr Lambert, the CORP when set gives rise to a probability as to the exercise of the options. Mr Lambert gave an example of a case where the CORP was right on strike (which we understand to be either ATM or within \$1 - \$2 or \$3 of the strike price). In that case the assumption would be 50% exercise and 50% abandonment. The trader would then react to price movement in the period between 35 12.30pm and 1,15pm. If the market goes down it would be assumed that most efficient traders would be aware of the position and that they would tend to exercise more of the puts and abandon more of the calls. The percentage probability would move accordingly.

166. That was the position for an efficient trader. But Mr Lambert also described to 40 us the possibility of a trader being caught unawares. His example, however, was not of a trader being caught unawares by the CORP being set at an unexpected price (such a trader would have had to have been aware enough to have had an expectation before

12.30pm, so it is doubtful whether that trader would have been taken unawares by the CORP itself), but described the position that actually obtained on 15 August 2007, when the market after 12.30pm went lower than the strike price, thus moving the options from OTM (in the case of the puts) to ITM, and from ITM (in the case of the calls) to OTM. Mr Lambert referred to 27% or 28% of the puts being abandoned. This meant, according to him, that most traders did not take into account the CORP; they had to actively decide to exercise their put options. The remaining 27% or 28% either willingly abandoned their puts or were not aware that the market had moved and left their expiry to the CORP. In these circumstances a roaster who was short of the puts might have assumed that it would be assigned futures under those options. The change in price would then potentially lead the roaster to buy futures. This buying could have an impact on the market.

167. In his report, Mr Beagles rightly identified the relationship between the coffee futures, the options and the CORP as a key issue in this reference. He stated that market participants might well act on the basis of the CORP. Specifically, he said that they may decide whether to exercise options that are long and (which he regarded as the more crucial matter in these circumstances) whether or not they were likely to be assigned upon options that they were short. In this way, Mr Beagles' view was that the buying and selling of futures to manipulate the CORP might potentially mislead option market participants and influence their subsequent behaviour.

168. Mr Beagles referred to the fact that, just before the Trade, the September future was trading at US$1745. At that time, according to his report, shorts of the September US1750 puts and calls had to decide whether or not they were likely to be assigned upon their short option positions and what would be the appropriate September futures hedge for them to hold as a delta hedge. Based upon the only available information at that time (the September future trading at US$1745 seconds before 12.30pm), Mr Beagles' report told us that, first, shorts of the September US$1750 puts might have expected to be assigned upon their (at that moment ITM) short puts, while, secondly, shorts of the September US$1750 calls might have expected not to be assigned upon their (at that moment OTM) US$1750 calls. Any futures delta hedges held by such option shorts would have reflected these views.

169. As Mr Beagles' report went on to describe, just after the Trade, the September future traded up to US$1757. In light of this information, shorts of the September US$1750 calls might have expected to be assigned upon their (at that time ITM) short calls while shorts of September US$1750 puts might have expected not to be assigned upon their (at that moment OTM) US$1750 puts. This would then have been the opposite view than that which was likely to have been taken just prior to the Trade.

170. In order to reflect this change, Mr Beagles described the need for such traders to buy futures in order to adjust any futures delta hedge held against their short options.

171. In giving his oral evidence, and in response to questions from the Tribunal, Mr Beagles told us that he did not believe that the CORP was enormously significant to all market participants. Nonetheless, he did give it some significance. Some market participants, but not all, might use the CORP as one piece of information in trying to

determine whether options were likely to be exercised or not and, in so doing, that might influence their hedging behaviour. Certain market participants might not understand the CORP.

172. Mr Beagles accepted that at the moment in time at 12.30pm, the CORP would not have been published. However, he said that the trading in the last minute would be visible, so that market participants could "hazard a guess", on an informed basis, as to what it might be. But prior to the CORP being published a trader would not ignore any actual movements in the market. Mr Beagles explained that he was looking at the moment in time at 12.30pm. He said that some traders might make instantaneous decisions at that time; he in particular came from a standpoint that was very risk-averse. Other traders by contrast would allow the market to develop. In short, Mr Beagles said that the CORP was not the most important thing; it was one piece of a complex jigsaw.

173. In our view, the CORP cannot in isolation have the effect of misleading market participants. Nor can this be the case even if the CORP is set at an unexpected reference price taking into account the market shortly before 12.30pm. The futures market continues to trade, and so the CORP is overtaken by actual price movements, some of which will probably take place even before the CORP is announced. Any impact on the behaviour of option market participants by reference to the CORP itself, and the expectation it might create as to the exercise or abandonment of the options, would depend on the price moving through the strike price after 12.30pm (and so after the establishment of the CORP) so as to change the probability of exercise. The CORP has relevance to the longs of the options, because it affects whether they can rely on automatic exercise, or have to give specific instructions to the clearers. Its relevance to the shorts is that it can affect their perception of the likelihood that some options will be automatically exercised or abandoned, but the issue of unaware traders can arise only where the price moves through the strike price after 12.30pm and before 1.15pm. If there is no such movement, automatic exercise or abandonment will in any event reflect the actual ITM or OTM status of the options. There will of course always be the inherent uncertainty if the market price is close to the strike, because delta traders might have their own directional reasons for exercising or not exercising their options. But those are not matters which are affected by the CORP.

174. The CORP provides the context for traders who must assess their positions as the time for exercising or abandoning options approaches. The CORP does not itself affect that decision, which is impacted by a number of factors, including the price of the futures which can continue to move after option expiry, and the delta position of the particular trader. Although the CORP is a reference price, it is not that price which influences a trader; it is the actual futures market price. A trader long in options may, for directional exposure reasons, elect not to exercise ITM options or elect to exercise OTM options. The only relevance of the CORP to that trader is in knowing whether the trader's position will be automatically reflected by the automatic exercise or abandonment of the option, or whether the trader must give countermanding instructions to the clearing house. The relevance to a short is that the CORP will be a factor in assessing the likelihood of options being exercised or not by the longs. That is merely a piece of information; the important thing is not what the

CORP is, but that it is known in good time to enable traders to be made aware of it so that they can base their decisions on the correct context.

Was the Trade intended to "do the ultimate"?

