



**RESPONSE TO MARKET CONSULTATION DATED 10 DECEMBER 2013**

**Consultation on the market structure for the trading of  
smaller equity securities outside of the FTSE 350 index**

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23 May 2014





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## 1. Executive Summary

In December 2013 and January 2014, London Stock Exchange conducted a market consultation to further enhance the trading of equity securities outside of the FTSE 350 index (“smaller securities”). The paper covered the following areas:

- Proposals to improve the functionality of SETSqx Auctions
- Improving the depth at touch of smaller SETS securities by preventing small quantity orders setting the best bid or offer
- Criteria for a security moving from quote driven to SETS

The purpose of this document is to provide an overview of the feedback received and the resultant steps that will be taken. The consultation paper can be found as a download at:

[www.lseg.com/setsqx](http://www.lseg.com/setsqx)

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## 2. Introduction

- I. In order to ensure that we continue to deliver an optimal market structure for the trading of smaller securities, a consultation focusing on the trading of equity securities outside the FTSE350 index was issued on 10 December 2013 as an attachment to Stock Exchange Notice N16/13. The closing date for comments was 31 January 2014. The original consultation document is available to download at: [www.lseg.com/setsqx](http://www.lseg.com/setsqx)
- II. London Stock Exchange currently provides three trading services for smaller securities: SETS, an electronic order book (with provision of integrated electronic market maker quotes); SETSqx, a hybrid trading service providing non-electronic market maker quotes and four periodic auctions; and SEAQ, a quote driven trading service.
- III. As of April 25 2014, there are 930 equity securities on SETS, 1057 equity securities on SETSqx, and 571 equity securities on SEAQ.
- IV. London Stock Exchange received responses from a range of interested parties including market makers, retail brokers, investment banks and wealth managers. In addition to written responses, London Stock Exchange also conducted a number of meetings with participants to ensure a wider set of views were considered.
- V. London Stock Exchange thanks those parties who responded and those who contributed with feedback in meetings held with participants.

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### 3. Feedback on SETSqx Auctions

London Stock Exchange proposed the following developments to the SETSqx auction service to improve the trading experience for investors, market participants and issuers:

Moving the existing 08:00 auction to 09:00, or the 11:00 auction to 10.15 to create a mid morning auction. The mandatory quoting period for market makers would remain from 08:00 until the completion of the closing auction; and

Changing the current SETSqx auctions. Once the price has been formed as per current practice to maximise execution value at a given price point, orders will then be filled on time priority rather than strict price priority. This proposed change would ensure that an order would only take priority over an older order where it actually delivered price improvement.

Another potential change proposed to the SETSqx auction process was where orders can continue to be entered throughout the trading day but would not be displayed. Instead, where there are matched orders in the auction, an indicative uncrossing volume and price would only be disseminated for the 10 minute period immediately before each of the scheduled 4 uncrossing times.

#### Questions

1. Would the creation of a mid morning auction be more attractive to potential client flow?

There was clear support for an auction uncrossing at 09:00 which was recognised by many as a time when investors had digested early morning news and research and were ready to commit to investment decisions. Some respondents felt that this could be achieved by adopting hourly SETSqx auctions, thereby retaining the 08:00 auction. A number of other respondents did not want to see an overall increase in the number of daily auctions. There was limited support specifically for moving the 11:00 auction to 10:15.

2. Would you support only allowing a new SETSqx order to take execution priority over an older order if it led to genuine price improvement?

Over half of respondents were in favour of the proposal. Of the respondents not in favour, a number of firms indicated that they felt the proposal would undermine the auction process, and that they were comfortable with the current price formation mechanism. Several respondents noted that they felt improvements to visibility and withdrawal of orders was more important.

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3. Do you support converting SETSqx auctions to only the display of indicative uncrossing price and size which would be disseminated in the 10 minutes ahead of a scheduled uncrossing?

