



LSEG Response to ESMA Consultation: “Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities” ESMA/2011/224

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EXECUTIVE SUMMARY

1. Agree that systems and controls are best tools for ensuring that markets remain orderly, fair and stable;
2. We broadly agree with the guidelines. These may well remove the need for more intrusive measures with unintended consequences;
3. Circuit breakers have a key role in maintaining orderly and fair markets, without influencing genuine market sentiment;
4. Highly automated trading is not abusive in itself and there is no evidence of market failure – any regulatory measures should be evidence-based;
5. The Commission’s guiding principle of the “same regulation for the same activity/function” and ESMA’s common proportionate approach to all participants should be adopted and followed here.

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INTRODUCTION

The London Stock Exchange Group (LSEG) welcomes the opportunity to respond to ESMA's Consultation on guidelines for systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities. The issues raised by this Consultation are of importance to financial markets, given the legislative initiatives due from the European Commission (MiFID) and the ongoing technological and regulatory developments in financial markets.

This submission represents the views and experience of London Stock Exchange plc, Borsa Italiana, and other market operators and investment firms within the LSEG, including Turquoise and MTS.

LSEG is well qualified to respond to this Consultation. It has significant experience of operating neutral, well regulated, fair and efficient markets in these areas. LSEG operates equity, fixed income and derivatives markets in the UK and Italy as well as Turquoise, a pan-European Multilateral Trading Facility (MTF) trading equities and derivatives.

We provide our response in three parts:

Part A contains LSEG's high-level comments on the general issues concerning highly automated trading environments, which informs our approach to our response to the Consultation.

Part B contains our detailed responses to the individual questions posed in the consultation.

Annex A contains a description of circuit breakers operating on the LSE

We confirm that we acknowledge that this response may be published by ESMA.

PART A – LSEG KEY HIGH LEVEL POINTS

Introductory notes:

The highly automated trading environments are a natural evolution of market structure

- Financial markets have seen vast changes in the last few years, and technology and regulatory change have played a key role in these developments. In the EU, MiFID has been instrumental in bringing about fundamental shifts in equity trading, contributing to the fragmentation of liquidity.
- A natural consequence is the increase in the prevalence of the type of proprietary trader who uses a variety of strategies in an attempt to take advantage of the opportunities that have arisen through changes in market structure.

Highly automated trading techniques are not new. The increase in this activity has been facilitated by market developments

- Statistical arbitrage, liquidity provision and other “technical” trading techniques undertaken by automated traders have been employed by proprietary firms for many years; the development of technology and regulatory change has simply provided new opportunities to conduct this trading in different ways, more rapidly. Such traders are always looking to find ways to reduce the risk exposure of their firms; these new elements facilitate this.
- However, high frequency trading, algorithmic trading and electronic trading are all part of the market place now- it is not helpful or meaningful to attempt to focus only on one discrete group of investment firms.

We note that ESMA has not sought to prescribe a legal or narrow definition for “HFT”; in the context of these guidelines, this seems sensible.

Key Points:

1. Agreement with the proposed guidelines

LSEG welcomes this Consultation and broadly welcomes the measures proposed by ESMA. We agree that these are the appropriate way to regulate these issues and that appropriately applied, should obviate the need for more intrusive and as yet unproven measures, such as order to trade ratios and/or minimum resting periods.

2. Systems and controls are the best tools for ensuring that markets remain orderly, fair and stable

We are supportive of the proposal that the guidelines focus on systems and controls. These will play a key role in seeking to ensure that markets remain orderly, fair and stable and free from incidences of market abuse.

3. Evidence-based regulation is required

We appreciate ESMA's approach in not seeking to pre-empt an evidential analysis of the impact of automated trading. It is essential that all rules are based on evidence and relevant principles, including ensuring that markets are able to continue in their key function of providing capital to the real economy.

4. We agree that investment firms should have appropriate controls and supervision

We also support the proposal that all investment firms participating in markets should have appropriate mechanisms in place to prevent the submission of erroneous or inappropriate orders and to avoid or minimise the potential for disorderly trading, supported by trading venues as necessary.

We recognise that the review of MiFID may bring more firms within the scope of regulation or supervision and we generally see this as a necessary and positive development.

