

U K SHAREHOLDERS' ASSOCIATION

David Beckett, Competition Policy Division
Office of Fair Trading
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29 December 1996

Dear Mr Beckett

REQUEST FOR AN IMMEDIATE ENQUIRY INTO STOCK EXCHANGE ELECTRONIC ORDER BOOK PROPOSAL: MINIMUM ORDER SIZE

Thank you for speaking to me earlier this month.

You will recall that the UK Shareholders' Association is the only independent body in the UK run by and for private shareholders and maintaining accountability to its membership through regular elections.

INTRODUCTION AND REQUEST FOR AN ENQUIRY

We have taken an active interest in the Stock Exchange's proposals for an electronic trading service since the first consultation document was published in January 1996. The Stock Exchange's first Proposal was published in May. On 7 August, we met with John Tanner, of the Stock Exchange's Market Development department, to discuss a number of issues to do with private shareholder access to the order book. At that meeting, we were advised that the Stock Exchange was considering the possibility of introducing the concept of 'Minimum Order Size'. We immediately expressed our concern at the idea. On 17 August, we wrote to confirm that we seriously doubted whether private shareholders obliged to deal through intermediaries (then described as Registered Principal Traders) could expect to achieve the same terms as shareholders dealing through the order book.

In October, the Stock Exchange published its draft proposal for the service. This confirmed that Minimum Order Sizes would be introduced, that only orders of at least 500 or 1,000 shares (depending on the share price) would be accepted onto the order

book and that investors wishing to deal in orders below these levels would be obliged to trade via Retail Service Providers (RSPs). No indication was given of the proportion of private investor deals that would be affected, or of the average Minimum Order Size that would result.

On 11 November, we wrote to John Tanner and Dan Sheridan at the Stock Exchange, stating that we believed most private investor deals would be excluded from the new market by the proposed Minimum Order Size, that the average Minimum Order Size, which we estimated at £4,000, would be far too large, and that we did not believe it would be possible for private investors dealing through RSP intermediaries to deal at the same prices as institutional investors using the new order book.

We made similar representations to John Whitmore at the Securities & Investments Board, and to Claire Curtis at the Securities & Futures Association. Neither of these representations have received a response to date.

On 19 November Mr Tanner replied, indicating that around 60% of private investor deals would be affected, and that the largest Minimum Order Size, based on current share values, would be about £8,000, for Zeneca. However, the 60% figure did not allow for the many low-value deals that are currently agglomerated by execution-only brokers, so the actual proportion of private investor transactions involved will certainly be far greater than 60%. Mr Tanner wrote that the RSP service would be an improvement over existing arrangements, and that:

...For these reasons, we believe that the cost for retail investors should not increase and that they are not being restricted to a second-class market, but, instead, are getting just a good a deal as institutions.

A copy of this letter is enclosed.

This month (December), the Stock Exchange's 'Update to the Proposal' was published. The Minimum Order Size envisaged remains the same. The document does not address or even acknowledge our concerns. Neither the average Minimum Order Size value nor the proportion of private investor deals are mentioned. Instead, the relevant section (page 4: Minimum Order Size) states:

It is generally accepted that a minimum order size, along with appropriate arrangements for transacting business below that size, enhances the attractiveness of the order book.....There is some concern, however, that the level of minimum order size set out in the proposal is too low and will not deter some participants from 'fishing' in the order book to discover who has placed orders on it or from manipulating the book with very small orders. The Exchange is keen not to raise the minimum order size for business overall but may implement two different minimum order sizes - one for agents and another for principals.

It is now very clear that the Stock Exchange is not going to accept our fundamental case that the current proposal does not provide sufficient access to the order book for private investors, and that private investors cannot hope to trade on the same terms as institutional investors through the other mechanisms being proposed.

In the last few weeks, various newspapers have reported that the OFT is investigating other aspects of the Stock Exchange's proposals. We believe that there is a strong case for the OFT also investigating the Minimum Order Size rule. Our reasons are stated in greater detail later in this document.

The Stock Exchange has announced that consultations end on 10 January 1997, and that the order book proposals will be finalised during the same month.

We therefore ask you to initiate an immediate enquiry into the proposed Minimum Order Size rule, to satisfy yourself as to whether this rule constitutes an unacceptable breach of fair trading principles and to take whatever actions are available to you to ensure that private investors are given fair access to what will be the primary market for share trading in the UK.

GROUNDNS FOR OBJECTING TO THE MINIMUM ORDER SIZE RULE AS PROPOSED

You will be aware that the Stock Exchange is effectively a trade association owned by its members, who represent most aspects of the financial services industry as well as some major listed companies. Private investors and other consumers of collective investment funds are not represented.

Over the past few years, the Exchange has been accused, most notably by the House of Commons Treasury Select Committee, of being primarily concerned to protect the interests of its members. In particular, the Stock Exchange was accused of delaying the introduction of order-based trading because of resistance from its Marketmaker members.

At our meeting with Mr Tanner on 7 August, we were told that the Exchange's primary responsibility was to its members, and that our comments, as representatives of non-members, would be weighted accordingly.

We believe that the proposed Minimum Order Size rule is ample confirmation that the interests of Stock Exchange members still take precedence over the interests of private citizens.

The rules create a new and substantial area of business for Stock Exchange members, acting as Retail Service Providers, to replace the Marketmaking business. Those members who were concerned to protect their interests as Marketmakers will continue to have a large and captive market.