175. Mr Hunter submitted that the purpose of the Trade was to achieve a very specific effect on price, namely the rapid upward movement of the September coffee futures price at exactly 12.30pm from its price of US$1745 (which was in the settled trading range of the previous two and a half hours) to a price above US$1750.

176. Mr Hunter argued that the purpose of manipulating the price in this way by the Trade was the implementation of a scheme conceived by Mr Hobbs to "do the ultimate". Mr Hobbs' contemporaneous statements to Mr Kerr, argued Mr Hunter, reveal that Mr Hobbs believed that if he was able to cause a last second increase in the September coffee futures price and thereby a change in the CORP, then he could catch out the market makers in coffee futures and force them to buy (in order to adjust their put options hedges). This was based on Mr Hobbs' belief that market makers who were the counterparties to his put options would be forced to close short positions taken to hedge those options when the put options switched from ITM to OTM (and hence became likely to lapse). The circumstances were that Mr Hobbs' buying would have removed any available sell orders, thus causing a larger, more prolonged, spike in prices, which Mr Hobbs would be able to take advantage of by selling his recently-acquired coffee futures and/or exercising his put options.

177. As Mr Hunter acknowledged, Mr Hobbs, despite what Mr Hunter argues was his intention, did not manage to "do the ultimate". Although the rapid price increase over US$1750 at exactly 12.30pm was achieved, and although this caused a change to the CORP so that it was set at over US$1750 rather than below that strike price, the market reaction and greater price rally which Mr Hobbs had, on this analysis, been hoping for did not occur. Rather there was a lull in trading, and after a few minutes the price of the September 2007 future returned to its previous level (US$1745). Moreover, the publication of the CORP was delayed, and by the time it was published the futures price had fallen again, and most market participants had been advised that the CORP was not reflective of the real price of the September 2007 coffee future, and that they should act to countermand the default positions on their options.

178. However, Mr Hunter submits, and we agree, that, if there was an overall scheme of Mr Hobbs of this nature, the fact that it failed would be irrelevant to the determination of his trading rationale at the time. And in respect of that issue Mr Hunter submits that the answer is spelled out in Mr Hobbs' own words during the telephone conversations commencing at 12.06pm.

179. On the other hand, we do not accept that, as Mr Hunter argued, it can make no difference to the analysis even if it could be said, with hindsight, that such a scheme was never likely to work. We agree that this would not be determinative; if the elements of market abuse are present and the trade is not a legitimate one, then it cannot matter if the purpose of the market abuser was incapable of being achieved. But in determining whether a trade is legitimate or not, it may be necessary, in a

particular case, to weigh all the observable features, including the implausibility of the success of the scheme, in assessing what could have been the purpose of the transactions.

Trading rationale: Mr Beagles' report

180. In Mr Beagles' report he too puts forward the view that it is not just what actually happened, but that which might have happened that is significant. Specifically, he attaches significance to the consequences that it was reasonable to anticipate were likely to follow from the placing of the Trade at that time and in that size. Mr Beagles' report concludes that other market participants might have reacted differently to the Trade and the increase in the futures price might have been more pronounced. Had the market's reaction been greater, the CORP might also have settled at a higher level. In Mr Beagles' opinion, a reasonable person in Mr Hobbs' position would have anticipated that one likely consequence of the Trade at that time and in that size was that some market participants would react to the rise in the CORP above US$1750 by adopting strategies that further pushed up the futures price, creating a rally into which Mr Hobbs could then sell his recently-acquired 600 futures.

181. Mr Beagles expresses the view that the volume, timing and price limit of the Trade are all consistent with an intention on the part of Mr Hobbs to manipulate the CORP. Mr Beagles assesses that Mr Hobbs could have benefitted from an increase in the September 2007 futures price in a number of ways. First, having bought 600 September futures at prices between US$1746 and US$ 1757, Mr Hobbs could have sold those futures at a profit, as shorts of the US$1750 calls and puts bought futures to adjust the delta hedge on their short options positions. Secondly, depending upon the effect of selling these futures back to the market, Mr Hobbs could then have unexpectedly exercised his US$1750 puts, possibly catching shorts of the US$1750 puts off-guard, and forcing such shorts to sell futures to cover the long futures positions resulting from the unexpected assignment of their short puts. Finally, Mr Beagles suggests that, apart from the material benefit that Mr Hobbs might have derived in these ways, he might also have gained insight into the nature of other market participants' positions from their reaction to the fluctuation in the September futures price.

182. Mr Beagles derives support for his conclusions from the telephone conversations between Mr Hobbs and Mr Kerr. In his evidence before us he said that his analysis of the Trade was an attempted explanation of what Mr Hobbs and Mr Kerr had discussed. He acknowledged, in answers to questions from the Tribunal, that, although in his report he had concluded that it would have been reasonable to anticipate at the time of the Trade that the market reactions described by him were consequences that were reasonably likely to occur, those market reactions were possibilities and not probabilities. As Mr Beagles put it: "… markets are inherently subjective and uncertain."

183. In explaining to the Tribunal how the market might have reacted to the price movement consequent upon Mr Hobbs' Trade, and the setting of the CORP, Mr Beagles accepted that the actual effect of the Trade was minimal. The Trade moved

the futures price up to US$1757, but there was no immediate reaction in the market. When the market did trade again, the price went down again, to below US$1750, rather than up. Mr Beagles illustrated how the market could possibly have reacted by reference to a hypothetical example, which he prefaced by saying that it would be highly unusual, or even absurd, where the Trade had moved the market to US$1800 so that it could be said with a degree of certainty that market-makers would have reacted.

Trading rationale: Mr Hobbs' submissions

184. Mr Hobbs argues that the market abuse which the Authority discerns from the telephone conversation would have been counter to his financial and trading interests. Mr Hobbs' position must be assessed by reference to his whole trading book, and not just his options position.

185. Mr Hobbs' trading book was short at all the material times under review. He was short at the close on 14 August 2007 and at the opening on 15 August 2007, though there was no immediate concern at that time on his limits. It was when the market fell during the morning of 15 August 2007 that Mr Hobbs' position became very short, and there was a concern about his limits. Mr Hobbs needed to buy whilst increasing the price as little as possible, as he remained short overall.

