



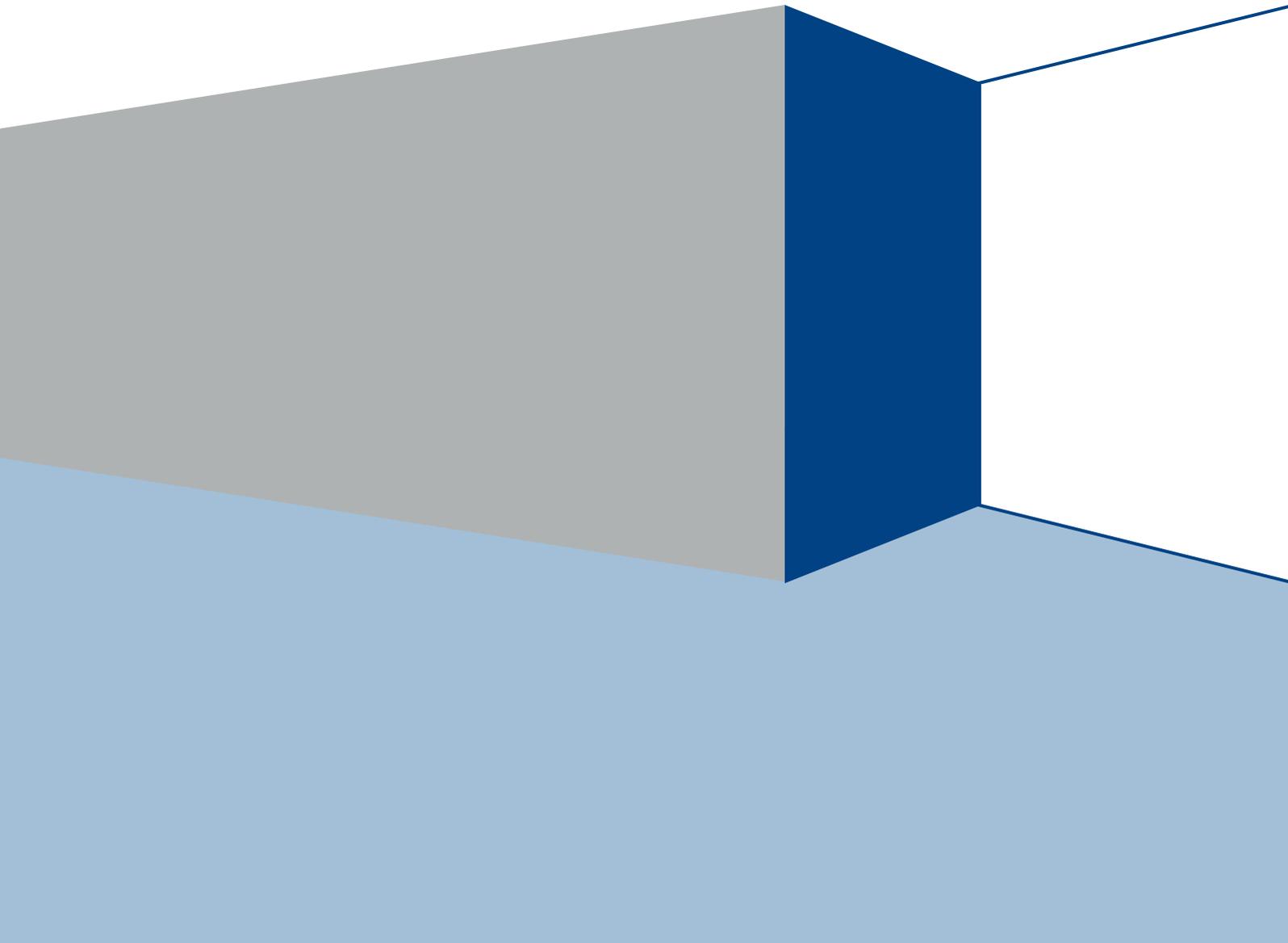
**London**  
Stock Exchange

**Market Consultation**

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

- **Closing date for responses: 14 January 2013**

**Issued: 17 December 2012**



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## Executive Summary

London Stock Exchange is conducting a market consultation to further enhance the trading of equity securities outside of the FTSE 350 index (“smaller securities”). This paper covers the following areas:

- allocation of stocks to trading services
- the SETS electronic order book trading service
- the SETSqx quote and periodic auction service

This paper will be used to guide development of the secondary market for smaller securities and invites responses from involved and interested parties.

