Attachment 1 to Stock Exchange Notice N10/14

London Stock Exchange

Response to Market Consultation dated 19 March 2014

Consultation on the market structure for the introduction of an intra-day auction for SETS Equities and IOB

November 2014

London Stock Exchange Group

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Disclaimer

October 2014

1.0 Thanks to Respondents

London Stock Exchange conducted a market consultation into potential enhancements to auctions on London Stock Exchange during March and April 2014. The paper focused on the potential introduction of an intra-day auction for SETS equities.

Feedback from this consultation will be used to help define the future development of auction trading on London Stock Exchange.

We would like to thank all those who participated in the consultation and those who provided additional comments and insights. The following paper summarises the feedback we received.

2.0 Background

Auctions currently occur for SETS equities on the London Stock Exchange as follows:

- London Stock Exchange's order book trading day commences with an opening auction
- If a security in regular trading breaches its price monitoring levels it will enter an auction call period
- Order book trading ends each day with a closing auction
- FTSE 100 securities have an expiry auction at 10:10 on the third Friday of the month and FTSE 250 securities have an expiry auction at 10:10 on the third Friday of March, June, September and December.

Before an auction generates an execution it will check whether:

 a market order extension should be invoked;

 a price monitoring extension should be invoked; and

 any volume check prevents the execution taking place (SETSqx auctions only)

To avoid participants knowing the exact time of uncrossing a configured random period of up to 30 seconds precedes invocation of each extension and the final uncrossing.

For more details, please refer to "London Stock Exchange MIT201 – Guide to the Trading System" which is available from the London Stock Exchange Group website using this link:

www.lseg.com/tradingservices

3.0 Introduction

In addition to the current SETS auctions (opening, closing, expiry and price monitoring) the London Stock Exchange is considering the introduction of a new intraday auction as an alternative to “dark pools” for the matching of larger sized orders.

Feedback from a broad range of market participants prior to the consultation had indicated that an intraday auction would be a useful addition to the options available for executing orders in the market. This feedback had focused in particular on the advantages of trading larger sized orders in a price forming environment. Based on this information, London Stock Exchange asked market participants for their views on an intraday auction implemented along the following lines:

I. Daily auction at 14:00 – feedback has been that this would be a more useful auction time for the market rather than 12:00. Note subsequent feedback has favoured 12:00
II. Call period of 3 minutes, with a randomised end of up to 30 seconds (as per current auctions). Note subsequent feedback has favoured 2 minutes.
III. Possibility to move Expiry auction from 10:10 to this 14:00 auction (subject to discussions with all relevant stakeholders and further analysis)
IV. Move the current SETSqx 15:00 auction to 14:00 to coincide with the auction in SETS securities (this move has happened on 15 September 2014 as part of our consultation on SETSqx securities)

The proposals would apply to all SETS equity securities. Due to the trading hours for IOB securities, we requested specific feedback for these securities in question 8.

3.1 Next Steps

London Stock Exchange will implement an intraday auction for SETS equities (excluding IOB) as part of a major technology release scheduled to go live in late 2015. The auction will occur daily at 12:00 with a 2 minute call period followed by a random 30 second period. During the auction call phase, only Level 1 data will be published (indicative uncrossing price and trade size). Further details will follow in due course.

4.0 Summary of Responses

Questions

1. **Would you make use of an intra-day auction if introduced?**

   Almost all respondents commented that the use and success of an intra-day auction would be dependent on the attitudes and participation of Buyside institutions.

   Buyside respondents were largely supportive of the idea, although cautioned that it may take time to build volumes for a new intraday auction.

   Aside form client business, some market makers also viewed an intraday auction as an opportunity for hedging or risk reduction, noting that the service was more suitable for larger cap securities than securities outside of the FTSE 350 Index.

2. **How would an intra-day auction affect your trading behaviour? (Please consider effects prior to auction, during call phase and in the period after the auction)**

   Most respondents said that their trading behaviour would adapt naturally over time to an intra-day auction. Brokers providing electronic trading services advised that their algorithms would adapt over time to trading volumes.

   Some Buyside institutions advised that some funds have a 12:00 benchmark, and that they would be prepared to support intraday auctions with this order flow. All Buyside noted that their access to trading in intraday auctions would be dependent on their brokers developing suitable DMA and algorithmic access.

   Many proprietary trading firms said that an intra-day auction would not suit their trading models and would therefore avoid trading on LSE during the auction period.

Retail execution only brokers expressed concerns about lack of reference pricing for trading on Retail Service Provider networks during the auction period (although those providing order book access could allow orders to be entered in the auction). A number of retail wealth managers noted that the service could be useful.