A number of firms noted that they felt the proposal could potentially reduce transparency in SETSqx securities. Several firms also noted that the proposal may limit participants in having sufficient visibility to respond to business residing on the order book. Respondents articulated more widespread support to have shorter discrete auction call periods, reducing the current elongated auction call period in order to improve the auction experience.

4. Do you have any other suggestions for improving the SETSqx auction service?

A common theme amongst a number of respondents was to have more frequent auctions, either hourly or with better and more even spacing during the trading day. Several firms proposed that the auctions should be replaced by continuous electronic execution. A number of firms suggested that the relationship between quotes and orders should be improved. Several firms articulated frustration at orders appearing that could not be directly interacted against for up to 4 hours.

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#### 4. Next steps on SETSqx Auctions

Following the consultation exercise London Stock Exchange will implement the following changes to the SETSqx auction process in autumn 2014:

- Retain the existing number of SETSqx auctions with more even spacing throughout the day at 09:00, 11:00, 14:00 and 16:35
- Replace the existing elongated auction call periods with a 10 minute auction call ahead of the scheduled uncrossing (5 minutes at the closing auction in-line with SETS). At the same time ensure that orders are only visible during the 10 (5 minutes at the closing auction) minute call period. In order to achieve this the following changes are required:
- Restriction of use of non-auction time in force orders; and orders entered for an auction will either be good for a single auction or all remaining auctions that trading day
- Introduction of the closing price crossing session (CPX) immediately after execution of the closing auction. Allows a further period of around 5 minutes of electronic trading at the closing auction price only (in line with SETS)

More details of the changes to the Customer Development Service and exact timings of the changes to production will follow in due course. The table below provides a summary of the changes.

<b>SETSqx</b>	<b>CURRENT</b>	<b>AFTER PLANNED CHANGE</b>
Pre-mandatory registered market making period	07:30 – 08:00	07:30 – 08:00
Mandatory registered market making FIRM QUOTE submission	08:00 to end of closing auction	08:00 to end of closing auction
Auction call scheduled <b>start</b> times	07:50, 08:00, 11:00 & 15:00	08:50, 10:50, 13:50 & 16:30
Scheduled auction un-crossings	08:00, 11:00, 15:00 & 16:35	09:00, 11:00, 14:00 & 16:35
Closing price crossing session (CPX)	NO	YES – for approximately 5 minutes after closing auction execution at the closing execution price.
Permitted Time in Force before CPX	Day, OPG, GTD, GTT, ATC, GFA	OPG, GFA, ATC & GFS (new TIF to target next and remaining SETSqx auctions that day)
Permitted Time in Force for use during CPX	N/A	CPX (new TIF to target CPX), IOC & FOK
Maximum order duration	90 days	Current trading day if using GFS, otherwise single auction targeted
Timing of order entry	07:50 to end of closing auction	08:50 to end of CPX
Visibility of orders outside auction call periods	As in almost continuous auction call - full visibility throughout the trading day	Orders only visible during 10 (5 at the close) minute auction call period plus any price or market order extensions



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## 5. Small orders setting the best bid or offer in smaller SETS securities

London Stock Exchange proposed a development to the SETS trading service for smaller securities in order to improve the depth available for execution at the BBO. It was proposed to introduce a minimum order size for new resting orders to enter the order book and create a new BBO.

Under this proposal orders of any size could still be submitted to SETS. All aggressive orders that execute without resting on the book would be completely unaffected. Only passive orders that are sized at least x% of the Exchange Market Size or greater would be able to set a new BBO. Smaller passive orders priced at or outside current BBO would be processed as per current practice today, however submitters of smaller passive orders within the current BBO would receive an acknowledgement message confirming that their order had been re-priced to join the ruling BBO.

### Questions

1. Do you think liquidity provision in smaller SETS securities would be improved if small orders had to be of significant size to improve the best bid / offer?

This proposal had a high degree of support. Of the respondents who supported the proposal, a number indicated that it would benefit the provision of liquidity in smaller SETS securities.