186. Mr Hunter argued that the evidence was inconsistent with Mr Hobbs having to address his short position in the way that he did. He pointed to the fact that Mr Hobbs was not concerned at the close of trading on 14 August 2007, nor on the opening the following day. That is right, but it fails, in our view, to take sufficient account of the fall in the market during the morning, and the consequent adverse effect on Mr Hobbs' short delta position.

187. Mr Hunter also points to the pattern of Mr Hobbs' buying from 9.50am to the start of the call at 12.06pm as not revealing any urgency. He submits that on the contrary there were substantial lulls – for example, 40 minutes between 11.09am and 11.49am. We do not consider that the pattern of Mr Hobbs trading suggests either urgency or lack of it. The fact is that there were buy orders in the market and Mr Hobbs bought a substantial number of futures. According to Mr Beagles' report, during the course of the morning trading on 15 August 2007, before the Trade, Mr Hobbs bought 802 lots of coffee futures. He used iceberg orders. In addition he had buy orders in the market at below market price. He also sold 326 lots, resulting in his net buying up to that time of 476 lots.

188. It is the case that during the morning of 15 August 2007 Mr Hobbs declined to sell any of his put options, despite receiving offers to do so at a premium, and purchased 50 more put options at 11.03am. Mr Hunter argues that these matters are also inconsistent with Mr Hobbs being a forced buyer motivated by concern for his limits. We accept that the evidence given by Mr Hobbs in respect of the purchase of further put options was less that satisfactory. We consider later other aspects of that evidence and the weight we attach to it and to factors such as the purchase of more put options rather than any sale.

189. Mr Hobbs argues that the Trade was timed as it was, not to achieve any scheme such as "the ultimate", but to access what he considered would be an increased liquidity at and around options expiry. This has been a consistent explanation offered by Mr Hobbs since the earliest investigation by Mizuho.

5 190. In the evidence before us there was some support for Mr Hobbs' view of the liquidity of the market, but it did not go as far as to endorse that view. Mr Hearn, for example, agreed that because options become binary at around the expiry, more liquidity should be anticipated. More volume would be traded at around that time because traders are looking to address their delta positions. Mr Beagles also agreed 10 that around expiry, when the options become binary, it would be expected that there would be more buying and selling. On the other hand, in relation to the actual timing of the Trade at two seconds before expiry, Mr Beagles' view was that he would expect liquidity to have reduced.

191. Mr Hobbs emphasises that the 600 lot order that was filled by the Trade was a 15 limit order (at US$1757) and not a market order. This necessarily limited any upward movement in the September futures market. He argues that a worst case price slippage of US$12, or 0.69%, of the futures price was achieved by placing a limit order of this nature. In fact, the actual average price slippage was 0.34%, which Mr Hobbs submits was well within the expectations of market participants at that time.

20 192. In this connection, Mr Hearn confirmed that, whilst slippage could vary from time to time, there would be less slippage at a time of greater liquidity. The slippage on the Trade, Mr Hearn said, was not unusual. Mr Lambert also concurred that a price slippage of around $6 to buy 600 lots was very acceptable and quite efficient. It was a "small variation" for 600 lots. The slippage would vary according to market 25 conditions, and would be greater if there were less liquidity. Mr Hardy agreed that the slippage was acceptable. Mr Beagles too agreed that, although the issue was inherently subjective, a slippage of this amount on an order of the size of the Trade two seconds before expiry was not entirely unexpected.

193. It can be seen therefore that slippage goes hand in hand with liquidity. In order 30 to reduce slippage, a trader will look to buy futures at a period of greater liquidity, when there is the selling volume to satisfy the order. As we understand it, this can manifest itself in at least two ways. Firstly that a trader who puts in an order for a set number of futures will be anxious that the price does not slip too greatly so that he ends up paying a high price for the last tranche of his order; secondly that a trader, 35 such as Mr Hobbs, who puts in a limit order, nevertheless wants to ensure that he has the best possible chance of buying the full amount of the futures ordered within that limit.

194. Mr Hobbs argues that, even conceding that the strategy alleged to have been revealed in the telephone call with Mr Kerr were feasible, that would only be so if a 40 trader's trading book were flat at the outset. It makes no sense, according to Mr Hobbs, if the trading position of the book is, as was Mr Hobbs', severely short. The problem with the strategy in real life as opposed to theory is that even if the market reacted by maintaining a significant upward spike, the action of selling into that rising

price would have had the effect of significantly damaging Mr Hobbs' overall trading book. It would have resulted in his book becoming even shorter, which, Mr Hobbs says, was not permissible, given that he was already in breach of his trading limits. Moreover, the Authority's case suggests that Mr Hobbs would then have exercised his put options. The result of such a strategy, Mr Hobbs submits, would have been to leave him enormously short, and massively outside his risk limits.

195. In his evidence, Mr Hobbs explained that, before the Trade, his position was very short. By buying the 600 lots at a time when he believed the market would have the necessary liquidity, he balanced his book. The book became effectively flat, but still slightly short, and he then had the ability to see what movement there might be in the market over the next 45 minutes. Although he could have balanced the book by not buying futures, but by abandoning options, this would not have enabled him to retain the flexibility of being able later to take a short view. There would not have been the liquidity in the market to go short by selling futures, as opposed to exercising options.

The "strategy of confusion"

196. Mr Beagles' analysis, and the Authority's case, rely heavily on what Mr Hobbs said in his telephone conversations with Mr Kerr being taken at face value. Mr Hobbs has sought to explain his words as being designed to mislead Mr Kerr as to the true state of his trading book (and in particular his risk limits), and that to that extent nothing said in the calls is a reliable guide to what Mr Hobbs was intending to do, or indeed to what he actually did. Mr Hobbs says that the need to hide his true trading intention, and by extension the true state of his trading book, from Mr Kerr arose from the fact that he was concerned that Mr Kerr would pass on such information to other market participants, thereby damaging Mr Hobbs' position. Mr Hobbs was, it is said, particularly concerned that, if he knew about it, Mr Kerr would tell Mr Hardy, with whom Mr Kerr was very friendly, about Mr Hobbs' significant short exposure.

197. Mr Hunter submits that Mr Hobbs' assertions in this regard are wholly incredible and should be rejected. He argues that Mr Hobbs was not a truthful witness. We shall comment on the credibility of Mr Hobbs as a witness a little later, but we focus here on the particular criticisms levelled by Mr Hunter regarding the "strategy of confusion".

