



London
Stock Exchange

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Sent by email: DEAReport@iosco.org

Public Comment on Policies on Direct Electronic Access

Dear Mr Tanzer,

The London Stock Exchange Group welcomes the opportunity to respond to IOSCO's consultation on Direct Electronic Access ("DEA"). This response is submitted on behalf of the London Stock Exchange ("the Exchange") and Borsa Italiana ("Borsa").

Overall we agree with IOSCO's possible principles and feel that market operators are best placed to develop and implement these principles in practice. We view new and varied ways to access markets as positive and believe that controls are key in ensuring that the market as a whole benefits from such developments. We believe however that it is important to recognise that some exchanges have already introduced rules and controls concerning DEA and that there are various valid ways to achieve the common objective of market orderliness. For example, the scope and level of responsibility of the exchange versus its member firms may vary in different jurisdictions. Our rulebooks set out rules on areas such as controls, but we give our member firms a degree of discretion in determining the details of the controls which they will implement for their DEA customers.

We would also highlight that it is important to appreciate the different nuances of the three types of DEA which are outlined in IOSCO's paper. We believe that it is necessary to formulate principles which are specific to each type of DEA.

The Exchange and Borsa offer Order Routing, which is similar to the concept of Automatic Order Routing ("AOR"), which is referred to throughout IOSCO's paper. The Exchange also offers Member Authorised Connection ("MAC"), which is similar to Sponsored Access ("SA"), however member firms must be able to control the MAC customer's order flow. For instance they must be

able to monitor and stop orders submitted by their MAC customers by arranging for a suitable control structure to be in place, even though the orders do not pass through their usual order management systems. The Exchange and Borsa allow Direct Access by Non-Intermediary Market Members, but we would classify these participants as member firms and not as DEA customers

Our responses, provided in detail in the attachment to this letter, reflect these distinctions.

I hope that our views are helpful to the IOSCO Technical Committee. Please do not hesitate to contact me should you wish to discuss any aspect of this letter.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Adam Kinsley', with a long horizontal flourish underneath.

Adam Kinsley
Director of Regulation
London Stock Exchange

B. Pre-conditions for DEA:

(1) Minimum Customer Standards

POSSIBLE PRINCIPLE: DEA Customers should be required to meet minimum standards, including:

- **appropriate financial resources;**
- **familiarity with the rules of the market and ability to comply with the rules of the market;**
- **knowledge of the order entry system which the Customer is permitted to utilize; and**
- **proficiency in the use of that system.**

o Are these the appropriate qualifications for DEA Customers, or should others be added? Please elaborate.

We agree that the criteria listed above are matters which we would expect member firms to take into account when deciding if it would be appropriate to provide a customer with DEA.

Exchanges should have rules which emphasise the importance of effective due diligence on DEA customers (to be carried out by member firms) and the importance of appropriate training and education. It is also essential to require member firms to have control over their customers' orders. In relation to SA specifically, as this involves direct access by customers to exchanges' markets, exchanges may wish to have some rules in relation to customers' access. For instance, an exchange may wish to have a right of veto before a customer's connection is put in place (and the right to suspend or terminate it thereafter) where the exchange has reason to believe that there are issues that have not or could not have been identified by the member firm's due diligence.

However, we believe that member firms will need to retain some level of discretion with respect to the detailed criteria they want to require of their customers. In addition, we believe that member firms should be given full responsibility for determining minimum standards to be met by their DEA customers with respect to financial resources as this is primarily a business decision.

(2) Legally Binding Agreement:

POSSIBLE PRINCIPLE: There should be a recorded, legally binding contract between the intermediary and the DEA Customer, the nature and detail of which should be appropriate to the nature of the service provided.

o Do you agree? If not, please explain or elaborate.

o What are the key points to be addressed in such a contract? See section V.B (2) for possible elements that could be included. Should SA

DEA Customers be required to enter into a contractual relationship with the market as well?

