

Attachment 1 to Stock Exchange Notice N19/10

DEFINITIONS

~~member authorised connection~~

sponsored access

a direct technical connection that enables a non **member firm** to access **TradElect[®] the trading system** directly under a **member firm's** trading codes. Orders submitted in this manner do not pass through the usual order management systems of the **member firm** but will pass through the **Exchange's** controls.

~~order routing~~

direct market access

a service facility provided by a **member firm** through which a **customer** is able to submit orders to **TradElect[®] the trading system** under the **member firm's** trading codes and via the **member firm's** usual order management systems, but without manual intervention by the **member firm**.

TradElect[®]

trading system

the trading system operated by the **Exchange**

CORE RULES

Notifications [1050-1051]

Immediate notifications

G	1050	A member firm shall, immediately upon becoming aware of any circumstances which have, will or may lead to a contravention of any of the rules, including system problems, notify the Exchange of such circumstances in as much detail as is available to it. Failure of a member firm to notify the Exchange in such circumstances may result in a contravention of the rules by the member firm .
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Guidance to Rule:

A **member firm** system problem is any in-house technical difficulty which prevents a **member firm** from accessing, viewing data from or submitting data to **TradElect[®] the trading system**. Where a **member firm** provides ~~order routing services~~ **direct market access to customers**, a **customer** system problem may also constitute a notifiable event.

Such notifications should be made to the Market Supervision department on (0044) 20 7797 3666, STX 33666.

ORDER BOOK TRADING RULES

Order entry

Access to TradElect[®] the trading system and the responsibility of member firms
[2100-2109]

G	2103	A member firm may allow a customer to submit orders to TradElect[®] the trading system under the member firm's trading codes, either by way of order routing direct market access or by providing a member authorised connection sponsored access , subject to the member firm having in place adequate systems and controls.
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Guidance to Rule:

Order routing and member authorised connection Direct market access and sponsored access

Submission of **customer** orders may be facilitated by either an ~~order routing direct market access~~ facility provided by the ~~member firm~~ or via a ~~member authorised connection sponsored access~~ to **TradElect[®] the trading system**.

~~Order routing Direct market access~~ is a facility service through which a **member firm** allows a **customer** to submit orders to **TradElect[®] the trading system** under the **member firm's** trading codes and via the **member firm's** usual order management systems, but without manual intervention by the **member firm**. These order management systems may be housed within the **member firm's** facilities or hosted within the **Exchange's** Primary Data Centre but, importantly, are the same systems through which the **member firm** submits at least some of its own order flow to **TradElect[®] the trading system**.

A ~~member authorised connection Sponsored access~~ is a direct technical connection provided so that a **customer** is able to access **TradElect[®] the trading system** under a **member firm's** trading codes. As the connection is direct, orders submitted by the **customer** to **TradElect[®] the trading system** do not pass through the usual order management systems of the **member firm**. To ensure that appropriate controls are in place, ~~the member firm and its customer may decide to implement a version of the member firm's controls within the customer's systems. Alternatively, the member firm may use the 'hosting' service at the Exchange's Primary Data Centre to implement specific controls for order flow submitted through member authorised connections, or employ another control structure (such as using controls provided by an independent software vendor).~~ **Exchange level controls are provided within the trading system to assist member firms with sponsored access order flow validation. All orders submitted via sponsored access will pass through the Exchange level controls before reaching the order book.**

Responsibility for customers' order flow (whether submitted to the Exchange via an order routing facility or a member authorised connection) direct market access or sponsored access)

Member firms providing customers with direct market access or sponsored access to the trading system are responsible for all obligations and liabilities arising from the entry, deletion and execution of all orders submitted by that customer.

The **Exchange** is aware that **member firms** may have contractual arrangements with their **customers** that mean the **customer** bears the financial risks of entering erroneous orders. However, under the **Exchange's** Rules the responsibility for such orders rests wholly with the **member firm** under whose trading codes the order is entered.

The **Exchange** requires a **member firm** to be able to delete a **customer's** orders from **TradElect[®] the trading system** or, if necessary, restrict the **customer's** ability to enter orders, without having the express consent of the **customer**. Such action by the **member firm** may be instigated unilaterally by the **member firm** because of its own concerns regarding the **customer's** behaviour or at the specific instruction of the **Exchange**.