198. Mr Hunter argues that Mr Hobbs had no need to lie to Mr Kerr. Mr Hobbs accepted in cross-examination that, so far as he was aware, Mr Kerr knew neither his short position nor his limits, and would not know them unless Mr Hobbs told him. Mr Hunter submits that if that is true, and Mr Hobbs genuinely wanted that to remain the case, then he simply needed to say nothing by way of explanation, or he could have avoided using a broker altogether and traded on his own account. Mr Hobbs was thus wholly unable to explain the most basic question about his strategy of confusion: why do it? If Mr Kerr did not know Mr Hobbs' position, why did Mr Hobbs need to lie to Mr Kerr, let alone so extravagantly? Mr Hunter argues that Mr Hobbs could offer no coherent explanation for this. What Mr Hobbs does say is that he should,

with hindsight, have executed the Trade himself. However, at the time he thought it would be easier and less onerous to have Mr Kerr carry out the trading on his behalf.

199. Mr Hunter submits that the timing does not add up. The thrust, Mr Hunter argues, of Mr Hobbs' story appears to be that he needed to prevent Mr Kerr from somehow inferring details of Mr Hobbs' short position from the mere fact of Mr Hobbs' buy orders. Those buy orders did not commence until 9.50am on 15 August 2007. Moreover, Mr Hunter continues, the evidence shows that at close of trading on 14 August 2007, and on the opening of trading on 15 August, Mr Hobbs was not concerned about his short position or his limits and was not contemplating buying: in fact he was still a seller. None of this, submits Mr Hunter, fits with what Mr Hobbs says about the timing of his strategy of confusion. Specifically:

(1) Mr Hobbs claims to have started his strategy of confusion in his call with Mr Kerr at 5.47pm on 14 August 2007. Yet at that time Mr Hobbs was not concerned about his short position or limits and was not planning to buy at all. In fact he was planning to sell.

(2) When Mr Hobbs did finally start to buy – at 9.50am on 15 August 2007 – he gave no explanation to Mr Kerr, other than to say that he was buying to take profits or with a view to selling later, and Mr Kerr did not ask for any explanation.

(3) If one looks at the exact timing of the conversations on 15 August 2007 in which Mr Hobbs advanced schemes to Mr Kerr which he now claims were part of a strategy of confusion, none of them are directed at explaining recent or imminent planned buying. On the contrary, the calls at 11.25am ("I've got about fifty things going through my head what I want to do with them and I haven't decided on any of them.") and 11.35am ("The other thing I was thinking about and obviously this goes no further…") were strategies for the unexpected exercise of put options. Moreover they came during a 40 minute lull in Mr Hobbs' trading.

(4) The articulation of the scheme to "do the ultimate" came towards the start of the call at 12.06pm. Yet this was 20 minutes before Mr Hobbs said that he first decided that he needed to buy urgently. In oral evidence Mr Hobbs was very clear that he decided this only three minutes before 12.30pm. Thus, on Mr Hobbs' own account, he advanced a very specific cover story (for buying heavily just before 12.30pm) a full 20 minutes before it had occurred to him that he needed to do that.

200. Mr Hunter submits that Mr Hobbs' claim that he did not trust Mr Kerr is false: he chose to deal with Mr Kerr and to give him unsolicited information about his positions. A central feature of Mr Hobbs' story is that he did not trust Mr Kerr because he believed that he might leak information to Mr Hardy or others and therefore decided to lie to him to prevent this. However, the evidence shows that it was Mr Hobbs' decision to deal with and through Mr Kerr on 14 and 15 August 2007 (he could easily have dealt himself or through another broker). Even more tellingly, argues Mr Hunter, it is clear from the transcripts of the telephone calls that, far from being guarded about his positions, Mr Hobbs freely volunteered detailed information

about this to Mr Kerr throughout his calls. Details were given of Mr Hobbs' large short position in the call commencing at 5.47pm on 14 August 2007. Mr Hobbs' decision to trade through Mr Kerr and to provide information to him are wholly inconsistent with Mr Hobbs' claim that he distrusted Mr Kerr so much that he needed to resort to deceit. The true position, submits Mr Hunter, is that which Mr Hobbs articulated when first questioned about this by the Authority:

> PRANGE: …So the answer is no, you didn't believe he would pass on the trades you were doing through him to other people?
>
> HOBBS: I hope he wouldn't.
>
> PRANGE: Did you have any reason to believe that he was?
>
> HOBBS: No not a reason to believe that he was, no.
>
> …
>
> HOBBS: … he wouldn't know my position that's what I'm trying to say.

201. Mr Hunter further submits that Mr Hobbs was not truly concerned about his limits, and was not a forced buyer. A central part of Mr Hobbs' strategy of confusion story is the contention that Mr Hobbs became a forced buyer due to concerns about his internal short position limits, and that he wished to conceal this from Mr Kerr. Mr Hunter argues that the evidence is wholly inconsistent with this:

(1) Mr Hobbs was plainly not concerned about his limits at the close of trading on 14 August 2007, as evidenced by his conversation with Mizuho's risk department at that time, nor at the open of trading on 15 August 2007 (when he started selling).

(2) The pattern of Mr Hobbs' buying from 9.50am to the start of the call at 12.06pm does not reveal any urgency at all. On the contrary, there were substantial lulls, for example 40 minutes between 11.09am and 11.49am. The transcript of the 12.06pm call reveals that the buying during the early part of that call was not remotely urgent.

(3) On the contrary, during the morning, Mr Hobbs both declined to sell any of his put options (despite having offers to do so at a premium), and purchased more put options at 11.03am. Both of these matters are wholly inconsistent with Mr Hobbs being motivated by concern for his short limits.

(4) At no point did Mr Hobbs call his risk department to enquire about the extent of his short position.

(5) In fact Mr Hobbs was never a forced buyer. As he accepted it was always open to him to sell his put options or let some or all of them expire.

