Market Matters

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Passive orders and appropriate limit prices

This article is to remind member firms of their responsibilities under London Stock Exchange Rule 2101 and associated guidance, particularly with respect to the appropriateness of passive limit order prices being placed onto our markets.

The majority of regulatory texts related to pre-trade controls relate to avoiding large order volumes or erroneous order prices which lead to immediate, aggressive execution – informally known as 'fat finger' errors. In more recent times, such a scenario tends to be as a result of a misconfigured execution algorithm or technical issue which immediately executes at an inappropriate volume and/or price.

Recently London Stock Exchange (the Exchange) has identified examples of passive orders which had a material impact on respective uncrossing prices of non-continuous trading periods. In various instances the Exchange observed relatively small passive orders being entered into the order book at price levels which were significantly away from the current market valuation, or any reasonable historical trading range. In an ordinary environment the insertion of such an order would simply sit at the boundaries of the order book without any impact, however, in periods of extreme market volatility and reduced liquidity such orders can materially impact execution prices. Not only does the order placement in itself create a potentially illogical uncrossing price, extreme indicative auction prices may also be exacerbated by automated trading or via direct market access whereby a number of unrelated algorithms place further orders at the new high/low set by the original passive order.

In some instances, the Exchange took action to temporarily halt trading in affected instruments, cancel transactions or restate closing prices related to such order flow. Such action causes material disruption to market participants and reference data; two such examples were observed in March 2020 in the case of AB Foods (N02/20) and Ricardo (N04/20). In both cases the Exchange intervened and cancelled automatic trades so that prices, or other users, were not materially impacted. As a result, the Exchange took disciplinary action in the form of private Warning Notices against the member firms involved.

Upon reaching out to market participants to discuss pre-trade controls, some of the following themes were observed:

- upon order entry, few firms utilised controls (hard or soft) or live alerting on passive order prices placed at extreme levels versus the current market price;
- scenarios where live monitoring failed to identify indicative (or realised) auction uncrossing prices far away from theoretical fair value; and
- some views that order prices were valid at any price level as long as they were passive.

The Exchange recommends that all member firms review and regularly reassess their pre-trade passive controls (such as price outside of any reasonable historic distribution/trading range or order prices many multiples away from the current bid offer spread) to ensure that orders are not placed at inappropriate levels resulting in market disruption in periods of increased volatility.