

# **UK SHAREHOLDERS' ASSOCIATION**

**response to**

## **Stock Exchange Electronic Trading Service** **(SETS)** **Review & Consultation**

**29 April 1998**

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## **INTRODUCTION**

The UK Shareholders' Association welcomes the Stock Exchange's decision to review SETS at this early stage, and to consider potential improvements. While SETS has been a technical success, there are major problems that have to be addressed; we believe that resolving those problems will benefit the market as a whole, but private shareholders most of all.

### **Major Aims**

Our major aims for this consultation, which are reflected throughout this document, are:

1. To ensure that the largest possible proportion of private shareholders is able to choose between the benefits of SETS and alternative trading mechanisms.
2. To maximise the benefits of SETS for private shareholders dealing both on and off SETS.
3. To recognise the extent to which some private shareholders are trading at poorer prices as a result of SETS, and to address this problem.
4. To extend the benefits of SETS to a wider range of stocks, without causing a deterioration in off-SETS trading conditions.

### **Major Concerns**

We also have a number of concerns about the document, as it reflects current Stock Exchange thinking:

1. The failure to quantify or even to recognise either
  - a) those instances where private shareholders are trading on **worse** terms as a result of the introduction of SETS; or
  - b) the costs that continue to be borne by those private shareholders who can only deal 'at best' because they are unable to place orders directly onto the order book.
2. The absence of any reference to practices on other stock markets, and of the resulting lessons that can be applied in the UK.

### **Format of this Response**

We have addressed these and other issues under the headings of the various questions put by the consultation document. We have not included in this response any reference to those questions that are not relevant to the interests and concerns of our members.

**SUMMARY OF OUR PRINCIPAL ANSWERS****3a. Is the new market structure overall meeting the needs of the retail community?**

No. While the operation of SETS has improved greatly over the first four months, most private shareholders are not sharing fully in the benefits and some are incurring greater costs.

**3b. If not, what changes would you propose?**

We would support:

- Elimination of the minimum order size rule
- Later market opening
- Volume-weighted closing prices.

When these measures are in place, we would want SETS extended to the FTSE-250. In due course, we want to see a parallel order book for dealing in certificated shares.

**3c. The minimum order size for the order book should be:**

- removed completely

**4a. Our preferred option for opening the market is:**

- delaying the official or actual market opening until 9am or 9.30am.

**5a. Our preferred option for closing the market is:**

- Volume-weighted closing price.

**5b. Would any of the other options offer improvement as an interim measure?**

We do not believe so.

**6b. Do you support the removal of the minimum order size for agent orders?**

Most emphatically, yes.

**13a. Is a change to market structure for FTSE 250 securities necessary?**

Yes. In principle, we strongly favour the extension of SETS to the FTSE-250.

**13c. If changed, the new market structure for these securities should be:**

- SETS with minor modifications (eg rule changes)

**13d. The change should take place:**

- within the next year but some months following any changes resulting from the review of SETS.

**14. Given the analysis set out in this section do you agree with the conclusions as set out for the introduction of a central counterparty?**

We do not agree with the analysis.

## **SECTION 4: RETAIL EXECUTION**

### **Question 3) Operation of the retail end of the market**

#### **3a) Is the new market structure overall meeting the needs of the retail community?**

**No.** While the operation of SETS has improved greatly over the first four months, most private shareholders are not sharing fully in the benefits of SETS, and some are incurring **greater** costs as a direct result of the manner in which SETS is currently operated.

#### **Denying the impact of excessive spreads**

In particular, we are concerned that there appears to be no acknowledgement that some retail trades have actually executed at far wider spreads than would have occurred pre-SETS, at considerable cost to private shareholders.

There have been many complaints about the high spreads that occur regularly, particularly at the start of each trading day. There has also been significant press coverage of this issue. However, the Consultation Document appears to be attempting to define the problem out of existence:

**'...attention has focused on those periods when spreads are wider...it has been suggested that on occasions these spreads have led to unrepresentative prices (so-called 'rogue trades'), to the detriment of private investors. This is not borne out by analysis....our investigation reveals that such trades very rarely involve retail orders and that the cause has normally been a program trade from a major principal dealing firm.'**

While we may be concerned about the occasional 'rogue trade', we are far more worried about the many instances known to us, and reported in the press, in which shareholders are dealing within the order book 'best prices' but at an excessive spread. These may not be rogue trades but they are a very major issue that must be acknowledged and addressed.

The 'average' spreads for various sizes of trade, as shown in Chart 8, cannot tell the whole story. We regret that there is no analysis of the numbers of trades affected by high spreads.