5. Circuit breakers are an effective tool to ensure orderly trading, without influencing genuine market sentiment

Our view is that venues should have adequate systems and controls in place to ensure orderly trading. In this regard:

- We support the general approach by ESMA to use controls around trading halts to maintain orderly markets and manage volatility. ESMA refers to the "Flash Crash" in the US in May 2010 and regulators are rightly concerned to seek to ensure that such an event does not occur in Europe or at least that the risk is minimised.
- There are obviously a number of key differences between US and European markets that are relevant in any consideration, not least the different market structure and types of orders available.

In general we suggest that ESMA's approach set out in Guideline 3 is the appropriate response – and we suggest the use of circuit breakers/ price volatility interruptions as an effective method of operating such trading

halts. For example, on the LSE and Borsa Italiana, we operate suspension of automatic trading for single securities based on dynamic and static price thresholds set by liquidity, relative size and volatility. In our view, these controls have been successful in preventing disorderly markets, including during the recent periods of market volatility in August 2011.

We note that in a recent study on the efficiency and stability of UK Markets¹ (Linton, 2011, see Footnote 1), the author finds that “it is difficult to judge whether the whether the last few years have seen an increase in the frequency of market crashes or dashes.” Also, in the context of “extreme events” (the twenty largest events by intra-day variation in the UK), the author studies a particular event on August 24, 2010 where there were “rapid changes in prices of five LSE listed stocks” - (what he terms a “mini-flash” crash).

Interestingly he finds that, “the LSE circuit breakers evidently prevented massive price changes on the day of the mini-flash crash, so this day does not even show up as an ‘extreme’ event.”

We present our views on circuit breakers in more detail in our response to Q8 below and provide a description of LSE circuit breakers in Annex A.

6. Highly automated trading is not of itself “abusive”

There is no clear evidence of any market failures caused by highly automated trading.

- The view majority view on HFT in academic studies is that market efficiency has been improved as a result² through tighter spreads and increased liquidity. Recent research also suggests that:
 - a. There is “no direct evidence that high frequency computer based trading has increased volatility”³.
 - b. Both daily and intraday “volatility measures of the FTSE All index show no statistically significant deterministic trend over the decade (2000-2009) or since the first round of MiFID”¹.
 - c. HFT assists in price formation in uncertain periods of trading⁴.
- Analysis from our own markets suggests that⁵:

¹ Foresight, Linton. O, *The Future of Computer Trading in Financial Markets - Driver Review 1*, September 2011;

² For example: J.A. Brogaard, *High Frequency Trading and its impact on Market Quality*, July 2010; Hendershott, T.J. and Riordan, R, *Algorithmic Trading and Information*, August 2009 among others;

³ Foresight, *The Future of Computer Trading in Financial Markets – Working Paper* p.23, September 2011

⁴ Analysis for FSA by CMCRC: <http://www.efinancialnews.com/story/2011-08-16/capital-markets-cooperative-research-hft>

⁵ LSEG Market Analysis

- a. HFT firms demand and supply liquidity (i.e. use aggressive and passive trading strategies) in a fairly even proportion in aggregate;
 - b. There is negligible evidence of other market participants being “gamed” by HFT. We have seen limited downside impact on other market participants’ ability to capture liquidity due to the participation of HFT; and
 - c. HFT firms tend to compete with themselves more than with other market participants.
- We suggest that any incidences of distortive behaviour or market abuse are not specific to automated or high frequency trading. In our experience as a market operator, smaller sized intermediaries are just as likely as HFT firms to enter erroneous orders and cause disruption to markets. Market abuse is a wider market integrity issue, which should be managed within the context of the current Market Abuse Directive and any revisions.

7. We support a common proportionate approach based on function/activity – precise controls should be at the platform level

ESMA should seek to set a common proportionate approach to systems and controls across the wide range of trading platforms and participants, based on the principle espoused by the Commission and ESMA that the same function/activity be regulated in the same way. However, within this, there should be some discretion for trading venues to design controls and set parameters according to the nature and form of the markets they operate;

- Regulators should ensure that all trading platforms have appropriate mechanisms in place, under a common proportionate approach to systems and controls. This is important, not only to ensure a level playing field, but to ensure that the guidelines are comprehensive and minimise any opportunity for any regulatory arbitrage.
- Guidelines should not specify precise controls for venues to implement. We consider this to be a key feature of how markets are managed and therefore the responsibility of market operators to design specific controls that reflect their own markets and participants, so long as they achieve the same ends as identified by regulators.
- We agree that systems and controls should be “proportionate”, as noted by ESMA in paragraph 21 on p.13, to ensure that markets are not unduly burdened where the nature of the assets traded and/or the type of trading activity conducted are unlikely to be relevant to the specific aspects of the guidelines on “highly” automated trading or algorithms, and where there is no provision of Sponsored Access or DMA.