202. Finally, Mr Hunter draws attention to the fact that Mr Hobbs did not mention his strategy of confusion during earlier accounts of the relevant events. Mr Hunter submits that Mr Hobbs' explanation for his failure to do so is incredible. He says that one of the most striking features of Mr Hobbs' strategy of confusion story is that it did not appear at all during his many attempts to explain the conversations with Mr Kerr, first to Mizuho (both in its initial enquiries and in December 2007 during his

disciplinary meeting) and then to LIFFE during its investigation in December 2011. There was a hint of the story to come in the form of Kingsley Napley's letter of February 2008, but only on the basis that Mr Hobbs had no recollection of the conversations, and was "reconstructing" an explanation for his recorded words. One year later, in his interview with the Authority, Mr Hunter characterises Mr Hobbs' memory as having made a miraculous recovery, in that he was able for the first time positively to assert that, based on his recollection, he was indeed engaging in a deliberate subterfuge. That, submits Mr Hunter, is the tell-tale evolutionary pattern of a lie.

203. During his oral evidence, as Mr Hunter points out, Mr Hobbs attempted to explain away his earlier failures to mention the strategy of confusion on the basis that "it would have damaged Mr Kerr". Mr Hunter argues that this is a manifestly incredible claim. Mr Hobbs was at pains to explain that Mr Kerr was not his regular broker, was not a friend and was even someone he distrusted (though Mr Hunter says this latter claim cannot be made out). It is, submits Mr Hunter, inconceivable that Mr Hobbs would have lied to his employer and to LIFFE, even to the extent of losing his job, in order to protect a person to whom he owed no loyalty and with whom he had no personal relationship.

204. Mr Hobbs submits that whilst, as Mr Beagles stated in his report, brokers operate in confidence and are not allowed to reveal the orders or positions of one client to another, may be true in theory, the transcripts of the various telephone conversations between Mr Kerr and Mr Hardy make it clear that, as regards Mr Kerr, that was not the case. Mr Hobbs points to a call at 11.53am on 15 August 2007 where Mr Kerr and Mr Hardy are discussing the problem that Mr Hobbs has regarding his 2000 options. Again, shortly after the 600 lot trade, at 2.00pm, on questioning from Mr Hardy, Mr Kerr confirms that it was Mr Hobbs who carried out the large trade. Mr Kerr then goes on to discuss the rationale for Mr Hobbs' trade with Mr Hardy. Mr Kerr ends the call by asking Mr Hardy to be careful not even to insinuate to Mr Hobbs that he knows anything from Mr Kerr. Just over an hour later, at 3.04pm, they speak again and discuss what Mr Hobbs did with his options. Mr Kerr again acknowledges the impropriety of this and says: "I can't really be telling you stuff like that but yeh." He then continues to discuss Mr Hobbs' market activity.

205. Mr Hobbs says that he was not primarily trying to conceal from Mr Kerr that in general terms he was short. The crucial fact that Mr Hobbs was concerned to keep from the market was his risk limits. Mr Hobbs argues that if those limits had become known, the market would have realised the extent to which Mr Hobbs had very few alternatives open to him, and specifically that he was extremely restricted as regards how he could exercise his options. Mr Hunter submitted in closing that this was a development of Mr Hobbs' story put together because of the weakness of the argument that it was his short position that Mr Hobbs wished to conceal. He referred to the opening statement put in by Mr Hobbs. We do not accept Mr Hunter's argument in this respect. From a review of all the materials, it seems to us that Mr Hobbs has, since his first reference to the strategy of confusion claimed that it was motivated by a desire to keep his limits from the market.

206. Mr Hobbs says that the reason he did not explain to either Mizuho or LIFFE prior to the letter of 19 February 2008 in terms of the strategy of confusion was that he did not at that time have proof of the telephone conversations between Mr Kerr and Mr Hardy, and he did not at that time think he was at significant personal risk as a result of the Trade. It was only when he came to appreciate the seriousness of his position (as a result of a combination of his dismissal by Mizuho on 12 December 2007 and legal advice received), that he realised that he had no alternative but to explain the position fully.

207. Mr Hobbs did not have the proof he refers to until after his interview with the Authority. Yet, as Mr Hunter points out, his story of the strategy of confusion was advanced before Mr Hobbs had that proof. We accept that the reason given by Mr Hobbs for his failure to raise that strategy earlier is not supported by the facts. But we also note that the story of the strategy must have arisen independently of Mr Hobbs learning of the telephone conversations between Mr Kerr and Mr Hardy, and was not therefore concocted on the basis of those conversations.

Our conclusions

208. We start with our conclusions on the strategy of confusion. We do not regard this as a straightforward case of whether we believe Mr Hobbs or not. We consider the answer is more subtle than that.

209. What we do not accept is that Mr Hobbs had any strategy to confuse Mr Kerr. If he had then we are in no doubt he would have referred to it in his interviews with both Mizuho and LIFFE. We do not accept that he could have been unaware of the seriousness of the position as it affected him. He was at risk of losing his job. We are satisfied that the strategy of confusion story arose out of an attempt by Mr Hobbs to rationalise his conversations with Mr Kerr after the event, and not as part of any pre-conceived strategy.

210. Nor do we accept that Mr Hobbs had any particular reason to suspect Mr Kerr of breaching client confidentiality. If he had done, it would, we consider, be reasonable to conclude that he would simply not have conducted business through Mr Kerr when there was particular sensitivity over his limits. Mr Hobbs was unaware of the transcripts of the conversations between Mr Kerr and Mr Hardy at the time of his interview with the Authority, and he told the Authority's investigators that he did not believe that Mr Kerr would reveal his position. The fact that those telephone conversations show that Mr Kerr was indeed breaching client confidentiality has led Mr Hobbs, we believe, to place reliance on that as supporting a strategy of confusion that did not exist as a strategy.

211. That said, we find that, as a general matter, traders will wish to keep their own positions and their trading, and in particular any restrictions they may be under, out of the market domain. Whilst, therefore, we do not consider that Mr Hobbs had a strategy to create confusion in the mind of Mr Kerr, nor did he have reason to do so by reference to any concern that Mr Kerr would breach client confidentiality, we do

find that Mr Hobbs would not have wished to say anything to Mr Kerr that would have revealed his risk limits.