London Stock Exchange is proposing new criteria for the allocation of stocks to its different trading services, to ensure that a security is allocated to the trading service that is most appropriate.

Technical changes for smaller securities on SETS are also proposed, to enhance the provision of liquidity and price formation process. Participants are also invited to provide feedback on the timing of SETSqx auctions.

## Introduction

1. London Stock Exchange constantly strives to ensure that its markets remain attractive and meet the needs of its diverse user base. In order to ensure that we continue to deliver to meet customers’ needs in the changing European and global landscape, we are undertaking a consultation focused primarily on the trading of equity securities outside the FTSE 350 index.
2. The UK has a well-established tradition of supporting the development and trading of smaller securities that is of significant importance to the provision of capital to the wider economy and compares positively with other European and international jurisdictions. Appendix 2 compares AIM with a non-exhaustive selection of other European growth markets.
3. 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. As of December 2012, there are approximately 600 securities on SETS, 1,000 securities on SETSqx, and 700 securities on SEAQ.

4. For trading in these smaller securities to flourish, it is vital that the market structure continues to meet the diverse needs of all market participants. The market structure needs to encourage the provision of risk capital in a manner that allows for a transparent and fair price formation. Additionally, it needs to enable the market in smaller securities to continue to thrive in a regulatory environment that is moving towards ever greater harmonisation of market practices across the European Union.

## **Approach**

5. London Stock Exchange seeks to gather feedback from all stakeholders with interest in the secondary market trading of equity securities outside the FTSE 100 and FTSE 250 indices. This feedback will be used to inform London Stock Exchange on how its trading services can be enhanced from liquidity, operational and trading rules perspective, and to enhance its understanding of customers' views on topics that are likely to be subject to future regulatory debate.
6. This consultation focuses on several key areas in the secondary market for smaller securities in order to improve secondary market trading. This document contains specific proposals for revising the criteria used to select the trading service a security trades on. It also seeks to identify broad areas in which improvements to its services would be welcomed by users of the market. You may find the information included in the appendices helpful in answering the consultation questions.

## **Timetable and Contact Details**

7. The consultation period is 4 weeks, and responses are requested by 14 January 2013
8. Responses can be sent by email to: [clients@londonstockexchange.com](mailto:clients@londonstockexchange.com)
9. Alternatively, they can be posted to:

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## Consultation Questions

### Information on Respondent

Type of Firm (indicate as many functions as appropriate)	Issuer <input type="checkbox"/> Corporate Adviser <input type="checkbox"/> Market Maker <input type="checkbox"/> Institutional Investor <input type="checkbox"/> Retail Broker <input type="checkbox"/> Banks / Institutional Broker <input type="checkbox"/> Clearing Firm <input type="checkbox"/> Index publisher <input type="checkbox"/> Other <input type="checkbox"/> Regulator <input type="checkbox"/> Trade Association <input type="checkbox"/> Individual investor <input type="checkbox"/>
Name of Organisation/Individual	
Business Functions Represented (we request one response per-entity representing that entity's corporate view):	
Roles of Individuals contributing:	
Name of Individuals contributing (optional);	
Contact details	