PART B – RESPONSES TO INDIVIDUAL QUESTIONS

Background, Scope and Definitions

Question 1 – Do you agree with ESMA that it is appropriate to introduce guidelines already before the review of MiFID covering organisational arrangements for trading platforms and investment firms in relation to highly automated trading, including the provision of DMA/SA?

1. Yes, we agree. In our view, if the guidelines are introduced under existing MiFID legislation, they will go a long way towards dealing with any issues or perceived issues surrounding highly automated trading and may remove or considerably reduce the need for any further, more intrusive, measures to be introduced in any legislation that follows the review of MiFID.
2. With regards to the scope identified for the guidelines (p.91, I.1), we assume that this will be based on the principle espoused by the Commission and ESMA that the same function/activity be regulated in the same way in the application of these guidelines; it might be useful to see this reflected in the scope section?
3. In the same way, within our Group we have a number of markets, operated as RMs or MTFs, (e.g. MTS Europe) where the assets traded and/or type of trading activity conducted are unlikely to be relevant to the specific aspects of the guidelines on “highly” automated trading or algorithms, and where there is no provision of Sponsored Access or DMA.
4. The products available for trading on platforms operated by MTS are fixed income products, such as European government bonds, repo, and investment grade credit products. The trading characteristics of these asset classes, and the manner in which they are traded on MTS, means that they are traded on a principal basis and trading volumes are relatively low: the total current number of transactions per day, across all products on all MTS platforms, is less than 5000. There is no “high frequency trading” undertaken and MTS does not provide direct market access.
5. Whilst there will be elements of the Guidelines that will apply to all trading platforms, others are clearly specific to managing high frequency order and trade generation, which would not be relevant to a low volume market such as MTS. We believe that this should follow the proportionate approach suggested by ESMA in paragraph 21 on p.13 of the Consultation: “For both trading platforms and investment firms the systems and controls employed will need to be effective and proportionate to the nature, scale and complexity of their business.”
6. Accordingly, we would trust that the relevant competent authority would only seek to apply those parts of the guidelines that were relevant to avoid a disproportionate application of the Guidelines.
7. We suggest a clarification on the point of proportionality would also be useful in the Guidelines, for both competent authorities and the regulated entities.

Guideline 1 - Organisational requirements for regulated markets' and multilateral trading facilities' electronic trading systems

Question 2 – Do you think that the draft guidelines adequately capture all the relevant points relating to the operation of trading platforms' electronic trading systems?

8. We welcome and broadly support the proposed guidelines on organisational requirements for trading platforms.
9. We note an additional comment on guideline 1 in our answer to question 4.

Question 3 – Are there areas where it would be helpful to have more detail on the organisational requirements applying to trading platforms' electronic trading systems?

10. No. We think that the guidelines on organisational requirements are sufficiently detailed.

Question 4 – Do you have additional comments on the draft guidelines on organisational requirements for trading platforms' electronic trading systems?

11. As we explain in Part A of our response, whilst we support ESMA's initiative to introduce a common approach to systems and controls, it is our view that venues should have the discretion to specify the precise design of the controls.

Specifically, we comment with reference to the relevant text in guideline 1.2 on the management of the capacity of electronic trading systems. Whilst, we support the principle that systems should be resilient and adapted to the flow of message traffic, we note that technology architectures differ by platform. Also, whilst platforms are designed to be scalable, they usually operate with sufficient headroom to deal with large volumes. In our experience, it is unusual for message capacities to be “easily and rapidly” elastic to volumes. Consequently, our view is that it would be difficult for regulators to define a meaningful single specific metric/methodology for capacity management. Capacity limits, testing procedures and controls on message flows should be governed at the platform level, and not prescribed by ESMA.