We agree with this principle, and in particular that a legally binding contract between the intermediary and its DEA Customer be put in place. This serves to protect both parties and would seem a prudent arrangement. However, member firms should be able to decide, with their customers, what form this contract should take and what provisions it should contain. For example member firms may wish to state that they will pass any losses to the customer that are associated with erroneous orders being entered at the customer. As member firms could be required by an exchange to terminate a DEA customer's connection, member firms may wish to consider including this in the contract too.

We do not think that it is necessary or appropriate for DEA customers to enter into a contract with the market. Provided the exchange's rules ensure that the member firm is responsible for all orders submitted under its trading codes, contracts between individual DEA customers and the market should not be necessary. Also, retaining a straightforward exchange-to-member, bilateral relationship ensures clarity of who is responsible for what.

(3) Sub-delegation:

POSSIBLE PRINCIPLE: Where a DEA Customer is permitted to sub-delegate its direct access privileges directly to another party (sub-delegatee), the responsible intermediary should seek to ensure that its contractual arrangements with its DEA Customer allow it to identify the sub-delegatee if required by a market authority.

o What requirements should be applicable if a DEA Customer is permitted to delegate its access privileges directly to another party (sub-delegation)? For example, should the sub-delegatee be required to enter into a contractual relationship with the intermediary, the DEA Customer and/or the market? If yes, what areas should be covered by such a contract?

We agree that a member firm should be able to request and obtain information on the identity of the sub-delegatee and be able to provide this to exchanges or the market authorities as required. However, as noted above, we do not consider that contracts between the sub-delegatee and the market are necessary or appropriate.

C. Information Flow

(1) Customer Identification

POSSIBLE PRINCIPLE: Intermediaries should disclose to market authorities upon request and in a timely manner the identity of their DEA Customers in order to facilitate market surveillance.

- o What problems, if any, do intermediaries have in obtaining or delivering the identity of their DEA Customers? If problems exist, how could information flow be improved? (e.g., the use of sub-user identifiers for sponsored access or sub-delegated DEA orders? Are there other possible solutions?) Please explain.**
- o Should DEA Customers each be assigned their own Customer ID or mnemonic? Please explain.**

We agree with this principle and require our member firms to provide us with accurate information in a timely manner about business and trades under their trading codes. We do not often encounter difficulty with member firms providing information on the identity of their customers.

If orders flow directly from the DEA customer to an exchange (e.g. SA) then we believe that it should be mandatory for these customers to use unique customer IDs to allow exchanges to identify their trading activity on an ongoing basis. In relation to AOR, we believe that customer identification on orders is not necessary and should be optional for the member firm. This is because all these orders pass through the member firm's usual order management systems. However, an exchange may wish to retain the right, as we do, to require a member firm to use a unique customer ID if it has concerns about the behaviour of the member firm's AOR customer.

(2) Pre and Post-Trade Information

POSSIBLE PRINCIPLE: Markets should provide member firms with access to all pre- and post-trade information (on a real-time basis) to enable these firms to implement appropriate monitoring and risk management controls.

- o Do you agree with this proposed principle? If not, please explain.**
- o What information do intermediaries need to receive on a pre- and post-trade basis in order to perform effective risk management? What information should a market provide the intermediary regarding pending order flow and other data in order for such a firm to implement properly pre-trade controls?**

We agree that markets should provide member firms with access to all pre- and post trade information and believe that this information is vital if member firms are to have appropriate controls.

Member firms that provide SA or AOR are able to receive all real-time market data from us and we consider this to be important to help them implement controls. As pending order flow (i.e. orders which have not yet been entered into the system) is not public information we would not consider that this information should be made available to member firms. However, a member firm under whose codes an iceberg order is submitted would receive an order confirmation, just as it would for any other order.

For SA, it is essential that a member firm receives information on orders placed and trades executed in its name on a real time basis. In accordance with the spirit of IOSCO's proposed principle, we believe this information to be core to the sort of controls member firms will want to have in place. We organise the provision of such information through the sending of 'drop copy' messages to the member firm. For AOR, member firms receive order entry and trade confirmation information directly as the customer's orders are routed through the firm's usual order management systems.