## Allocation of Stocks to Trading Services

10. Following discussions with market participants over the past six months, London Stock Exchange believes it is appropriate to amend the criteria by which stocks are allocated to a trading service in order to maximise liquidity and thereby ensure the most efficient and reliable price formation. London Stock Exchange invites feedback in terms of the process and impact of trading service allocation.
11. London Stock Exchange proposes revised criteria for trading service selection that improves identification of where a smaller security may benefit from a change of trading service. The criteria whereby securities that are a constituent of the FTSE All Share or the FTSE AIM UK 50 indices are included on the SETS trading service remain unchanged. There will be a change to the quarterly review process for identifying SETS securities outside this list that may be suitable for migration between trading services.
12. Where market makers' executable quotes are contributing to the depth weighted spread at Exchange Market Size ("EMS") for more than a quarter of the time, it may be an indication that the stock is more dependent on market maker named liquidity and is, therefore, potentially better suited to a quote-driven environment. For these securities, if the member firms responsible for the majority of the weighted value traded (on/ off book combined) agree, and providing the issuer itself does not object, the security will be moved to SETSqx.
13. Current Criteria
  - **For trading on SETS**
    - All constituents of the FTSE All Share Index
    - All constituents and reserve list members of the FTSE AIM UK50 Index
    - New trading lines that by their size are likely to fall within the above criteria within the next three months
    - Where the issuer (or its adviser) has requested subject to the following:
      - Electronically settleable in CREST;
      - Eligible for central counterparty clearing; and
      - Support of at least one market maker that will register to provide a two way obligation of at least £2,500

- **For trading on SETSqx**

- All domestic Main Market equity securities that are not on SETS
- AIM securities that have previously traded on SETS or have less than two registered market makers
- New trading lines which do not meet the criteria for SETS and the issuer has not expressed a preference for SEAQ
- Where the issuer (or its adviser) has requested and the security has not been a constituent or reserve list member of the FTSE All Share or the FTSE AIM UK50 indices for at least three months
- Where the majority of registered market makers (that express a preference) by value traded on London Stock Exchange in the previous three months have requested subject to the following criteria:
  - the issuer provides its consent; and
  - the security has not been a constituent or reserve list member of the FTSE All Share or the FTSE AIM UK50 indices for at least the previous three months.

14. Proposed Revised Criteria

- **For trading on SETS:**

- The stock is included within any of the following indices or their reserve list (if applicable): FTSE100, FTSE250, FTSE Small Cap, FTSE AIM50.
- New trading lines that by their size are likely to fall within the above criteria within the next three months
- Subject to the non-objection of the issuer/advisor, acceptance for central counterparty clearing, and at least one market maker is prepared to make the EMS in at least £2,500 on SETS - stocks outside the above indices would be allocated to SETS where:
  - The weighted majority of market makers (that express an opinion) as measured by proportion of time at the best bid /offer ("BBO") over the previous three months request it; OR
  - The weighted majority of top five member firms by value traded in the previous three months (that express an opinion) request it.

- **For trading on SETSqx:**

- Subject to the non-objection of the issuer/advisor, SETS stocks outside the above indices would be allocated to SETSqx as part of the quarterly review process where:
  - Over the previous three months market maker executable quotes have contributed to the depth spread at the EMS at least 25% of the time; AND
  - The weighted majority of the top five member firms (that express an opinion) as measured by value traded (on/off book) over the previous three months request it.

## Issuers / adviser preference

- Issuers/advisors may still request their stock be traded at any time on a specific trading service as follows:
  - SETS – acceptance for central counterparty clearing and that at least one market maker is prepared to make the EMS in at least £2,500 on SETS.
  - SETSqx – no extra criteria for stocks not in one of the above listed indices.

## Questions:

1. Do you support the suggested approach?
  
2. If not, what alternative criteria would you prefer to see utilised?

## Trading Services

15. Liquidity provision plays a significant role in the trading experience of smaller securities on London Stock Exchange's trading services. This section makes several proposals to improve the trading conditions on SETS and SETSqx, whilst asking participants for feedback on market structure issues relating to the trading of smaller securities to ensure that securities are traded in the most optimal way. All questions are in reference to equity securities outside the FTSE 350 index.
  
16. **SETS**
  - i. As a result of market discussions, London Stock Exchange is proposing changes for smaller securities on SETS in order to improve the trading conditions of these securities. The first being the extension of the minimum order size of £1,000 to a wider range of securities outside the FTSE350 index.
  