Accordingly, we suggest amendment of the relevant text in guideline 1.2 to read:

- have electronic trading systems with sufficient capacity to accommodate reasonably foreseeable volumes of messaging and that are scalable to allow for capacity to be ~~easily and rapidly~~ increased in order to respond to rising message flow and emergency conditions that might threaten their proper operation, in particular through controls on message flows ~~through a 'normal activity/maximum IT capacity' ratio;~~

Also, please refer to para no19 in our answer to Question 8 re: “slowing down of order flow”.

Guideline 2 - Organisational requirements for investment firms' electronic trading systems including trading algorithms

Question 5 – Do you think that the draft guidelines adequately capture all the relevant points related to the operation of trading algorithms?

12. We agree that the proposed guidelines capture the relevant points related to the operation of trading algorithms.

Question 6 – Are there areas where it would be helpful to have more detail in the guidelines applying to the organisational requirements for investment firms' electronic trading systems?

13. No. We think that the guidelines on organisational requirements for investment firms are sufficiently detailed.

Question 7 – Do you have additional comments on the draft guidelines relating to organisational requirements for investment firms' electronic trading systems?

14. With regards to the reference in guideline 2.2 to testing of algorithms by investment firms, we agree with the proposal for a progressive “controlled” deployment of trading algorithms into a live production environment.

However, we are concerned with the reference to “small-scale live testing (including reconciliation with simulation testing)” in the accompanying explanatory text on p.19. Although we understand that algorithms may perform differently in testing and a live environment, there needs to be a clear distinction between “phased roll-out” (of which we are in favour) and “live testing”. As a markets operator, we would not mandate or encourage firms to conduct any live testing, small- or large-scale, prior to the completion of all internal testing and sign-off of the algorithm in question.

We note the clarification given at the public hearing by ESMA on 27 September 2011 and understand this to mean that trading platforms would not be expected to provide “live testing” but to seek to provide a test environment that replicates or represents the current trading conditions, with sufficient material and relevant data to provide a valid test. We suggest that this reference be clarified wherever it appears in the Guidance/Notes.

Indeed, we provide for such testing environments on our markets. Our Customer Development System (CDS) is a testing environment which closely mirrors the anticipated configuration of the live production environment (i.e. it has similar service timings and rules, for both trading and information feeds). The principle difference between the CDS and a production environment is that securities on the CDS are only updated periodically and they may temporarily lag behind the securities on the production service. Investment firms use the CDS for development activities and for testing the compatibility of their software. To simulate a “real environment”, the CDS features a background message flow generated by a liquidity injector tool. The CDS also ensures that a set of stocks will continually have liquidity available on both sides of the order book to assist with customer testing and ensure trade execution.

15. Similarly, we support ESMA's stated objective in the explanatory text on p.19 to ensure that algorithms work effectively, and that an algorithm can be withdrawn in an orderly manner when it is not behaving as expected. However, we note that "not letting an algorithm exit all positions simultaneously" (one of the examples used by ESMA to illustrate how algorithms should exit from markets) could quite possibly cause the opposite – to disrupt markets and expose other participants to risk. ESMA should clarify what it intends and allow for the various possibilities for an algorithm to exit positions and strategies.

Guideline 3 - Organisational requirements for regulated markets and multilateral trading facilities to promote fair and orderly trading in a highly automated trading environment

Question 8 – Do the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading offer a sufficiently comprehensive list of the necessary controls on order entry?

16. In principle, we agree with the proposed guidelines. We address several of our concerns regarding guideline 3.2 in the following points.
17. With regards to the reference to "[arrangements to prevent excessive flooding of order books at any one moment, notably \[...\]](#)." We agree with the guideline and note the text of the explanatory note, and we also prescribe limits per participant on order entry capacity on our own markets. However, again based on the ESMA responses at the hearing on 27 September 2011, it is clear that this is not intended to suggest a definition of any prohibited or undesired activity, but simply to refer to the scale of order entry that would cause capacity difficulties to the trading system.
18. Accordingly, we suggest that this be amended to read: "[arrangements to ~~prevent excessive flooding~~ ensure that capacity limits of the order book are not breached at any one moment in time, notably through limits per participant on order entry capacity](#)" or similar.
19. With regards to the reference to "[arrangements to prevent capacity from being breached through a mechanism for slowing down order flow from members which restricts the number of messages per participant \[...\] when there is a danger of capacity limits being breached.](#)" Again, we agree, in principle, with the guideline; however, as we mention in our answer to question 4, trading platforms may have different mechanisms (such as queuing of messages during high volume trading) which have the same effect as slowing down of order flow. We do not think that ESMA should prescribe any one of these over the other.
20. We support steps to ensure orderly trading and believe that circuit breakers triggered by price volatility, with call periods to carry price formation and resume automatic execution, are an effective way of doing this. On circuit breakers and any other arrangements to "constrain trading", we note that:
 - The purpose of these controls is to maintain orderly trading, and not to control or influence genuine market sentiment. We see that circuit breakers are generally triggered by erroneous orders or by price volatility due to market