D. Adequate Systems and Controls

(1) Markets

POSSIBLE PRINCIPLE: Markets wishing to permit AOR and SA should have rules in place that seek to ensure that intermediaries providing DEA access to their Customers have adequate pre-trade controls to manage adequately the risk to fair and orderly trading.

- **Do you agree? If not, please explain.**

We agree with this principle. Exchanges should have rules that require member firms to have controls in place that are sufficiently robust in order to prevent errors, possible abuse or disorderly markets. However, as such controls need to be appropriate in light of the customer's order flow, trading strategies and volumes we consider that an exchange's rules should not be overly prescriptive in this respect, but principles based, such that member firms may set their controls in different ways for different customers. If an exchange becomes aware that a member firm's controls are insufficient, the exchange should have the ability to require the member firm to amend its controls as appropriate or to require that the DEA customers be disconnected.

(2) Intermediaries

POSSIBLE PRINCIPLE: Intermediaries (including clearing firms) should have in place both regulatory and financial controls, including automated pre-trade filters, which can limit or prevent a Customer from placing an order that exceeds existing position or credit limits on such a Customer.

We agree that such controls should be in place. It is our view, however, that a member firm should have the flexibility to determine which detailed controls are appropriate to manage its customer's position and credit limits due to its in-depth knowledge of its customer's business. Credit controls are evidently an issue for the member firm but order entry controls should be designed within parameters set by the exchange in question.

POSSIBLE PRINCIPLE: Intermediaries (including clearing firms) should have adequate operational and technical systems to manage their DEA systems.

o Do you agree that such automated pre-trade filters are desirable and feasible? If not, please elaborate? Please clarify precisely which types of pre-trade filters you deem appropriate. For example, pre-trade filters might range from “fat finger” stop buttons, to more sophisticated filters applying Customer position and/or credit limits.

We agree that such automated pre-trade filters are desirable and feasible. Indeed, they are essential in ensuring the orderly functioning of the market. As explained above, member firms are best placed to determine the precise detail of the pre-trade controls that they wish to have in place for their DEA customers' order flow.

o Do you believe any distinction needs to be drawn between pre-trade filters for position limits and credit limits; that is, filters that stop or limit trades that exceed such position limits and/or credit exposure, taking into account latency and other factors, as well as the inherent relationship between a Customer's position limit and credit limits that might be imposed on such a Customer?

We are unclear as to why a distinction should be drawn between pre-trade filters for position limits and credit limits, nevertheless we believe that such pre-trade filters are likely to be very important for member firms and that they should agree and manage them for their customers, given that the activity under a member firm's trading codes is its responsibility. However we believe that this is an issue for member firms to consider for themselves and that firms should manage the financial risk of their relationships with their customers as they see fit.

o As an alternative to pre-trade filters, some intermediaries and markets believe that post trade controls, performed on a real time basis, can be an effective tool to manage risk involved in DEA transactions. What are the relative merits and drawbacks to such post-trade controls in comparison to pre-trade controls, from both a risk management perspective and the point of view of market participants interested in the fastest possible execution?

We believe that pre- and post-trade controls are *both* necessary. Whilst post trade filters should be used to monitor activity levels and for credit purposes they cannot entirely replace pre-trade controls in terms of maintaining an orderly market and preventing the submission of erroneous or potentially abusive orders. It is important that orders that could adversely affect the market are identified and prevented from reaching exchanges. Only pre-trade controls can do this.

o Should pre-trade controls be at the intermediary or market level or both? Please elaborate. What level of responsibility for risk management of DEA, if any, should be assumed by the market?

We believe that pre-trade controls should be positioned at the intermediary level as member firms are best placed to determine which controls are most

appropriate for their customers' business. In terms of detailed controls, we do not consider it appropriate to be prescriptive given the broad spectrum of activity and trading volumes that different member firms and their customers generate. We view it as the responsibility of member firms to establish their own controls, taking into account the nature of their order flow, rather than relying on an exchange putting in place 'one-size-fits-all' controls. As a result, we recommend that exchanges provide member firms with broad guidance in this area with which they must comply when designing the details of their controls.

