Market Matters

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Safeguards against erroneous order entry - with emphasis on 'basket orders'

The Rules of the London Stock Exchange ("the Exchange"), including those of the London Stock Exchange Derivatives Market ("LSEDM"), stipulate that member firms must have adequate systems and controls in place to prevent the entry of erroneous orders to the trading system (see Exchange Rule 2101 and LSEDM Rule 4.1.4).

The purpose of this article is to highlight the importance of member firms maintaining appropriate pre-trade controls in order to prevent the submission of erroneous orders into the trading system which have the potential to cause short-term market dislocation, particularly in relation to the Exchange order book. The Exchange would like to stress to all member firms that Exchange circuit breakers or volatility constraint mechanisms, such as the Automatic Execution Suspension Periods ("AESPs", commonly referred to as circuit breakers), should never be relied upon to deal with erroneous orders, or used as an alternative, to in-house pre-trade controls.

Erroneous orders can have a significant impact on trading across single and multiple instruments and erroneous program trades (also known as basket orders) have a particularly high potential to cause trading disruption, primarily due to the nature of their order entry and execution. These execution factors include multiple instruments selected in a single dealing instruction, large notional basket values at closing/expiry auctions and the general 'wave' functionality of program execution, whereby multiple similar waves of orders can be entered into the market.

The wave dynamic can mask potential erroneous order duplication, particularly where the member firm is providing Direct Market Access ("DMA") to a client and does not therefore have full visibility of the parent order size. Maximum order value limits may also prove ineffective where the overall basket consideration, although potentially large enough to cause a significant market impact, remains below an internally approved limit. This is more likely during derivative expiry periods, when larger basket orders and trading volumes are expected. The Exchange has observed instances where a combination of these factors has caused short-term price disruption across multiple instruments.

Member firms should carefully consider effective technical and manual mechanisms (including pre-trade front office intervention) to potentially identify and prevent erroneous duplicate orders being released to the Exchange.

The importance of using sophisticated pre-trade controls around Direct Electronic Access ("DEA") orders were highlighted in the FCA's Market Watch 48. The update also notes that firms with less sophisticated controls may be at risk of not fully complying with the ESMA guidelines on 'Systems and controls in an automated trading environment for trading platforms, investment firms and competent authorities'. Examples of sophisticated controls as observed by the FCA included:

- Symbol (stock) specific criteria such as percentage of average daily volume (ADV).
- Aggregate/Exposure controls that are symbol (stock) specific.
- Aggregate/Exposure limits broken down into separate time segments (for example 30-60 minute slots).
- Participation (percentage of traded volume) alerts.
- Automated restrictions on non-priced (market) orders.

- Market impact controls.

It should be noted that, whilst the above mentioned controls can be highly effective, they require considered parameters and thresholds to be maintained in order for them to function correctly.