reaction to news related to a single security or trading sector and, in rarer circumstances, by general wider regional or global market conditions.

- In our experience, markets generally operate best when trading is continuous. For this reason, we do not support the use of market-wide circuit breakers, which would effectively close entire markets and which are typically based on large movements of an index. We do, however, support and already operate intervention on an individual stock basis in the form of “price volatility interruptions” that prevent automatic execution taking place at potentially erroneous prices that are often caused by trader error (so called “fat finger” errors). In our experience, these stock specific controls are adequate for preventing erroneous movements in indices such as the FTSE 100; it is the prices of individual instruments that cause indices to move, and controlling the individual stocks is more effective than halting trading in the entire index or a market. For instance, see Annex A for more details on LSE’s circuit breakers.
- Regulators should ensure that all venues have appropriate controls in place to control volatility, but we do not consider it their role to specify the precise controls that venues implement. We consider this to be a key feature of how markets are managed and therefore the responsibility of market operators to design specific controls/circuit breakers that reflect their own markets and participants.
- It is currently our view that venues should not be inter-linked for any instrument, such that if one venue triggers a circuit breaker, then all others should follow suit (other than for regulatory suspensions, e.g. per those notified by the competent Listing Authority). We consider that this risks an isolated incident, including a fat finger error in one market and/or the impact of trading in a small number of securities, causing unnecessary widespread impacts by interrupting trading on all markets. To prevent trading on all venues in response to such incidents would be highly disruptive to markets.
- With reference to the relevant text on circuit breakers, we note that there is a difference between a participant’s ability to enter an order and the execution of that particular order. Our view is that participants must have the freedom to enter orders to rest in the order book at whatever different price levels they consider necessary according to market conditions, intra-day market news etc. (absent error or manipulation). Automatically rejecting orders at entry on the basis of thresholds could inhibit efficient price formation. However, if the price of a potential execution based on that order would be outside a defined percentage above or below the applicable reference price(s), then the order should be rejected.

We, therefore, suggest the following amendment to the relevant text in guideline 3.2. (additions in **bold**):

“ - arrangements [...] **this may include automatic rejection of orders on entry that would execute** outside certain volume/price thresholds;”

21. With regards to the reference in the text to “minimum requirements for members’ pre- and post- trade controls”. We agree with the purpose of the guideline and do publish minimum requirements in our rulebook. However, we suggest this would be more appropriately enforced/supervised by the Competent Authority, and not by the trading platform.

22. Further, with regards to the reference to “standards covering knowledge if persons within members that will be using order entry systems”; it is sensible for platforms to publish minimum requirements on knowledge. But it is the Competent Authority that should set/enforce 'standards' for those accessing the systems – such as registration, training and qualification/approval. It would be appropriate for trading venues to offer only a supporting role.

Question 9 – Are there any areas of the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading where you believe it would be helpful to have more detail?

23. The issue of circuit breakers is one area where ESMA could issue stronger common minimum principles for trading platforms. For example, an addition on the following lines, either to Guideline 3.2 or the explanatory note could ensure that all platforms have more robust, objective and transparent controls:

“[...] Controls should be robust, and resilient to the failure of similar mechanisms on other platforms, and/or the failure of other platforms to be operating normally (i.e. publishing of prices that might be relied upon as a reference).

“Controls should be objective, clear to members and publicly available, to avoid uncertainty about whether regulators might retrospectively break trades, thereby exposing members to risk.”

Question 10 – Do you have additional comments on the draft guidelines on organisational requirements for trading platforms to promote fair and orderly trading?

24. We have no additional comments.

Guideline 4 - Organisational requirements for investment firms to promote fair and orderly trading in a highly automated trading environment

Question 11 – Do the draft guidelines on organisational requirements for investment firms to promote fair and orderly trading offer a sufficiently comprehensive list of the necessary controls on order entry?