Many firms felt that repricing orders was not feasible from a client perspective and were more supportive of SETS rejecting orders that were below the proposed threshold. Several firms expressed concern that the threshold may be restrictive for retail limit orders. Several firms noted preferences for closer spreads, irrespective of size and concerns that liquidity providers may widen spreads.

2. Would you support this development?

As per responses on question 1.

3. Do you have any other suggestions for improving liquidity provision in smaller SETS securities?

Several respondents underlined the need for appropriate trading service selection between order driven and quote driven services. Current and future challenges of European Union regulation in settlement discipline were cited as being a concern for liquidity providers in smaller securities. A number of respondents indicated that they felt better order book access for participants could be achieved though lower overall transaction costs.

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## **6. Next steps on small orders setting the best bid or offer in smaller SETS securities**

In response to the feedback received, London Stock Exchange will introduce functionality in the second half of 2015 that allows it to reject orders that are smaller than a prescribed percentage of Exchange Market Size (market makers EMS quote size) that would otherwise set a new Best Bid-Offer during regular (non-auction) trading.

Further discussion will take place between the London Stock Exchange and participants to determine the exact population of smaller SETS securities the new functionality will be applied to and the calibration of the rejection threshold. This new functionality will not restrict small orders that execute on entry, those that do not set a new BBO or those are entered during an auction call.

Further technical details including changes to the Customer Development Service and exact timings of change to production will follow some time in 2015.

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## **7. Criteria for a security moving from quote driven to SETS**

In December 2012 London Stock Exchange conducted a market consultation in smaller securities which proposed new criteria for the allocation of stocks to trading services. A new quarterly review process that identifies smaller SETS securities that may be more suited to a quote driven trading service, was implemented in February 2013.

Further information on equity trading service selection criteria can be found in the third tab of the Millennium Exchange Business Parameters document that can be accessed from: [www.lseg.com/tradingservices](http://www.lseg.com/tradingservices)

London Stock Exchange's current process is that an issuer residing on the SETSqx or SEAQ trading service can request to be moved to SETS, providing it:

- Has support of at least one market maker prepared to quote the EMS of at least £2,500; and
- Is eligible for clearing

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London Stock Exchange gives the issuer and its adviser the ability to choose the trading service it resides on, dependant on market maker support, to ensure that the issuer resides on the trading service it feels is most suitable for its security. London Stock Exchange is proposing that where a market maker agrees to support a security on SETS, it must guarantee support for a minimum of three months.

## Questions

1. Do you believe that support of at least one market maker is sufficient for a security to reside on SETS?

Respondents indicated divided opinion on this question. A reasonable number of firms indicated that they felt support of one market maker should be widened to support of at least two market makers. A number of firms noted that support of one market maker would be sufficient in the instance where the supporting market maker is also the NOMAD / corporate Broker. A number of respondents indicated that they felt that support of one market maker was sufficient.

2. Do you have any further comments on this?

Several respondents indicated that the issuer along with its adviser should have the final say in trading service allocation. Support from a market maker for a SETS security, of a minimum of 3 months was also suggested. An alternative to the current process for trading service selection was also noted, which suggested forming a committee of participants who would input into the selection process along with the issuer and its adviser. A number of respondents indicated a preference for the SETS trading service, and noted some frustration with the movements of securities between trading services as a result of the quarterly review.

The need for the FTSE AIM UK50 reserve list to be order driven was questioned with a small number of respondents indicating that the reserve list of 10 securities (at the time of conducting the consultation) was superfluous. Further education on London Stock Exchange trading services and the process of trading service selection was also suggested.

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## **8. Next steps on criteria for a security moving from quote driven to SETS**

Due to the divided opinion received, London Stock Exchange will carry out further discussion with participants to determine the best criteria for SETS inclusion that meets the needs of issuers, investors and participants.

Following discussions with FTSE, the FTSE AIM UK 50 reserve list was reduced from 10 companies to 5 companies, effective March 2014.

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## **9. Contact details**

Should you wish to discuss the consultation further, please contact:

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