212. It follows that we reject the evidence of Mr Hobbs that what he said to Mr Kerr in the course of their conversations was a strategy of confusion or "spin". That presents us with the serious question whether, if Mr Hobbs' evidence was unreliable to this extent, we should not rely upon it in other aspects. Mr Hunter referred us to a number of elements of Mr Hobbs' evidence which was either contradictory, or plainly false on its face. We need not refer in detail to those aspects save as they are material to our determination, but what we do say is that, as a general matter, we regard Mr Hobbs as having been an unsatisfactory witness. He appeared to regard questioning by Mr Hunter as a challenge to which his response was evasive and less than frank in many respects. He was more candid in questioning by the Tribunal, but overall we do not consider that we can accept what Mr Hobbs told us at its own face value. In giving weight to his evidence, therefore, we have looked for other evidence to support it.

213. The fact that we have found that there was no strategy of confusion does not lead inevitably to a finding that Mr Hobbs' discussions with Mr Kerr must be given the meaning for which the Authority contends. Market abuse of the nature alleged cannot be shown by mere words; there must be a correlation between those words and the actions that are said to constitute abuse. It is not enough for someone to talk about a potentially abusive transaction if he does not subsequently act with the intention of putting it into effect. We therefore need to examine what Mr Hobbs' intention was when he entered into the Trade. Was it, as the authority submits, to do "the ultimate", or was it simply a trade to address Mr Hobbs' short position?

214. In considering this, we take the view that Mr Hobbs' intentions must be considered having regard, not only to what he said to Mr Kerr, but also the feasibility of "the ultimate" in the context of the actual actions of Mr Hobbs in effecting the Trade and by reference to the objective evidence before us. We bear in mind when doing this that the burden of proof is on the Authority, and that the standard of proof is the balance of probability.

Was "the ultimate" a likely outcome of the Trade?

215. We do not consider that the Authority has shown that "the ultimate" was a likely outcome of the Trade. First, we have earlier concluded that, whilst the CORP was significant in the mechanics of the exercise and abandonment of options, and in the assessment by market participants of the likelihood of those options being exercised, it was not, for the reasons we have explained, a materially significant factor influencing the trading of those participants. It is the timely publication of the CORP that is most important; the actual level of the CORP is not as significant as the knowledge of what it is.

216. Secondly, in the context of a limit order trade, such as that executed by Mr Hobbs, we are not satisfied that it was likely that the increase in price consequent upon that Trade, which was limited to a US$12 increase from US$1745 to US$1757,

could have created any market reaction that would have driven the market higher. This is so, in our view, even if the CORP had been declared within the usual period after 12.30pm, and had not been delayed. An earlier declaration of the CORP would have enabled traders such as Mr Hearn and Mr Lambert to have had information on the matter of automatic exercise and abandonment sooner, and would have assisted them in the decisions they would have to take, but there is no evidence that their knowing the CORP sooner than they did would have changed any of those decisions.

217. The evidence, particularly that of Mr Beagles, whose analysis relied to an extent on earlier statements by Mr Lambert to LIFFE, but largely on his interpretation of the discussions between Mr Hobbs and Mr Kerr, pointed to the "ultimate" being a mere possibility, rather than a probability, or likely outcome of the Trade. Indeed, although we appreciate that Mr Beagles did so in order to help us understand the position, we find it telling that his explanation of the possible market reaction to an increase in price relied upon a much greater increase than could have been achieved by the limit order placed by Mr Hobbs in connection with the Trade.

218. Mr Beagles himself might have reacted to the increase in price immediately after 12.30pm, but as he told us he was a particularly risk-averse trader. Having heard the evidence of Mr Hearn and Mr Lambert, we would regard their views as more representative of the market. They each took a more measured approach – though Mr Lambert was particularly exercised about the late publication of the CORP – in that each made it clear that they would be making decisions concerning their positions by reference to the movements in the futures market price between 12.30pm and 1.15pm.

Was Mr Hobbs' purpose in executing the Trade, "the ultimate"?

219. That of course, as Mr Hunter rightly submitted, is not the end of the matter. It remains necessary for us to examine the evidence, and in particular the discussions between Mr Hobbs and Mr Kerr, to determine whether, in spite of the fact that the "ultimate" was not likely to have been achieved by the Trade, but was no more than a possibility, that was nevertheless the purpose of Mr Hobbs when he instructed Mr Kerr to execute the Trade. It is clear that something that would otherwise be a legitimate trade can be rendered illegitimate by an abusive purpose. This is the "actuating purpose" referred to in MAR 1.6.5.

220. We have already determined that we do not accept that Mr Hobbs had a strategy to confuse Mr Kerr based on any pre-conceived concern that Mr Kerr would breach confidentiality in relation to Mr Hobbs' dealings. That of itself does not, however, lead us to conclude that everything Mr Hobbs said in those various conversations was his purpose in entering into the Trade. To conclude that, in our view, we must be satisfied that there is a correlation between what Mr Hobbs said and what he did, that persuades us that the Trade was not legitimate as it was effected for an abusive purpose.

221. We are satisfied that Mr Hobbs' overall position was short at all material times. We are also satisfied that he was not concerned about his limits on the evening of 14 August 2007, or early in the morning of 15 August 2007. This was because the price

was above US$1750 at those times. His sale through Mr Kerr of 150 lots was before the price fell below US$1750. Although he also bought 111 futures very shortly after the price had fallen below US$1750, a single lot at 9.51am at US$1736 and some small sales later in the morning, even as late as 11.59am, we do not regard Mr Hobbs' sales of futures during this time as an indication of a lack of concern as to his short position overall. He was a net buyer of options.

222. We accept that Mr Hobbs was addressing his short position later during the morning of 15 August 2007. He purchased 723 lots in that time, and he had a number of buy orders in the market. This was the case at those times (particularly the 40 minutes between 11.09am and 11.49am) during which there was no overt trading activity, in the sense of actual purchases. His conduct at that time is therefore consistent with that of a trader seeking to address his position, and does not indicate that he was careless of that position because he had an abusive purpose. We accept, as we stated earlier, that the evidence of Mr Hobbs in relation to the purchase of 50 put options at 11.03am was unsatisfactory, but we do not regard that as material to our overall conclusion that Mr Hobbs was as a general matter trading so as to address his short position.