The **member firm** is expected to adopt a regime where ~~similar checks are made to those that would be made by reasonable human intervention. Consideration should be given to:~~ **sufficient consideration is given to assess matters such as:**

- the training that has been given to the individuals entering orders;
- the access controls over order entry that the ~~originating third party~~ **customer** applies;
- security controls over any network link between the ~~originating third party~~ **customer** and the **member firm**. These should be sufficient such that the **member firm** can be sure that an order purporting to come from a particular ~~third party~~ **customer** actually has done so (e.g. by use of authentication codes in a similar manner to the secure interactive interface linking the **member firm** to the **Exchange**); and
- ~~the need for order acknowledgements from the originating third party;~~

- ~~controls over maximum order sizes that can be submitted by different originating third parties;~~
- ~~controls over prices of orders and having system parameters that would generate an alert if the order would execute at a price with which the **member firm** would not be satisfied;~~
- ~~monitoring and controls over the total exposure of the **member firm** to orders routed for a particular originating third party; and~~
- clear allocation of responsibility for dealing with actions and errors (e.g. it should be clear how, when and by whom orders on the book would be deleted).

All of these matters should be dealt with in formal agreements between the **member firm** providing ~~the order routing service or member authorised connection~~ **direct market access or sponsored access** and any relevant third party (whether ~~member firm or non-member~~ its **customer**. (**Member firms** may provide **sponsored access** to non **member firms** only.)

Order routing Direct market access

Whilst ongoing education, training and guidance for a **member firm's** customers that ~~route~~ **submit** orders through the **member firm** to **TradElect® the trading system** are to be encouraged, these cannot entirely replace the safeguards that internal system controls and alerting functionality can provide.

In order to prevent the submission of erroneous orders by a **customer**, a **member firm** may wish to consider the following controls and system alerts:

- prevention of submission of an order if the **customer** has overridden alerts and/or notification to the **member firm** that the **customer** has attempted to over-ride the alert;
- the segregation of this order flow by the use of the Trader Group facility within **TradElect® the trading system**; and
- appropriate training, education and guidance provided to those **customers** entering orders;
- the need for order acknowledgements from the **customer**;
- controls over maximum order sizes that can be submitted by different **customers**;
- controls over prices of orders and having system parameters that would generate an alert if the order would execute at a price with which the **member firm** would not be satisfied; and
- monitoring and controls over the total exposure of the **member firm** to orders submitted for a particular **customer**.

Member authorised connection Sponsored access

~~Member firms providing customers with a member authorised connection to TradElect® are entirely responsible for all obligations and liabilities arising from the entry, deletion and execution of all orders submitted by that customer.~~

The **Exchange** mandates that all orders submitted via **sponsored access** will pass through **Exchange** level controls, however **member firms** should also assess whether any additional controls are necessary to appropriately manage **customer** order flow, taking into consideration the nature and complexity of its **customer's** business.

Member firms are responsible for determining the limits of the configurable **Exchange** level controls within the parameters provided by the **Exchange** and ensuring that they are appropriate for each individual **sponsored access customer**, based on the scope and scale of its business.

A **member firm** that provides this facility for a **customer** must:

- complete a **sponsored access** application form for each of its **sponsored access customers** and inform the **Exchange** if it becomes aware that the information provided on the form has changed;
- ensure that relevant staff at the **customer** are conversant with the Rules and, in particular, those relating to **order book** trading. Relevant staff include the Head of Trading, the Head of Compliance and person(s) who signs off trading algorithms at the **customer**;
- segregate each **customer's** order flow from the **member firm's** order flow using the Trader Group facility within **TradElect**[®] the **trading system**. This is necessary to assist the **Exchange** in maintaining fair and orderly markets;
- ~~restrict **customer** access to **central counterparty order books** only;~~
- ~~use the Copy To functionality within **TradElect**[®]~~
- provide the **Exchange** with the name, head office address and country of incorporation of the **member firm's customer** for regulatory purposes. This information will be treated as confidential and will not be subject to commercial use;
- ~~ensure it maintains appropriate management of **customers'** order flow, including having in place order entry controls. The **Exchange** is aware of a number of independent software vendors that may be able to provide software solutions to satisfy this requirement. **Member firms** may wish to consult the list of these independent software vendors on the **Exchange's** website or, alternatively, discuss this with their current software provider; and~~
- have systems in place which will allow the **member firm** to accept and review drop copy feeds from its **customer** and monitor all **sponsored access** order flow.
- proactively utilise the **Exchange's** kill switch facility to disconnect a **customer** which it has reason to believe is behaving inappropriately; and
- inform the **Exchange** and take appropriate action if it loses either its connectivity with the **Exchange** or its connection to its **customer(s)** where that connection allows the **member firm** to ~~maintain order management controls over~~ monitor the **customer(s)** order flow. The **Exchange** mandates the use of its cancel on disconnect facility. Where a connection is dropped by either the **member firm** or its **sponsored access customer** the **sponsored access customer's** orders will be deleted from the **order book**.