#### **Why the 'best price' is not good enough**

The consultation document refers to the off-SETS trading activities that **'allow cost-effective, automated access to the best price on the market'**.

This is a crucial matter, since most private shareholder deals are excluded from SETS by the minimum order size rule or because the shares are certificated. If private shareholders can achieve just as good a price trading on SETS or through alternative, competitive services, there is indeed no need for SETS to be extended to embrace these trades.

However, 'best price' is a misnomer, as we have argued consistently over the past year.

Any institutional investor can place an order at a price that is **better** than the 'best price' and is visible to every other market participant. If the order's price is between the existing best buying and selling prices, it itself becomes the best price, and will be matched by the very next 'at best' order, to the mutual benefit of both parties.

A shareholder dealing via the marketmaker, on the other hand, must either accept the price on offer, or try to negotiate a better price with the very limited number of marketmakers, or wait in the hope that the market will move in his/her favour.

The Consultation Document does acknowledge that spreads carry a cost, and that this cost can be removed by leaving a limit order on the book. This is a significant concession, and we welcome it; however the risk that a limit order will not be matched is overstated: since a limit order priced between the existing best buying and selling prices will be matched by the very next 'at best' order, it will normally be matched very rapidly.

It should be evident that being unable to deal via the order book carries a significant cost for small shareholders and certificated shareholders. We have argued consistently that we should be able to choose between carrying that cost and accepting the risk of an unmatched trade. 'Best price' is not good enough.

### **Measuring SETS against other markets**

Chart 8, on page 8 of the Consultation Document, **'shows that under SETS typical retail trades are done at a bid-offer spread that is some 15% better than under the previous structure.'**

We welcome that improvement, which has broadly benefited private shareholders.

However, the success or failure of SETS, and the potential for improvement, cannot be properly measured except by comparison with the spreads that occur on other markets. This document provides us with no such measures.

SETS serves one of the world's largest and most liquid markets. If it cannot consistently match the best spreads achieved for equivalent stocks on other markets, it is not adequately meeting the needs of the retail community.

We regret that this information has not been provided.

### **Question 3b) If not, what changes would you propose?**

We would support:

- Elimination of the Minimum Order Size rule
- Later market opening
- Volume-weighted closing prices

We believe that the first two measures should increase liquidity and reduce spreads, particularly for less liquid stocks and early in the trading day.

We note that these measures would not in themselves enable holders of certificated shares to deal through the order book, but that the reduced spreads should be of significant benefit to shareholders dealing off the order book.

Once these measures are in place, we would want SETS extended to cover FTSE-250 stocks. In due course, we want to see a parallel order book with a longer settlement period (probably T+10) to allow order-based trading in certificated shares.

All these matters are covered at greater length later in this response.

**Question 3c) Should the minimum order size for the order book be:**

**(i) removed completely?**

**(ii) reduced to 250/500 shares from 500/1,000 shares?**

**(iii) unchanged?**

The minimum order size for the order book should be **removed completely**.

If deals below a certain size are more efficiently carried out off the order book, they are likely to remain off the order book. Simple competition should be allowed to operate between the order book and alternative dealing methods, so that private shareholders may be able to choose for themselves the most appropriate and competitive dealing method.

When SETS was launched, the main reason for the Minimum Order Size was given as the need to prevent multiple fills. We welcome the Consultation Document's disclosure that this rationale has not proven, with hindsight, to be an important factor.

We welcome the position that allowing most business onto the order book is inherently desirable. However, we are very concerned that new reasons should not now be found for excluding private shareholder deals from the order book.

We have always believed that large numbers of small limit deals flowing through an order book are the most efficient mechanism for ensuring a constant and orderly market with the lowest possible spread: every small deal that is placed on the order book at mid-price effectively reduces the prevailing spread until it has been matched. That may not make a great difference to the most liquid stocks, where larger limit orders are constantly being placed and matched, but it would make the market more competitive at the lower end of the FT-100; if SETS were extended to more illiquid stocks, these smaller deals might make all the difference between success and failure.

The Consultation Document notes (pages 17/18) '**...it appears that those securities with very few order book eligible bargains perform least well. This is a concern because more than half of the FTSE 250 have fewer than 10 order book eligible trades each day.**'

It would appear sensible, then, to increase the proportion of trades that **are** eligible. Here, again, the elimination of the minimum order size might improve the situation by bringing more trades onto the order book.