223. As Mr Hobbs was a delta trader, any movement of the futures price through the strike price of his options would have an effect on his position. Mr Sherman's own analysis of Mr Hobbs' trading, which was produced in October 2007 for the Mizuho compliance department, made the point that if the price had remained below US$1750 as a result of Mr Hobbs' buying up to 12.30pm on 15 August 2007, he would have been very short in delta terms (on the assumption of the exercise of the ITM puts). The increase in price above US$1750 switched the position in September 2007 to long, on the basis that the puts would not exercise (as being OTM at that stage), but the ITM calls would be exercised. If the put options were not exercised, Mr Hobbs' overall position would be virtually flat, but with a large spread exposure to Sep-Nov07. Mr Sherman goes on to say that by exercising the US$1750 puts (1,147 contracts out of 2,000) Mr Hobbs reduced the long in the September 2007 puts and re-established a net short. (Mr Sherman refers to the September puts being OTM; they were OTM by reference to the CORP, but by the time they were exercised, those puts were back ITM, as the price had fallen below US$1750.)

224. In considering the Trade itself, the most crucial issues are those of timing and the fact of the limit order. As regards timing, we have found that the evidence supports to an extent the view taken by Mr Hobbs that liquidity would increase around options expiry, although Mr Beagles said that he would not expect there to be optimum liquidity at the precise time of the Trade. Our understanding from that evidence is that the delta attached to options will move towards binary at that time, and a movement in delta will lead to traders having to consider an adjustment to their positions, thus creating market activity. In closing, Mr Hunter argued that there was no evidence that there would be greater liquidity in the few seconds just before 12.30pm, which is of course the relevant time for the Trade. We accept that. Liquidity cannot explain the precise timing of the Trade. What it does, however, is to explain why Mr Hobbs waited until shortly before options expiry to buy futures rather

than, as was suggested to be the more natural approach, to buy all the futures he needed to address his short position earlier in the morning of 15 August 2007.

225. How then can the precise timing of the Trade be explained? There are two possibilities. Either, as Mr Hunter submits, it is because Mr Hobbs believed that the CORP would affect the way the market would behave, and deliberately set out to conduct the Trade so that it had that effect, or else it is simply a trade to take advantage of Mr Hobbs' perception of liquidity, which may be conducted legitimately in the last few seconds before 12.30pm as well as at any other time approaching options expiry, when liquidity would be likely to be increasing. There was no evidence of any market practice not to trade in the last minute prior to 12.30pm on options expiry. Although Mr Beagles' report referred us to the fact that for the 12 option expiries between September 2006 and July 2008, there were no trades at all (and therefore a zero trading range) in the expiry minute in eight of the twelve expiries, the volume weighted nature of the CORP anticipates that trades will take place in that minute, and there was no evidence to the contrary. Mr Lambert, for example, told us that the timing of a trader covering a short position was a matter of a judgment call by that trader.

226. The evidence of the transcripts shows that Mr Hobbs was concerned to understand the operation of the CORP. There was a good deal of confusion between Mr Hobbs and Mr Kerr about how it operated, which tends to support the conclusion that it was not regarded as a material factor in trading; otherwise a trader such as Mr Hobbs and a broker such as Mr Kerr would have been expected to have been keenly aware of the rules. We do not regard that, however, as pointing to any purpose of Mr Hobbs to manipulate the CORP. His enquiries in that respect, concerning automatic exercise and the relevant parameters within which different instructions could be given to the clearing house, were, in our view, all based on an assumption that the options would be ITM, in other words that the CORP would be below US$1750. Those enquiries cannot therefore have been part of a grand design to manipulate the CORP so that it was above US$1750.

227. We are then faced with the statements made by Mr Hobbs in the lead up to the Trade. On their face individual statements suggest an intention to push the CORP above US$1750. Mr Hobbs asks Mr Kerr about the depth up to $1760. He then asks how many lots are needed to buy "if I want this thing to finish through 50". Having received the answer that it is 330 lots, Mr Hobbs then says:

> "OK I want you to on the close, and this is the idea that it finishes obviously higher than 1750. I want you to buy 600 lots of September up to 1757."

228. Mr Hobbs goes on to reiterate his desire that "it", which must be a reference to the CORP, finish above US$1750, and he makes clear that the Trade must be before 12.30pm.

229. Taking these statements alone at their face value, it may be concluded that the purpose of Mr Hobbs was to raise the CORP above US$1750, and that would therefore support a conclusion that the overall purpose was, as the Authority contends,

to "do the ultimate", however unrealistic that might have been in practice. But those are not Mr Hobbs' only statements, and we have to take account of what he actually instructed Mr Kerr to do.

230. When the talking clock was switched on, that is at 12.27pm, Mr Hobbs said "… I can listen to it from there then I'm absolutely fine you letting it go light." He repeats this for the benefit of Mr Kerr: "I'm fine if you let it go light I just want to make sure you buy them. Yes?" To us, this suggested that Mr Hobbs was content to let the order be made at that time, so long as it was before 12.30pm. In cross-examination Mr Hobbs said that this was indeed the case. However, in later questioning by the Tribunal Mr Hobbs confirmed that the "letting it go light" was the passage he was referring to in that respect, but then confusingly said, in connection with that being shortly after 12.27pm,: "Yes, it is – yes, it was yes. Didn't let it go before 29, was what I was saying." And in final questions from the Tribunal, at the end of the parties' final submissions, Mr Hobbs said that "letting it go light" meant letting the buy order go early: Mr Hobbs' objective was to buy the 600 lots, and he did not mind Mr Kerr putting the order in earlier than the last minute before 12.30pm.

231. Faced with this contradictory evidence from Mr Hobbs, we have to make a judgment on what was meant by "letting it go light" in this context. We bear in mind our overall assessment of Mr Hobbs' evidence, and accordingly treat it with caution in this respect. But our assessment of the plain words is that Mr Hobbs was allowing Mr Kerr to place the order before 12.29pm, and he was doing so because his main concern was not to manipulate the CORP above US$1750, but, as he said, just to make sure the 600 lots were bought.

232. We move then to the limit order. This, in our view, points away from a conclusion that Mr Hobbs was genuinely contemplating "doing the ultimate". Given our conclusions on the likelihood of the "ultimate" being achievable in these circumstances, it would, in our view, require clear evidence to persuade us that an experienced trader such as Mr Hobbs could have intended to have such an effect on the market with a limit order of this nature.