25. We welcome and support the proposed guidelines on organisational requirements for investment firms to promote fair and orderly trading. This will help ensure that firms have adequate controls and policies in place to ensure orderly trading, and that staff are competent enough to perform their duties.
26. With regards to the reference to automatic controls in guideline 4.2 that investment firms should automatically block orders if “a client does not have adequate funds or holdings of, or access to, the relevant financial instrument to complete the transaction.” we note the following issues:
- It is not clear to us what would be the purpose of such controls at the pre-trade level, and we suggest that ESMA clarify what it intends. Does ESMA

intend to ensure that compliance has real time access to all orders to mitigate credit risk/ market risk?

- We suggest that it may be impractical to give effect to the text in its current form unless the investment firm has access to information regarding client funds/positions. As this is not usually the case, there could be significant unintended consequences, including negative implications for execution-only brokerage;
- In the extreme, this guideline could be interpreted as a prohibition on “automatic” short-selling, as an investment firm would have to block an order if it was a short sale, and would only be able to send the order through manually. Again, this appears impractical and was stated by ESMA at the hearing on 27 September 2011 not to be the intention. We suggest that this is clarified or removed.

Question 12 – Are there any areas of the draft guidelines on organisational requirements for investment firms to promote fair and orderly trading where you believe it would be helpful to have more detail?

27. No. We think that the guidelines are sufficiently detailed.

Question 13 – Do you have additional comments on the draft guidelines on organisational requirements for investment firms to promote fair and orderly trading?

28. We have no additional comments.

Guideline 5 - Organisational requirements for regulated markets and MTFs to prevent market abuse (in particular market manipulation) in a highly automated trading environment

Question 14 – Are there any areas of the draft guidelines on organisational requirements for regulated markets and MTFs to prevent market manipulation where it would be useful to have extra detail?

29. No. We think that the proposed guidelines are sufficiently detailed.

Question 15 – Do you have additional comments on the draft guidelines on organisational requirements for RMs and MTFs to prevent market manipulation?

30. A distinction should be drawn between market abuse, which is a criminal act, and market disruption or an activity having an impact on market integrity, which can be the result of erroneous orders and so called “fat finger” errors:
- Market Abuse is difficult to detect and respond to in real-time; it often requires extensive investigation after the event, using transaction data that can take several weeks or even months to analyse.

- Market disruption can be detected more easily in real-time, and dealt with rapidly by trading venues in their capacity of ensuring orderly and fair markets.

Therefore, although real-time capabilities are required for trading venues to ensure orderly trading, we do not see that they would be required by regulators to monitor for market abuse – certainly not for the cost that would be required to achieve such real-time surveillance in larger and fragmented equity markets. In Europe, competent authorities already receive transaction data at the end of the day, and may request further data from investment firms and trading venues if they believe that a case of market abuse exists.

31. With reference to the explanatory text on pg.27 illustrates potential forms market abuse. On this, we would like to note:

- We suggest that explanatory text does not contain illustrations/definitions of market abuse strategies; should limit itself to referring to definitions in the existing/revised Market Abuse Directives
- Specifically, with regard to “momentum ignition”; we are unaware of how/if “momentum ignition” can be quantified, and how it is supposed to be monitored. We are also unaware if any platform does this. Finally, we think it is difficult for such a strategy to be successful as rapid price movements can be protected so long as venues operate adequate and robust circuit breakers.

Guideline 6 - Organisational requirements for investment firms to prevent market abuse (in particular market manipulation) in a highly automated trading environment

Question 16 – Are there any areas of the draft guidelines on organisational requirements to deal with market manipulation for investment firms where you believe it would be helpful to have more detail?

32. No. We think guidelines are sufficiently detailed.

Question 17 – Do you have additional comments on the draft guidelines relating to organisational requirements to deal with market manipulation for investment firms?

33. We have no additional comments.

Guideline 7 - Organisational requirements for RMs and MTFs whose members/participants and users provide direct market access/sponsored access

Question 18 – Do the draft guidelines on organisational requirements for trading platforms whose members/participants or users offer DMA/SA deal adequately with the differences between DMA and SA?

Question 19 – Are there any areas of the draft guidelines on organisational requirements for trading platforms whose members/participants or users offer DMA/SA where you believe it would be helpful to have more detail?