Some respondents indicated that in a post-MiFID II environment, an intra-day auction could offer further interest due to potential restrictions on the waivers for OTC (Over the Counter) trading. However, at this stage (May/June 2014) it was difficult to say exactly how this might develop

3. **Would you consider an intra-day auction as a good opportunity for trading larger orders?**
   Brokers indicated that this would be entirely dependent on their clients' support of the intra-day auction.

   Some market makers believed that interest in an intraday auction would be focused on more liquid stocks (FTSE 350).

   However, Buyside respondents indicated that they considered an intraday auction as a good opportunity for trading in less liquid names, as well as larger orders for more liquid stocks.

   Some respondents pointed to the experience of Deutsche Börse and their intraday auction, which currently does not attract significant volumes, and questioned whether the London Stock Exchange experience would be similar.

4. **Is 14:00 an appropriate time for an intra-day auction?**
   Opinions on this were widely divided. Initially there was a small majority in favour of 14:00, closely followed by 12:00. During a revalidation process with some respondents, opinions shifted towards 12:00, most notably from the Buyside.

   Two key reasons were cited for shifting attitudes from the Buyside. Firstly, 12:00 is used as a benchmarking point for some funds, so an auction would help ensure accurate pricing as well as offering natural liquidity for a 12:00 auction. Secondly, by holding an auction at the same time as the current

Deutsche Börse intraday auction, a London Stock Exchange auction could become a catalyst for promoting 12:00 as a natural liquidity point in the trading day.

5. **Is a 3 minute call period appropriate?**
   There were several views on this, with the majority of respondents indicating that 2 minutes would be an appropriate call period (except for the monthly expiry auction, where a 5 minute call period was thought more appropriate).

   A 2 minute call period would be in line with the current Deutsche Börse intraday auction.

   Some brokers felt that 2 minutes might not be long enough for those who trade manually, whereas proprietary traders advocated as short a period as possible, even down to 1 minute.

6. **If a 14:00 intraday auction is adopted, would you support in principle the moving of the current 10:10 expiry auction to 14:00 in order to coincide with the intra-day auction (note that such a move would require discussions with all relevant stakeholders and further analysis)**
   The vast majority of respondents across the market indicated if an intraday auction were introduced, they would be in favour of re-aligning the current expiry auction with the intraday auction rather than holding a separate auction for expiry.

7. **Further the Consultation on the Trading of Smaller Securities, dated 10 December 2013, regarding the trading of smaller cap securities (see link below), would you support moving the 15:00 SETSqx auction to coincide with the proposed 14:00 intra-day auction?**
   Responses were generally in favour of moving the SETSqx 15:00 auction to 14:00 if an intraday auction at this time were introduced for SETS. On 15 September 2014, London Stock Exchange introduced improvements to the SETSqx auction service. As part of these improvements, the existing 15:00 auction was moved to 14:00. Further information on these changes to the SETSqx auction process can be found on page 11 of this document.

8. **Continuous trading for IOB securities ends at 15:30 with a closing auction. Would you consider a 14:00 intraday auction would be useful for IOB securities? If not, would you consider a different time more suitable?**

   Opinions were not strong on this, but general consensus was that a 14:00 intraday auction would not be suitable for IOB securities because of the proximity to the 15:30 closing auction for IOB securities.

   Those that proposed an alternative time suggested 12:00 as this time was sufficiently spaced from the 15:30 closing auction.

9. **If an intra-day auction were introduced, what is your estimate for time required to make appropriate preparations for your trading technology (where relevant)? What level of effort would this require?**

   Generally, responses here varied according to the complexity of trading platform used by the respondent.

   Buyside respondents noted that they would be dependent on their brokers to implement the necessary changes.

   Broker responses varied from 2 weeks to 3 months, with most around the 3 month mark.

   Proprietary firms indicated between 3-6 months.

10. **Are there any other comments you would raise?**

    The most common additional point was a concern about information leakage if Level 2 data were published during the call period of an intraday auction.

    Level 2 data displays all order details going into the auction, while Level 1 data displays theoretical uncrossing price and volume. London Stock Exchange currently publishes both Level 1 and Level 2 data during auction call phases.

    Many respondents were concerned that publishing order details in an intraday auction would place any unexecuted orders at a disadvantage as the market would anticipate their likely execution during the rest of the afternoon.

    Some respondents countered that the lack of Level 2 data might have a negative impact on the volumes that could be matched in less liquid names.

The argument here was that Level 2 data is useful in identifying price levels where liquidity is concentrated, which could help in matching larger blocks.

On balance, the majority of market participants were in favour of publishing only Level 1 data.

Consultation on the Trading of Smaller Securities – for anyone wishing to reference the consultation we carried out earlier this year regarding the trading of smaller cap securities, please follow the below link:

www.londonstockexchange.com/traders-and-brokers/rules-regulations/change-and-updates/stock-exchange-notices/2013/n1613_attach1.pdf

15 September 2014 improvements to the SETSqx auction service can be found at the following link:

www.lseg.com/setsqx

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