ShareSoc
UK Individual Shareholders Society

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Via email to: clients@londonstockexchange.com

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Response to Consultation on the market structure for the trading of smaller equity securities outside the FTSE 350 index

Dear Mr Lauder,

Our responses to your specific questions on the above mentioned consultation are given below, but I would first like to make some general comments.

There is currently a severe market failure in the trading of many smallcap stocks offered in the London market, as you know from previous discussions we have held. In many such stocks the primary source of liquidity for day-to-day price formation in such stocks is retail investors (who we represent) and smaller funds. However, a vicious circle exists that inhibits such liquidity:

- Where a stock becomes illiquid, market makers broaden the quoted spread.
- A broad spread deters investors
- Because investors are deterred from trading, the stock becomes even more illiquid

This vicious circle is the direct result of quote-driven trading and the inability of the vast majority of retail investors to directly access the market and place visible limit orders on the order book. To enhance the trading of the securities that are the subject of this consultation, these fundamental issues need to be addressed.

As evidence of this issue, I can do no better than to quote from the Blog of one of our members, Paul Scott (see http://paulypilot.blogspot.co.uk/2013/01/wed-9-jan-sbry-ted-grg-ztf.html):

*…Today's rant has to be about market makers, and their ridiculous spreads again. Take **Vianet (VNET)**…*

…There has been a fair bit of volume lately, typically 100-200k shares traded each day, if not more. So the market spread should be maybe 1-2% right? Wrong! Despite having 5 market makers providing quotes (of just 1,000 shares!), their resting position is a bid/offer spread of 7p. On a share that is just over a quid. Absolutely crazy.

Moreover, they don't compete with each other, they just rush to match each other's stance, leaving the spread so impossibly wide that they have effectively almost shut down the market in VNET shares. Nobody is going to trade if they have to absorb a 7% bid/offer spread, plus dealing costs. Get a grip please market makers! Either quote sensible prices, or don't bother quoting prices at all!

*What makes it worse, is that the **actual** price of trades going through is well within the quoted spread. So why do they insist on quoting prices which are far wider than the actual prices they are prepared to deal at? It just creates hassle, and deters people from dealing. So instead we have to go to an online broker, put in dummy trades, to see what the price on the RSP actually is. A ridiculous waste of time.*

Mr Scott's comments typify my own experience in a large number of smallcap stocks and that of many ShareSoc members who I have spoken to.

The current situation benefits no one:

- Issuers find that the market price formation mechanism fails them and quoted prices may differ widely from what is considered to be a fair valuation of their business. When liquidity dries up, share prices tend to fall because potential investors are deterred from investing in a company who's shares they may not be able to trade out of, without losing a significant portion of the value of their shareholding simply due to the spread. In turn, that deters businesses from raising capital via the equity markets, due to the dilutive effect of a depressed share price, and hence damages the ability of SMEs at the heart of the UK economy to raise the finance needed to grow.
- Investors are deterred from investing in promising, well-run businesses
- Even market makers' own business is diminished, because the low volumes traded in such stocks (due to the wide quoted spreads) cannot generate meaningful revenues for them.

We would welcome a proper forum to address these issues, involving issuers, investors, market makers and other LSE member firms. As these matters have a direct impact on SMEs with a consequent effect on the UK economy, I am copying our response to the business secretary.

Our detailed response to your consultation is given below:

Information on Respondent

Type of Firm	Investor Representative
Name of Organisation/Individual	ShareSoc, The UK Individual Shareholders Society
Business Functions Represented	Representation of individual investors
Roles of Individuals contributing	Director
Name of Individuals contributing	Mark Bentley
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Question 1. Do you support the suggested approach? Yes, on the understanding that these criteria are likely to increase and not diminish the number of stocks traded on SETS and SETSqx (vs SEAQ), given that issuers still have the ability to request a particular trading venue under the same criteria as at present.

Question 2. If not, what alternative criteria would you prefer to see utilised? N/A

Question 3. Currently, approximately 40 of the smallest AIM SETS securities have a minimum order size set at around £1k. London Stock Exchange is considering extending this to a wider number of smaller securities. Will increasing the size of orders at BBO improve the price formation in these securities? Possibly. Broadly, we support a minimum order size to the extent that it deters high-frequency traders (HFT) from placing frequent artificial small orders in an attempt to "game" the market. However, fixing a £1,000 amount appears too rigid, rather we would like to see a minimum order size that is related to the EMS. Where the EMS is small, a minimum order size that is correspondingly small may be desirable, so that positions can be built or unwound in small increments, and price discovery is more efficient.