Question 20 – Do you have additional comments on the draft guidelines relating to organisational requirements for trading platforms whose members/participants or users provide DMA/SA?

34. We provide a combined answer for Q18-20. In our view, the draft guidelines are sufficient, and adequately deal with the differences between DMA and SA. We have no additional comments to make.

Guideline 8 - Organisational requirements for investment firms that provide direct market access and/or sponsored access

Question 21 – Do the draft guidelines on organisational requirements for investment firms providing DMA/SA deal adequately with the differences between DMA and SA?

35. Yes. We welcome the draft guidelines on organisational requirements for investment firms providing DMA/SA and believe that they deal adequately with the differences between DMA and SA.

Question 22 – Are there any areas of the draft guidelines on organisational requirements for investment firms providing DMA/SA where you believe it would be helpful to have more detail?

36. No. We think that the guidelines are sufficiently detailed.

Question 23 – Do you believe that there is sufficient consistency between the draft guidelines on organisational requirements for investment firms providing DMA/SA and the SEC's Rule 15c3-5 to provide an effective framework for tackling relevant risks in crossborder activity and without imposing excessive costs on groups active in both the EEA and the US?

37. We offer no comments to this question

Question 24 – Do you have additional comments on the draft guidelines on organisational requirements for investment firms providing DMA/SA?

38. We suggest that the guidelines can be strengthened if it is included that the sponsoring firms should demonstrate an ability to recognise and respond appropriately to the rejection of orders from a sponsored participant by the venue as a result of risk controls being triggered.

39. With reference to the final sentence in the explanatory note on p.39, we propose a single amendment to clarify the importance of pre-trade controls for DMA SA: "[...] have the ability to cancel ~~a trade~~ **an order** which is in-built and automatic, should the trade pose a risk".

We are assuming this is a typo and should be a reference to an order; if not, we do not understand how an investment firm providing DMA/SA could cancel an executed trade and suggest that this should be revisited.

Explanatory text

Question 25 – Does the explanatory text provided in addition to the guidelines (see Annex VII to this CP) help market participants to better understand the purpose and meaning of the guidelines? Should it therefore be retained in the final set of guidelines?

40. We agree that the explanatory text is useful, and can be used to clarify the purpose and meaning of the guidelines. We have also suggested a few additions/amendments to the text throughout our response.

However, we do question the extent to which material that has the status of “Guidance” can then meaningfully have its own explanatory notes or “guidance”. Perhaps it would be clearer to amalgamate those elements that are truly part of the Guidelines (excluding discussions, respondents’ views received and suggestions) within the text itself?

In some cases, the “explanatory text” is useful in clarifying the Guidelines, or in others, more helpful or descriptive than the Guidelines themselves, and we would suggest that some is incorporated into the Guidelines to provide clarity (e.g. Guideline 1 Notes).

41. In others, we, we suggest the explanatory text should accompany the final Guidelines as a separate note, instead of within the text.

ANNEX A – DESCRIPTION OF CIRCUIT BREAKERS ON THE LONDON STOCK EXCHANGE

42. On our markets, we operate suspension periods of automatic execution during continuous trading based on both dynamic and static reference prices, where:
- the dynamic reference price is the last order book execution price (or previous closing price if more recent) prior to the submission of the incoming order; and
 - the static reference price is the most recent auction price from the current day. Where the most recent auction did not generate an execution, it will instead be the first automated trade that followed the previous auction period.
43. If the price of a potential execution is more than a defined percentage above or below the applicable reference price(s) then no executions at that price will occur. Instead, automatic execution will be temporarily suspended and a five minute intra-day auction will be triggered to allow the security's price to re-form in an orderly fashion and then be returned to continuous trading. Fill or Kill (FOK) orders which must be executed in their entirety or not at all, will be rejected if their execution would breach the price threshold, and no automatic execution suspension period will occur.
44. The price thresholds for securities trading on LSEG markets are managed in the first instance by its index or trading sector and then the relative size and historical volatility of the stock. Generally, more liquid securities have lower thresholds and less liquid securities have higher thresholds. For example, suspensions for FTSE 100 stocks are triggered at a 5 per cent dynamic price threshold during continuous trading; whereas for more illiquid small cap or AIM stocks, the dynamic price threshold may be 15 per cent or 25 per cent. Thresholds are tightened during the closing auctions and EDSP⁶ auctions; in EDSP auctions, the most liquid FTSE 100 securities are subject to a 1 per cent dynamic price threshold. A summary of the thresholds operating on our markets is provided in table 1.
45. At the end of the opening and closing auction call periods, if the indicative auction price is greater than a tolerance threshold away from the dynamic reference price, then a price monitoring extension to the auction call is triggered for a configurable amount of time. Further, if the indicative auction match price would result in market orders (un-priced) remaining unexecuted on the order book, a market order extension is triggered. The extra time allows participants the chance to review the prices of the orders that have been entered and, if appropriate, to add, delete or amend their orders.
46. On an average day, we observe 30-40 suspensions of automatic execution on a normal market day. In more volatile market conditions, this number may be much higher. For example, in the first two weeks of August 2011 we have seen 1700 such suspensions, at an average of 170 suspensions in a day (see table 2). In light of this high turnover and volatility, we believe that our