Retail consumers - private investors - will pay for this business to be sustained. Private investors making deals of less than around £4,000 will be obliged to route their deals through an unnecessary intermediary. It is inevitable that deals done via the RSP middleman will be more costly than deals done directly between buyer and seller through the order book, because the RSP has to cover costs and attempt a profit.

The source of profit for the RSP has to be through a fee or through maintenance of the 'touch'. The latter is the most likely option. Since the definition of **best price** has been deleted in the latest list of revised rules (Stock Exchange Notice N73/96, 12 December 1996, page 3), it is not clear exactly what the pricing obligations on RSPs will be. However, we understand that an RSP will be required to work within the **best offer** and **best bid** prices on the order book at the time. We believe that the best bid and offer prices will, for most of the time, not reflect the prices at which most deals on the order book are actually being completed, because deals put on the book at mid-price are likely to be matched instantly or very rapidly, disappearing from the system, whereas deals that are more ambitiously priced will tend to remain on the book for longer periods. Thus, the best bid and offer prices on the book at any one time will be determined not by the mid-prices at which trades occur but by the more ambitiously-priced orders that have **not** been matched.

We are not arguing that Best prices under the proposed system will be worse than prices achieved under the present system: there may well be a considerable improvement, although this is far from certain.

However, the order book will provide a far better, more efficient and cheaper service than exists today. Private investors will be denied access to that service for the great majority of our share deals.

We believe that the problems associated with small orders, as described by the Stock Exchange, may be genuine, but that they are not sufficient to justify the exclusion of most private investors from the market. Furthermore, the Minimum Order Size approach does not properly resolve those problems. This is described under the next heading.

We believe that alternative approaches, described below, may not have been explored because granting general access to the order book for private investors is not in the commercial interests of a large body of Stock Exchange members.

Finally, we note with great concern that the vital questions of the proportion of private investor deals affected (well over 60%) and the average minimum order size (around £4,000) have not been stated in the Stock Exchange's consultation or proposal documents. The effect, possibly intentional, has been to obscure the degree to which private investors will be excluded from the primary market.

REASONS GIVEN FOR THE MINIMUM ORDER SIZE RULE

The Stock Exchange has described various problems associated with small orders, to justify their exclusion from the market, as follows:

- The existence of a potentially large number of very small orders on the book could make the book less attractive to users if it results in multiple executions.
- Some participants may go ‘fishing’ in the order book to discover who has placed orders on it.
- Very small orders or even single share orders may be used to manipulate the best bid or offer prices, damaging the price and index calculators.

We note that Minimum Order Size as currently proposed will not resolve these problems, as follows:

- Multiple Fill: A large order, of, say £200,000, may still interact with a great many small orders over £4,000.
- Fishing Trips: Another participant may determine who has placed that £400,000 order by placing a £4,000 matching order. The information becomes more expensive to obtain if the Minimum Order Size is increased, but the problem remains.
- Manipulating Best Price: Again, it become more expensive to manipulate these prices, as the Minimum Order Size is increased. But there will always be situations where the commercial benefit is well worth the price.

The continuing pressure from market participants for the Stock Exchange to increase the Minimum Order Size yet further, as described on page 4 of the December proposal document, demonstrates the failure of Minimum Order Size to successfully address the stated problems. We have little doubt that, once the principle of a high Minimum Order Size has been accepted, the level will be raised at the earliest opportunity.

ALTERNATIVES TO THE MINIMUM ORDER SIZE RULE

In his letter of 19 November, Mr Tanner wrote:

...the ones [deals] that would be excluded would be predominantly execution-only business involving sales of privatisation stocks.

We reject this rationale. We note that:

- 1) few allocations of privatisation issues will have grown to a value of £4,000;
- 2) the number of stocks concerned are a very small proportion of FT-100 stocks, FT-250 stocks or small capitalisation stocks;
- 3) this would relate to sales only, and not to purchases.

If Mr Tanner’s statement is correct, the major purpose of Minimum Order Size - reducing the number of multiple fills - could be achieved by excluding from the order book just sales of privatisation and demutualisation stocks, and basing the Minimum Sale Order Size for each of these stocks on the original allocations.

The costs associated with Multiple Fills could also have been addressed by 'some form of central netting service', as described in the Consultation Document of January 1996. We believe that this would fully resolve all of the concerns associated with Multiple Fills. However, the concept appears to have received no further mention.

Another possibility would be to limit multiple matches between very large and very small orders by providing an option for orders not to trade with other orders less than one tenth (for example) of their size.

Even if the case for a Minimum Order Size were accepted, the level could be set far lower, so as to exclude transactions for 'trivial' sums (below, say £1,000) without excluding the majority of committed private investors.

No doubt there are other possible approaches.

We are confident that the problems associated with 'fishing trips' and price manipulation - which have never been described in detail in the Consultation and Proposal documents - could also be resolved effectively without excluding most private investor deals from the order book.

CONCLUSION

The Minimum Order Size rule, as proposed by the Stock Exchange, will prevent most private investors from trading on the new order book, forcing them to pay for the unwanted services of Retail Service Provider intermediaries.

In our letter to the Stock Exchange dated 11 November 1996, we stated:

We remain determined that private investors should not find themselves restricted to a higher-cost or second-class market.

We hope that you will agree that the Minimum Order Size rules currently proposed by the Stock Exchange will have just this effect, that this is not necessary for the orderly and efficient conduct of the market and that an immediate investigation is well justified.

Yours sincerely

Note: This letter was also sent to the House of Commons Treasury Committee on 17 February 1997, with a covering note, during the Committee's investigation into the London Stock Exchange.