~~**Member firms** should ensure that their controls over **customers'** order flow submitted via **member authorised connections** are designed to identify and prevent the entry of erroneous orders or orders that may distort or otherwise adversely affect the quality of the **Exchange's** markets. In determining whether a **member firm's** systems are adequate in this regard, **member firms** should consider the use of controls and system alerts, which may be based on some or all of the following:~~

- ~~the last **order book** traded price (from the previous day if appropriate);~~
- ~~the current spread in the market;~~
- ~~trader, security-specific or firm-wide size and price limits;~~
- ~~the likely movement in the price of the security if the order is submitted;~~
- ~~a minimum order size of a certain financial consideration per order; and~~
- ~~controls on limit orders and market orders submitted during an auction. When entering limit and market orders in auctions **member firms** must have sufficient systems and controls in place so that the type of order they submit does not have an inappropriate affect on the uncrossing price of the security in question. For instance, a **member firm** may wish to submit a market order to an auction to~~

maximise its probability of execution but should have regard to the possible impact of a large market order on the auction uncrossing price.

(Amended N43/08 – effective 5 January 2009)

G 2104	<p>A member firm must undertake due diligence on any customer to which it provides or intends to provide a member authorised connection sponsored access, in order to assess the suitability of any such customer to have a member authorised connection sponsored access connection. The member firm must confirm to the Exchange that such due diligence has been undertaken, and provide a systems diagram indicating how the customer will connect to TradElect[®] and the controls the member firm will have in place with respect to the customer's order flow.</p>
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Guidance to Rule:

A **member firm** must have undertaken due diligence to confirm that any **customer** to which it provides a ~~member authorised connection sponsored access~~:

- *is considered fit and proper to have a direct technical connection to **TradElect**[®] the trading system;*
- *has appropriate financial resources;*
- *has sufficient staff with adequate knowledge, experience, training and competence for the activities the **customer** undertakes on the **Exchange's** order books. **Member firms** may wish to consider whether training should be provided to the Head of Trading, the Head of Compliance and person(s) who signs off trading algorithms at the **customer**; and*
- *has adequate internal procedures and controls for these activities notwithstanding the **Exchange** level controls provided for all sponsored order flow, which may include a version of the **member firm's** own order management controls being implemented within the **customer's** systems that the **member firm** is able to control remotely, or the **customer's** order flow being subject to order management controls via an independent software vendor.*

*This assessment may fit within the **member firm's** existing due diligence framework or, if considered necessary, involve new due diligence processes that are specific to the provision of a ~~member authorised connection sponsored access~~. It is for **member firms** to judge what due diligence is necessary given the business, trading strategies and order flow of the **customer** or prospective **customer** to which the **member firm** wishes to provide a ~~member authorised connection sponsored access~~.*

***Member firms** are required to ~~submit a declaration to the **Exchange** confirming~~ confirm when submitting an application form that they have undertaken appropriate due diligence to be satisfied on each of the above points. The **Exchange** will exercise its right under rule 2105 to refuse ~~sponsored access~~ if it believes that the **member firm's** due diligence is inadequate. ~~A template letter is provided on the **Exchange's** website. **Member firms** should attach to the declaration letter a clear and concise systems diagram indicating the technical connectivity arrangements through which the **customer** will connect to the **Exchange** and where within this connection the **member firm's** controls will be placed. In addition, a clear and concise explanation must be provided of how the controls will operate and how they will be maintained by the **member firm**.~~*