## **SECTION 5. SETS DESIGN ISSUES**

### **Question 4) Market opening**

#### **4a) What is your preferred option for opening the market?**

- i) No change**
- ii) Changes to the market hours**
- iii) Changes to the opening process and the market hours**

We believe that opening spreads would be greatly reduced by option (ii), **delaying the 'official' or actual market opening until 9am or 9.30am**; since reduced spreads bring major benefits to many smaller shareholders, we would welcome such a move.

#### **The impact of opening spreads on private shareholders**

The opening spreads that characterise SETS are a major concern to us.

We believe that smaller shareholders are disproportionately affected by wide spreads at the start of trading, because many shareholders place their orders outside market trading hours and do not specify limits; we believe that low-cost execution-only brokers are likely to implement these trades at the earliest opportunity: the start of business, when spreads are worst.

We note that, while opening spreads now narrow far more rapidly than in the first months of SETS, Chart 9 (page 10) clearly shows that the spread at 8.33 (the effective start of trading) has hardly narrowed at all: it has fallen from c.180 basis points in month 1 to 170 basis points in month 4. This needs to be addressed urgently.

#### **The reality of opening spreads**

The Consultation Document states (page 10): **'The reality is that the start of day has always been characterised by thin trading - the difference is that it is much more visible to the whole market under SETS. The challenge now is how best to maximise overall liquidity at the opening.'**

The reality of opening spreads can be measured, and should have been presented in the Consultation Document: it is one essential indicator of the success or failure of SETS.

We regret that there no comparison between the opening spreads that occur under SETS (chart 9) and those that prevailed before SETS was introduced.

We fear the reality may be that opening spreads have widened considerably since the introduction of SETS. This is not just a matter of increased visibility: if the start-of-day spreads have increased, smaller shareholders are getting a worse deal as a direct consequence.

#### **Why a later opening hour should reduce opening spreads**

Any market clearly has to establish trading ranges for its stocks at the start of each day. This will present difficulties regardless of when the market opens.

It seems logical to suppose that a market opening early in the morning will get off to a slower start than a market that opens when most people are at their desks and ready to deal.

However, more analysis of practices on other markets is needed, to confirm that a later market opening hour will indeed reduce opening spreads.

**Question 4b) Would the following changes enhance the market opening?**

- (i) market at open orders**
- (ii) random time for uncrossing**
- (iii) other, please specify**

We are not in a position to determine the impact of the proposed changes upon spreads and liquidity at the start of trading.

However, we understand that some foreign exchanges are far more successful than SETS in achieving low start-of-day spreads. We regret that there is no analysis in the Consultation Document of practices on other markets, and of the associated spreads.

**Question 5) Market closing**

**5a) What is your preferred option for closing the market?**

We strongly favour Option 4b: Volume-weighted closing price.

Closing prices are a matter of concern to us, because misleading closing prices can create a disorderly market, in which private shareholders place orders overnight on the basis of unrepresentative closing prices.

The current approach of determining official closing prices from the price of a single trade is open to both manipulation and sheer chance, regardless of when that price is recorded. Furthermore, the problem of unrepresentative closing prices may be manageable for FTSE-100 stocks, but will become far more significant as less liquid FTSE-250 stocks are introduced.

The alternative of auction-based closing prices may also be worth considering. However, there is the risk that, as SETS is extended, there may be occasions when no trades occur at the closing auctions for certain illiquid stocks. In these circumstances, how would a closing price be determined? A volume-weighted closing price mechanism can more easily be adjusted to cater for these situations.

Once again, we would have welcomed an analysis of procedures used in other markets, and their effectiveness.

**Question 5b) If your preference is included in option 4, given that this change could not be implemented immediately, would any of the other options offer improvement as an interim measure?**

We do not believe so.

**We oppose option 2, closing the order book at 16:00 or 16:10**, because this would increase the number of private shareholder orders that were received outside trading hours and were held back until start of trading on the following day - the time when spreads are worst. More private shareholders would be significantly disadvantaged.

We also have concerns about allowing the derivatives tail to wag the equities trading dog. If it is appropriate to align derivative and equity trading hours, equities trading hours should drive derivatives hours, not vice versa.

**We oppose option 3, calculating the closing price at 16:00 but keeping the market open until 16:30 or 17:00.**

This seems like a perverse approach, since the official closing prices would no longer reflect the position at the actual close of trading.

The price at which any one company is trading may change substantially between the official market close and the actual market close. So the problem today - that 'closing prices' are not truly representative of trading at close of business - would simply be reproduced in a different way.

As stated earlier, our primary concern is for those private shareholders who may place orders on the basis of unrepresentative closing prices. In order to avoid confusion, 'closing prices' should be just that: a true reflection of prices at the actual close of business each day.