233. Mr Hunter argued that the fact that the order was a limit order did not assist Mr Hobbs at all. He submitted that all this showed was that Mr Hobbs wasn't prepared to pay absolutely any price in his attempt to do "the ultimate". He argued that the limit order was consistent with what Mr Hobbs had told Mr Kerr. Mr Kerr had been asked what sell orders he could see up to US$1760; the answer was 330 lots. Mr Hobbs more or less doubled that number up to 600, and repeated that he wished the CORP to finish through US$1750. Mr Hobbs chose the limit order as a means of achieving that.

234. We are unable to accept Mr Hunter's theory as to Mr Hobbs' concerns. The placing of a limit order necessarily limited the maximum price that Mr Hobbs would have to pay. But he could not be sure that his order would not be filled at levels below that price. There could have been icebergs in the market. The limit order, we find, was placed in order that Mr Hobbs could achieve his purchases at an acceptable price slippage. That in our view is consistent with the legitimate trading action of

reducing the short position of Mr Hobbs' book, and is not consistent with a scheme to create market buying and a further rise in prices. Such a limit order restricted the level to which the futures price could rise as a result of the Trade.

235. If Mr Hobbs had genuinely intended to "do the ultimate", the logical course would have been for him not to buy any futures up to 12.29pm so that he would have the capacity, given his position, to buy a far greater number of lots than 600, in the expectation that the price would truly spike. Mr Hobbs did neither of these things. He bought throughout the morning before 12.30pm a net 476 lots, and even between 12.03pm and 12.23pm, shortly before what the Authority argues was "the ultimate", he bought 184 lots. That is, in our view, not consistent with a plan to raise the futures price at 12.30pm to the extent that would be required to "do the ultimate".

236. In our view, although we are mindful that there are statements of Mr Hobbs that suggest otherwise, the primary purpose of Mr Hobbs in executing the Trade was to buy the 600 lots of September 2007 futures. Just before the Trade Mr Hobbs is recorded as having said, in one breath, "I just want it to finish above 1750", and in another, "I just want to make sure you buy them." However, immediately after the Trade, and just after Mr Kerr has told Mr Hobbs that "The last print was 1757", but with no indication of other prices at which the order was satisfied, Mr Hobbs' concern is as to volume only (HOBBS: OK so how many did we do? KERR: 600. HOBBS: OK very good.).

237. It was some eight minutes later, when according to normal practice the CORP would already have been announced, that the transcripts indicate that Mr Hobbs made enquiries about the level of the CORP. He did not place any sell orders into the market. His concern was to ensure that he was able to exercise and abandon the required number of put options, taking account of the procedure for automatic exercise and abandonment with a CORP set at US$1752. The exercise of put options would have been at their strike price of US$1750, so that this could not have been part of any strategy to sell into a rising market. It must instead, and we so find, have simply been in order that Mr Hobbs could reinstate his short position having regard to his view of the market. The fact that he took into account the call options that were subject to automatic exercise in determining how many put options to exercise supports our conclusion that this was simply to bring Mr Hobbs' book back into line with his own view of the market.

238. If there was a scheme to "do the ultimate", then we do not consider that there is anything in the subsequent conversations which Mr Hobbs had to indicate that he was concerned that it had failed. His reference, in the 1.03pm conversation, to the market staying down as being "rubbish" is explicable in terms of his having bought the 600 futures. Nevertheless, by retaining the put options, Mr Hobbs was able to restore his overall short position, which makes sense in terms of a falling market.

239. Our analysis of the post-12.30pm conversations is that Mr Hobbs is seeking to boast about the effect his Trade has had on the market and what he assumes to be the confusion he has created, including his statement that: "I created a false impression". However, we do not consider that the Trade, executed to address Mr Hobbs' short

position, by means of a limit order which simply accessed prices already in offer in the market can be regarded as creating a false impression. In short, we do not accept Mr Hobbs' own boastful description of what he had achieved.

Mr Hobbs' conversations with Mr Kerr

240. That leaves us finally to consider what Mr Hobbs was doing in the various telephone conversations if he was neither engaged in a strategy to confuse Mr Kerr nor detailing how he intended to "do the ultimate" or abuse the coffee futures market. In our judgment, having considered all the evidence, and in particular all the transcripts, is that this was, as Mr Hobbs himself described it when interviewed by the Authority, "trader bravado". We have concluded, after much consideration, that these were merely fantasies intended to portray Mr Hobbs as a "player" or big fish in the coffee futures market. The modus operandi of Mr Hobbs was to remain on the telephone with his broker even when little or no activity was taking place. The conversations were, in our view, often mindless and illogical. That, we consider, was the quality of Mr Hobbs' descriptions of "doing the ultimate"; it was a mere fantasy, concocted for no reason other than to fill the time available by making himself feel important.

241. As we have described, despite our finding in his favour on the reference before us, Mr Hobbs emerges from these proceedings with very little credit. We have already referred to the unsatisfactory nature of the evidence he gave to us. We have, as we have described, found that his assertions that he was engaged in a strategy of confusion were false. That is a serious matter. We can only surmise as to why, in the light of our own findings, Mr Hobbs thought fit to develop and persist with such a story. We can only think that he did so as a desperate attempt to explain what he feared might otherwise be inexplicable, namely what we have concluded, on balance, were his rambling and nonsensical conversations with Mr Kerr. That was a grave error. Not only did it cast Mr Hobbs in a poor light. It could very easily have led to his words being taken completely at face value, with a different conclusion to this reference.

Determination

242. Taking all the evidence into account we have reached the conclusion that the Trade was carried out for legitimate reasons and in conformity with accepted market practices on the coffee futures market. We are not satisfied that the Authority has made out its case against Mr Hobbs on market abuse. We find, accordingly that Mr Hobbs did not engage in market abuse within s 118(5) FSMA.

243. The Authority's case on whether Mr Hobbs was a fit and proper person for the purpose of s 56 FSMA rested on a combination of his alleged conduct in committing market abuse and then lying about it. We have found that Mr Hobbs' assertions that he was engaged in a strategy of confusion were false, but that he was not engaged in market abuse. In those circumstances, we are not satisfied that the Authority has made its case that Mr Hobbs is not a fit and proper person.

Direction

244. For these reasons we have concluded that the appropriate Direction to the Authority is to take no action against Mr Hobbs.

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ROGER BERNER

UPPER TRIBUNAL JUDGE
RELEASE DATE: 22 November 2012

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