*Prior to agreeing to a ~~member authorised connection~~ being provided to a **customer**, the **Exchange** will meet the **member firm** to discuss the controls the **member firm** intends to put in place and the due diligence it has undertaken. This process is aimed at giving the **Exchange** sufficient comfort regarding the overall adequacy of the **member firm's** controls. However, **member firms** will retain responsibility for ensuring that their due diligence and controls are appropriate and sufficiently robust for their **customer's** business. The **Exchange** will not provide a specific endorsement of a **member firm's** due diligence or the controls it proposes to put in place but will confirm, based on the information it has received from the **member firm** and subsequent discussions, that it is satisfied that a **member authorised connection** can be put in place. Equally, the **Exchange** will exercise its right under rule 2105 to refuse a **member authorised connection** if it believes that the **member firm's** controls or its due diligence are inadequate.*

Furthermore, **member firms** are required to satisfy themselves and, when requested, the **Exchange** that the **customers** to which they have provided ~~member authorised connection sponsored access~~ continue to meet these requirements. For instance, if a **customer** to which a **member firm** has provided a ~~member authorised connection sponsored access~~ has a significant change in trading volumes or its trading model, the **member firm** may consider it appropriate to refresh its due diligence ~~on that customer and/or the limits at which the Exchange level controls have been set for that customer~~ to ensure that its systems, controls, training and staffing are adequate for its changed business. Otherwise, due diligence should be periodically reviewed according to the **member firm's** normal timetable, and the **Exchange** may require the **member firm** to share this reviewed due diligence with it. A **member firm** that becomes aware that a **customer** no longer meets the requirements must notify the **Exchange** immediately and cooperate with the **Exchange** to halt the **customer's member authorised connection sponsored access**.

(Amended N43/08 – effective 5 January 2009)

D G	2105	The Exchange reserves the right to refuse a member firm's request that a customer be provided with a member authorised connection sponsored access to TradElect[®] <u>the trading system</u> .
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Guidance to Rule:

The **Exchange** may refuse a request to provide a **member firm's customer** with a ~~member authorised connection sponsored access~~ where the **Exchange** is not satisfied in any respect with the due diligence undertaken by the **member firm** or where, in the **Exchange's** view, provision of the connection would present a risk to the orderly functioning of the **Exchange's** markets. Whilst the **Exchange** does not conduct due diligence on **member firms'** prospective **customers**, it may refuse a request to provide a **member firm's customer** with a ~~member authorised connection sponsored access~~ where it is aware of adverse information about the prospective **customer** which may not have been detected by a **member firm's** due diligence;

The **Exchange** may also, at its own discretion, take other factors into account in applying this rule. The **Exchange's** view of the risks that may be posed by the provision of a ~~member authorised connection sponsored access~~ to a **member firm's customer** overrides any contrary view taken by the **member firm**.

(Amended N43/08 – effective 5 January 2009)

D	2106	The Exchange reserves the right to terminate or suspend a customer's member authorised connection sponsored access without notice or consultation with the member firm or its customer where the Exchange believes this is necessary to preserve the orderly functioning of the Exchange's markets.
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(Amended N43/08 – effective 5 January 2009)

D G	2107	The Exchange reserves the right to restrict or segregate a member firm's access to and use of TradElect[®] <u>the trading system</u> as it sees fit.
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Guidance to Rule:

The **Exchange** may decide to segregate a **member firm's** access to and use of **TradElect[®]** the trading system in order to protect market orderliness or for other regulatory reasons.

Whilst the **Exchange** does not mandate how a **member firm** should segregate its **order book** business at **trader group** level, the **Exchange** reserves the right to do this as it sees fit. Typically, this would be where it suspects a **member firm's** controls to be inadequate or inappropriate, or, more generally, where it considers this to be in the interest of maintaining a fair and orderly market.

For instance, where a **member firm** chooses to use only one or a limited number of **trader groups** for its order flow, and the **member firm** has repeated problems in relation to erroneous orders being entered by an ~~order routing direct market access~~ **customer**, the **Exchange** may require that all orders from that **customer** are assigned to a specific **trader group**.

(Amended N43/08 – effective 5 January 2009)