#### **Question 6) Multiple fills**

**a) Given the impact of program trades on multiple fills, should the minimum principal order size be increased?**

We oppose this measure because it would reduce liquidity, and would therefore increase spreads at the expense of private shareholders.

**Question 6b) Do you support the removal of the minimum order size for agent orders?**

**Most emphatically, yes.** The minimum order size rule for private shareholder deals has always been, and remains, our main grievance against the way in which SETS was introduced.

This issue is discussed in greater detail under question 3c.

#### **Question 11) Implementation**

**a) Are there any options for change identified in this section which you would have difficulty implementing in the next 12 months?**

**b) If so, what do you think is the appropriate timing for the change(s) concerned?**

We recognise the difficulties that industry faces in making software changes to cope with Year 2000, EMU and other matters.

However, we are concerned that extension of SETS to cover FTSE-250 stocks may not be practical unless existing problems with start-of-day spreads and closing prices have been resolved. The proposed reforms should therefore be in place before FTSE-250 stocks are brought onto SETS.

Our major priority is the abolition of the minimum order size for retail trades. If, as the consultation document indicates, this can be achieved without a central counter party, implementation of that central counter party is not itself a priority.

**SECTION 6. EXTENSION TO FTSE 250****Question 13) FTSE 250****13a) Is a change to market structure for FTSE 250 securities necessary?**

Yes. In principle, we strongly favour the extension of SETS to the FTSE 250.

Currently, lack of both liquidity and competition in smaller stocks leads marketmakers to make large spreads, which then damage liquidity further, to the point where it is now virtually impossible to acquire meaningful holdings in some stocks. These are the stocks that are most in need of a trading mechanism that more efficiently matches buyers and sellers.

**Question 13b) If changed, should the migration of the FTSE 250 securities be:**

- (i) en masse?**
- (ii) phased?**
- (iii) dependent upon some other criterion (e.g. liquidity).**

We would, in principle, like to see an early migration of all FTSE-250 stocks to SETS. However, we recognise that a phased migration may be appropriate, to allow problems to be identified and resolved.

**Question 13c) If changed, should the new market structure for these securities be:**

- (i) identical to SETS?**
- (ii) SETS with minor modifications (eg rule changes)?**
- (iii) entirely different (eg a specialist)?**

We favour (ii), because we believe that minor modifications are likely to be required, but should be sufficient.

For example, we recognise two issues that arise from introducing relatively illiquid stocks to the order book:

- adjusting the closing price mechanisms to cope with stocks that only have a few trades a day.
- ensuring that private shareholders recognise the danger of entering 'at best' orders in these stocks;

It may be appropriate to limit the risk to private shareholders, by rejecting 'at best' orders that are keyed outside opening hours for less liquid stocks, or by rejecting 'at best' orders whenever the order book spread is greater than, say, 5%.

**Question 13d) If you believe a change is necessary, when should it take place?**

- (i) within the next three months?**
- (ii) within the next year but some months following any changes resulting from the review of SETS?**
- (iii) at some later date?**

We support option (ii): the changes currently under review should be introduced before SETS can be extended with confidence.

**Question 13e) Are there alternative mechanisms that you would prefer to see for less liquid stocks?**

No.

**SECTION 7 CENTRAL COUNTERPARTY - PRELIMINARY FINDINGS**

**Question 14) Case for a central counterparty**

**14a) Given the analysis set out in this section do you agree with the conclusions as set out for the introduction of a central counterparty?**

We are very concerned that the business case for a central counterparty has not been properly made, because the potential savings to smaller shareholders from removing the minimum order size rule have not been acknowledged.

We believe that, while only the benefits to a business need be considered in a normal, competitive environment, the near-monopoly position of the Stock Exchange means that the potential savings for consumers **must** also be considered.

If the decision not to introduce a central counterparty results in the minimum order size being retained, considerable cost savings for smaller shareholders will be lost. The Stock Exchange's position may be damaged if it has not been willing to quantify or even acknowledge those cost savings.

This concern will of course be resolved if the minimum order size rule is scrapped.

**SECTION 8: LONGER TERM ISSUES**

**Additional securities and Functionality**

In the longer term, we would certainly welcome increased functionality and extended coverage from SETS.

**Non-standard settlement**

The effective exclusion of certificated deals from SETS is a major concern of our members.

We want to see an order book in a single alternative settlement period (probably T+10) running alongside the order book, to allow order-based trading in certificated shares.

However, we believe that the immediate priority should be reducing spreads on the existing order book, since lower spreads will provide an immediate and substantial benefit to all market participants, including certificated shareholders.

We look forward to further consultations on this matter.