Question 4. If so, which additional SETS securities should be included? If there is an EMS-related minimum order size, then it should apply to ALL SETS securities, to deter HFT.

Question 5. London Stock Exchange is considering a longer term technical development to the SETS trading service, whereby small orders are permitted, but are not able on their own to set an improved BBO. Would this change be welcomed, and if so, how should it be calibrated and to what universe of stocks should it be applied? No. If a minimum order size is implemented, then there would be no benefit from this change, as it would increase quoted spreads, deterring investors from trading.

Question 6. Currently there is a closing price cross session allowing further order book trading at the closing auction price. Is this considered useful for smaller SETS securities? Yes. An additional facility to trade for a brief period at the closing price increases the opportunity for investors to get their trades executed at a clear, specific price.

Question 7. If so, should the facility be extended from current five minute duration? No. Five minutes should be adequate for market participants that wish to trade at the closing price to enter/amend their orders.

Question 8. The auction following the invocation of our circuit breakers currently lasts five minutes. Is this still considered an appropriate duration? If not, what should it be? Yes, the duration is appropriate. Retail investors that do not have access to DMA (i.e. the vast majority) are unable to trade during this auction period. A longer period would cause more confusion concerning market operation to such market participants.

Question 9. What are your general observations on the thresholds used to generate the circuit breakers? Are there areas for improvement? No comments.

Question 10. Do you have any other suggestions for improving liquidity provision on smaller securities traded on SETS? Broaden access to DMA for retail investors.

Re SETSqx

Question 11. What are the areas for improvement? The auction mechanism offered by SETSqx is potentially ideal for price discovery/formation in less liquid securities. However, effectiveness is substantially reduced due to the inability of most retail investors to access this mechanism. Access to DMA for retail investors needs to be improved.

Subsequent questions address the frequency of auctions. Broadly speaking, for stocks that are insufficiently liquid to support continuous order book trading, we see little need for more frequent auctions. However, there is one specific circumstance where additional auctions may be desirable, and that is where a "substantive" RNS is released during market hours (i.e. not RNSs such as holdings notices, blocklisting applications etc). It may be desirable to hold an additional auction, say, 30 minutes after the release of such an RNS (giving participants time to digest the RNS's implication). However, this may be difficult to implement and requiring participants to wait until the next scheduled auction subsequent to such an event before executing direct orders is not unreasonable.

Question 12. Would you support an additional auction at 9am? No. For stocks that are too illiquid to support continuous trading via SETS, more frequent auctions may "spread trades too thinly" and result in inefficient price formation causing higher price volatility. We see no benefit from increasing the number of daily auctions beyond the current number of four.

Question 13. Should the auctions frequency be extended even further to hourly? No. See response to Q12.

Question 14. Is there adequate visibility via data vendors of SETSqx orders submitted to an auction? No. Our members report that they do not have good visibility of auction orders.

Question 15. Would auction price formation be improved if the random period to trigger the end of the auction was extended from current 30 seconds? If so, what should the duration be? No. Increasing the random period simply offers greater scope for "gaming" the auction mechanism. Participants should be encouraged to finalise their orders BEFORE the end of the fixed (5 minute) auction period, to maximise visibility of available liquidity.

Question 16. Do you have any other suggestions for improving liquidity provision on SETSqx traded securities? See response to Q11.

Please do not hesitate to contact me to discuss our comments further.

Yours sincerely

Mark Bentley
Director

Cc Dr Vincent Cable, Secretary of State, Department for Business, Innovation and Skills

About the UK Individual Shareholders Society (ShareSoc)

ShareSoc represents and supports individual investors who invest in the UK stock markets. We are a mutual association controlled by the members with "not-for-profit" articles and incorporated as a company limited by guarantee. The organisation is financed by member subscriptions, donations from supporters and by its commercial activities. More information on ShareSoc can be obtained from our web site at www.sharesoc.org (our objects are fully defined on this page: www.sharesoc.org/objects.html).