⁶ The Exchange Delivery Settlement Price ("EDSP") for FTSE 100 and 250 Index Futures and Options Contracts is based on the Index value created by the intra-day auction (third Friday of every month for FTSE 100 Index Options, and third Friday of every quarter for FTSE 100 and 250 Index Futures) in each of the constituent securities which is run specifically for that purpose by the London Stock Exchange.

mechanisms have been successful in maintaining orderly trading without attempting to control or constrain genuine market sentiment.

Trading Service ⁷	Sector and segment	Example security ⁸	Static threshold	Dynamic threshold	
				Continuous	Close
LSE					
SETS	FTSE 100 - Liquid/ Non Liquid 5 - Liquid/ Non Liquid 15	Glencore/ Schroeders (No security)/ (No security)	10% 15%	5% 15%	3% 3%
	FTSE 250 - Liquid/ Non Liquid 05 - Liquid/ Non Liquid 10 - Liquid/ Non Liquid 15	Ladbrokes/ 3i Infra Regus/ Avis Europe (No security)/ Northgate	10% 10% 10%	5% 10% 15%	5% 5% 5%
	FTSE Small Cap - Liquid/ Non Liquid 10 - Liquid/ Non Liquid 15	Yell Group/ UK Coal (No security)/ Findel	10% 10%	10% 15%	5% 5%
	ETFs	DB X-TRACKERS DJ EURO STOXX 50 ETF	10%	5%	5%
	IRISH - Liquid/ Non Liquid 05 - Liquid/ Non Liquid 10 - Liquid/ Non Liquid 15 - Liquid/ Non Liquid 25	Ryanair Holdings/ Paddy Power Bank of Ireland/ Glanbia (No security)/ (No security) (No security)/ Greencore	10% 10% 15% 25%	5% 10% 15% 25%	5% 5% 5% 5%
	AIM - AIM on SETS 10 - AIM on SETS 25	Mulberry Leed Petroleum	10% 25%	10% 25%	5% 5%
	SETSqx	AIM - AIM on SETS-qx 15 - AIM on SETS-qx 25	Fuse 8 Manganese Brown	N N	15% 25%
SEAQ	AIM AIM on SEAQ	Vertu Motors	N	N	N
IOB	- IOB 10 - IOB 25	Samsung Electronics Tata Motors	10% 25%	10% 25%	5% 5%
ORB	ORB - Gilts, Supranational and Corporate - 1 - Corporate and Others	European Investment Bank 3/4% 25/08/17 (VAR) (BR) Morgan Stanley 5.375% NTS 14/11/13 £ (REGD)	3% 7.5%	3% 7.5%	N N

Table 1: Summary of static and dynamic price thresholds on LSE markets⁹

Period	Number of Automatic Execution Suspension Periods	Average suspensions per trading day
July 1-14 2011 (10 trading days)	347	35
August 1-14 2011 (10 trading days)	1702	170

Table 2: Number of Automatic Execution Suspension Periods on LSE markets, July-Aug 2011¹⁰

⁷ For a description of trading services, please visit:

<http://www.londonstockexchange.com/products-and-services/trading-services/trading-services.htm>;

⁸ (No security) refers to a threshold segment does not contain any security;

⁹ Compiled from the Rules and Guidelines to Parameters of the London Stock Exchange, as of August 2011;

¹⁰ Source: LSEG Market Surveillance;