  - ii. The second is a longer term technology development to the SETS trading service where small orders on their own would not set the touch price. London Stock Exchange believes this would be beneficial to the market as only orders of significant size would set the BBO but orders below £1,000 could be accepted.
  
  - iii. The Closing Price Crossing Session was introduced to SETS in April 2012. This follows the established closing auction, providing a further continuous trading session where trading can take place, fixed at the closing price. London Stock Exchange seeks feedback on this service to understand its effectiveness in the context of smaller securities.

- iv. Participants are also asked for feedback on the current price monitoring process (circuit breakers) to understand whether participants believe further improvements could be made.

**Questions:**

3. **Currently, approximately 40 of the smallest AIM SETS securities have a minimum order size set at around £1k. London Stock Exchange is considering extending this to a wider number of smaller securities. Will increasing the size of orders at BBO improve the price formation in these securities?**
4. **If so, which additional SETS securities should be included?**
5. **London Stock Exchange is considering a longer term technical development to the SETS trading service, whereby small orders are permitted, but are not able on their own to set an improved BBO. Would this change be welcomed, and if so, how should it be calibrated and to what universe of stocks should it be applied?**
6. **Currently there is a *closing price cross session* allowing further order book trading at the closing auction price. Is this considered useful for smaller SETS securities?**
7. **If so, should the facility be extended from current five minute duration?**
8. **The auction following the invocation of our circuit breakers currently lasts five minutes. Is this still considered an appropriate duration? If not, what should it be?**
9. **What are your general observations on the thresholds used to generate the circuit breakers? Are there areas for improvement?**
10. **Do you have any other suggestions for improving liquidity provision on smaller securities traded on SETS?**

17. **SETSqx**

- i. SETSqx combines a continuous quote driven market (supported by market makers) with four electronic auctions (8am, 11am, 3pm and 4:35pm) which are open to all market participants. London Stock Exchange seeks to understand market perceptions and observations of SETSqx as a trading service in order to ensure that SETSqx functionality can be used to benefit the wider market.

**Questions:**

**11. What are the areas for improvement?**

**12. Would you support an additional auction at 9am?**

**13. Should the auctions frequency be extended even further to hourly?**

**14. Is there adequate visibility via data vendors of SETSqx orders submitted to an auction?**

**15. Would auction price formation be improved if the random period to trigger the end of the auction was extended from current 30 seconds? If so, what should the duration be?**

**16. Do you have any other suggestions for improving liquidity provision on SETSqx traded securities?**

## Appendices

### 1. Summary of Changes to London Stock Exchange Market Structure

Year	Market Structure Development	Tick Sizes
1986	“Big Bang”. Introduction of SEAQ, the Stock Exchange Automated Quotation system which allowed registered market makers to publish their two-way quotes to market participants. Execution was either telephonic or via participants’ own systems.	A standard tick size (minimum price differential for orders and quotes) of 0.25p (a quarter penny), with flexibility for stocks priced less than 10p to have a more granular tick size.  Stocks on SEAQ still use this tick regime.
1997	Introduction of the SETS central limit order book model for FTSE100 constituents.	The SEAQ tick regime was adopted for SETS, with a modification such that stocks priced above 500p (£5) had a tick size of 0.5p and stocks priced above 1000/ (£10) had a tick size of 1p. Tick sizes for each stock were reviewed and adjusted quarterly.  Stocks outside the FTSE350 still use this tick regime.
2001	Introduction of Central Counterparty Clearing Service for SETS securities, improving management of counterparty risk and providing post trade anonymity.	
2003	Extension of full order book to FTSE250 constituents, with these stocks migrated from SEAQ.	
2005	Extension of full order book to FTSE Small Cap constituents and liquid AIM stocks, with these stocks migrated from SEAQ.	
2007	Introduction of SETSqx – combining the quote driven SEAQ model with four electronic auctions accessible to all market participants.  All Main Market securities not on SETS moved to SETSqx from SEAQ.	Migration to a “dynamic tick table” model, in which the tick size changes according to the price of the order entered, (rather than being “static” and adjusted periodically).  0.1p tick size introduced on SETS for FTSE 100 stocks priced between 10p and 199p.
2009		Increased competition in secondary market trading that resulted from the introduction in late 2007 of MiFID, resulted in the adoption of more granular (and inconsistent) tick regimes by different venues. In 2009 agreement was reached amongst venues and market participants to standardise tick tables for liquid stocks trading on multiple venues.  London Stock Exchange allocated FTSE350 stocks to either the FESE1 or FESE2 tick tables. Small Cap and AIM stocks remain on legacy tick tables.