Nevertheless exchanges may wish to consider implementing additional control mechanisms, for example trading halts or Automatic Execution Suspensions (AESPs), if they do not already have them. Such mechanisms trigger suspensions of trading when there is a significant price movement in a security (the precise level depending on the security in question). The suspensions give the market time to react to significant price movements and we believe they complement the member firms' order entry controls.

o Should DEA systems and control procedures (including pre-trade filters and post trade controls), be similar or equivalent to those applied at present to non-DEA business? Please elaborate.

Yes – clearly all orders submitted to the market should be subject to broadly similar controls. Controls are essential to the orderly functioning of the market and should be required for both DEA and non-DEA business. While trading venues may not need to be prescriptive about the specific controls that are necessary, we would expect controls between DEA and non-DEA firms to be broadly equivalent as we view all activity under a member firm's trading codes as being that firm's responsibility.

As stated above, control structures should be appropriate given the order flow generated by the DEA customers in question; but we believe that it is for member firms to decide the detail of the controls.

o Do markets or the CCP currently provide intermediaries with the functions/systems needed to conduct effective risk management relating to SA?

Yes – the Exchange has functionality built within its trading systems to assist member firms in this regard. We provide 'drop copy' functionality so that member firms are aware of the orders submitted and the trades executed under their codes by customers with direct technical access to the Exchange's markets. The Exchange also offers technical functionality so that the activity of member firms' MAC customers can be separately identified and, if necessary, their access to the markets suspended or terminated.

o When a non-clearing market-member places a trade, does the mere fact that the Customer is a market-member reduce the credit risk to the clearing firm that accepts the trades?

Possibly, but not necessarily. Market members will have met the exchange's criteria for membership and this may serve to provide clearing members with some comfort regarding credit risk. However, it is for the clearing firm to determine the risk posed by each entity whose trades it clears and we would not expect clearing firms to rely on membership as the sole criterion for providing credit. The fact that the customer is a market member does not necessarily reduce risk to the clearing member; however the fact that trades will be cleared by a clearing member does reduce the overall risk to the market.

o Can intermediaries who receive “drop copies” of their SA Customer’s orders stop the orders prior to execution? If not, what is the utility of such a tool?

This depends on the nature of the order in question. Where such orders are passive (i.e. do not execute immediately upon entry), the member firm receives a 'drop copy' of the order entry confirm and can delete the order. This is because a member firm can delete any resident order submitted under its trading codes. However, where the order submitted is aggressive it will execute immediately, and so deleting the order is clearly not possible. In this case, the 'drop copy' will be of the execution confirm.

We do not view the drop copy as the only mechanism through which erroneous and/or inappropriate orders can be identified and stopped by the member firm – this is primarily the function of pre-trade controls. The drop copy is also there to provide the member firm with an audit trail of all orders sent and trades executed in its name.

o Do differences in latency raise any concerns that should be addressed by means other than disclosure and equitable access? If so, please explain the problem

No, we do not believe this should be the case. There should be no systematic discrimination in any technology solutions provided to market participants by an exchange. Crucially, once within a trading system, all orders should be treated equally in terms of the speed with which they are handled by the system. However, latency levels in terms of access to trading systems are affected by a number of factors including the effectiveness of a member firm's own internal systems (and it may use a number for trading on an exchange), the speed of its connections to an exchange and, potentially, the physical distance between its data centre and the exchange's data centre. These are technical and/ or budgetary issues for each member firm to consider for itself. By extension, it is not practical for exchanges to ensure that all like classes of participants experience the same levels of latency or to inform such participants of the extent of firm-specific time lags.

o Please describe the minimum operational and technical systems that intermediaries should have in order to manage effectively the DEA that they permit.

Member firms should have the technical capability to halt a customer's order flow. In addition member firms should be able to utilise the 'drop copy' messages sent to them and to work with an exchange should the decision be taken to suspend or terminate a DEA customer's access to its markets. Member firms must also have appropriate controls built into the customer's connection to ensure compliance with the exchange's rules on controls etc around DEA business.