For more details on all London Stock Exchange's trading services please see the link below. A brief summary is also included at Appendix 3. [www.londonstockexchange.com/tradingservices](http://www.londonstockexchange.com/tradingservices)

## 2. Comparison of European Growth Markets

The table below lists 11 growth markets that are currently operating across the European Union. Please note this is not a complete list. All data is as at August 2012.

Member State	Growth market	Market Operator	Number of companies	Market value (€ billion)
France	Alternext	NYSE Euronext	180	6.2
Germany	Entry Standard	Deutsche Borse	135	12.7
Greece	The Alternative Market (EN.A)	ATHEX (Greece)	14	0.17
Ireland	Enterprise Securities Market	Irish Stock Exchange	25	3.5
Italy	AIM Italia – Mercato Alternativo	London Stock Exchange Group	24	0.6
Poland	NewConnect	Warsaw Stock Exchange	365	2.2
Sweden	First North	NASDAQ OMX	129	3.2
Spain	MAB	Bolsa de Madrid	18	0.5
Slovenia	Entry Market	Ljubljana Stock Exchange (Slovenia)	40	0.6
UK	AIM	London Stock Exchange Group	1120	85.7
UK	PLUS-quoted	PLUS Markets Group ( <i>Now ICAP Securities &amp; Derivatives Exchange – ISDX</i> )	145	3.0

Source: FESE statistics

### 3. Current Features of Trading Services

Feature	SETS	SETSqx With Market Makers	SETSqx Without Market Makers	SEAQ
Stock Universe	FTSE All share securities, ETFs ETPs, other Liquid non-index securities including AIM and Irish	All Main Market and EURM AIM equity securities not traded on a full order book are traded on SETSqx		AIM securities not on SETS or SEAQ
Opening Auction	Uncrossing process commences at 8am	Uncrossing process commences 8am		None
Continuous Limit Order Book	Following opening auction uncrossing, until 4:30pm	None		None
Scheduled Periodic Auctions	FTSE 100 3 <sup>rd</sup> Friday of month at 10:10am FTSE 250 3 <sup>rd</sup> Friday of Mar, Jun, Sep, Dec at 10:10am	11am and 3pm daily		None
Volatility Interruptions & Auctions extensions	In place throughout trading day parameter varies according to phase of day and liquidity of security	Yes - 15%	Yes - 25%	None
Closing Auction	Uncrossing process commences at 4:35pm	Uncrossing process commences at 4:35pm		None
Closing Price Crossing Session (CPX)	Up to 5 minute period of order book trading at the closing price, immediately following the closing auction execution	None		None
Executable Quotes	<ul style="list-style-type: none"> <li>• Yes for registered market makers, minimum size obligation of EMS</li> <li>• Maximum spread &amp; presence rule</li> </ul>	None		None
Firm Quotes (non-executable)	None	<ul style="list-style-type: none"> <li>• Minimum size obligation = EMS</li> <li>• No max spread</li> </ul>	None	<ul style="list-style-type: none"> <li>• Minimum size obligation = EMS</li> <li>• No max spread</li> </ul>
Trade Reporting for off-book trades	Yes	Yes		Yes
Central Clearing	<ul style="list-style-type: none"> <li>• All Continuous &amp; Auction order book trades</li> <li>• Off-book trades non-cleared</li> </ul>	<ul style="list-style-type: none"> <li>• Auction trades only</li> <li>• Off-book trades non-cleared</li> </ul>	No cleared trades	No cleared trades