Trading System Enhancements at the London Stock Exchange

a report by

Chris Broad

Head of Broker Services, London Stock Exchange

It was a busy start to 2001 at the London Stock Exchange (LSE) as it continued to develop and invest in its trading services. In the first four months of 2001, the standard settlement period for equities was reduced from five to three days. A central counterparty service was introduced for trades executed on the electronic order book trading system, Stock Exchange Trading Services (SETS). Three new trading system enhancements were made at the end of April 2001. The first was the International Order Book, enhancing the trading service for emerging market securities. Secondly, changes were made to the quote-driven trading system, Stock Exchange Automated Quotations System (SEAQ), making it easier for customers to participate in the auctions for SEAQ securities and increase the likelihood of execution. The third was the International Retail Service, which enables retail investors to trade more easily in international blue-chip stocks.

These changes have been developed to meet market demands and they have all been introduced with close involvement from market participants. The LSE's commitment to continue to upgrade and develop enhancements is part of its strategy to build its business with a focus on customer services and the further internationalisation of its markets.

The Move to Trade Date Plus Three Days (T+3)

The LSE's domestic equity market had operated on a 'standard' settlement cycle of trade date plus five days (T+5) since 1995. Market participants can choose, by mutual agreement, to settle on other periods of up to 25 days. However, most choose the standard cycle. In recent times, 75% of trades were dealt for standard settlement. The main other cycle chosen is trade date plus ten days (T+10), usually to enable certificated investors to trade, as it could be difficult for them to achieve T+5.

There is a de facto international standard of trade date plus three days (T+3) for settlement, and this was set as long ago as 1989, but not all markets were ready to achieve it at that time. As for other major markets, the US has been on T+3 for a number of years, France recently moved to T+3 and Germany is on trade date plus two days (T+2).

The main advantage of shorter cycles is risk reduction. This is because, as the time between trading and settlement reduces, the opportunity for problems to arise, such as the default of one of the trading participants, decreases. However, settling with too short a cycle can lead to other problems if it is unachievable in practice. One market actually increased its settlement cycle after the 1987 stock market crash because the previous standard was too aggressive. When the US market reduced from T+5 to T+3, the settlement failure rate increased, although it has since recovered to some extent.

Bearing all these factors in mind, LSE, CRESTCo, the Bank of England and the Association for Payment Clearing Services (APACS) jointly consulted the market in late 1999 to discover whether the UK market wished to reduce the settlement cycle from T+5. The conclusion of the consultation was industry consensus to move to T+3. A proposal to move to T+2 was rejected on the grounds that the settlement failure rate was likely to increase significantly.

Interestingly, the main problem was perceived as being in the wholesale market because of the lengthy instruction chain, from broker via the fund manager to the custodian. It was felt that there was insufficient automation to achieve cycles below T+3, particularly if any of the participants is in another time zone – a significant factor in the UK because of its role as an international financial centre. Even with T+3, this area was a concern, and so CRESTCo instituted some additional monitoring of matching performance to enable affected participants to measure their progress towards meeting the standards required for reliable T+3 settlement.

It is interesting to note that, although the US has proposed to move to trade date plus one day (T+1), the date for this has been put back to 2004, and it is believed that the cost of change will be significant, although it is expected to be quickly recovered. It is unlikely that the UK will move to T+1 ahead of the US move.

Chris Broad is Head of the Broker Services Group, which looks after the interests of the Exchange's Member Firms. Previously at the Exchange, he has overseen the implementation of the Central Counterparty, Stock Exchange Trading Services (SETS), the Exchange's electronic order book, the Sequence programme, which re-engineered the Exchange's trading systems infrastructure, and a range of other initiatives associated with trade confirmation, market access strategy, technology outsourcing, settlement and market regulation.

The UK market moved to T+3 with effect from 5 February 2001, as did the Irish market. The change has been completely successful and about 71% of trades are now dealt for T+3 settlement. The proportion of T+10 deals has stayed about the same (around 20%), with some remaining settlement on T+5. Contrary to the US experience, there has been no reduction in the rate of trades settling on time.

Central Counterparty Service

LSE co-operated closely with the London Clearing House and CREST to provide the markets with a flexible central counterparty service for equity trading in the SETS. The service was successfully launched on 26 February 2001, on time and on budget.

SETS processes over 55% of the value of order book stock trades on the LSE. As trading volumes increase, the need to reduce risk wherever possible becomes increasingly important to market firms. The new central counterparty service introduced a number of benefits for the equity markets in London by introducing post-trade anonymity, effectively removing counterparty credit risk, increasing liquidity on SETS and, hence, improving price formation and lowering spreads, and offering firms the opportunity of being able to cross-collateralise across UK cash and derivatives markets.

The central counterparty service combines the risk management strengths of LCH with the high capacity, realtime transaction processing abilities of CREST. In the phase launched in February 2001, the central counterparty settles each trade with market participants on an 'as-dealt' or 'gross' basis. The second phase of the programme will introduce optional settlement netting, increasing operational efficiencies and cost savings for users. The platform's flexible design is scalable to meet the strategic needs of not just the UK market, but those of Europe as a whole.

SEAQ International Order Book

The international equity trading service provides a central marketplace that is attractive to issuers, intermediaries and institutional investors alike. This helps London remain the market of choice in these securities and enables London to capitalise on an increasing interest in issuing and trading, in particular, global depositary receipts. Taking advantage of this market's potential depends on maintaining the right trading services to maximise participation, facilitating the continued provision of capital commitment and marketing the real benefits that London has to offer.

The introduction of the new international order book service specifically addressed the need to enhance trading for a number of the more liquid securities already trading on the SEAQ International platform. The key features of the order book are: the introduction of a SETS-style order book; the opportunity for participants to display their identity next to their order; that the most liquid emerging markets securities trade on the order book and the remaining securities continue trading on the SEAQ International service with market-maker quotes; and trade reporting and publication of trades in order book securities both on and off the order book.

SEAQ Crosses

Auctions were introduced in May 2000 on a selection of FTSE 250 securities that trade on SEAQ. Research into the use of SEAQ auctions confirmed that, while demand for such a service remained, usage was limited. To address this, some changes were made to the way in which the process worked and focused on increasing awareness of the facility amongst intermediaries and their institutional clients. The new service is called SEAQ Crosses.

SEAQ Crosses is an enhanced service for executing business in mid-cap stocks. The service provides an additional execution mechanism that focuses liquidity while minimising the adverse market impact of large client orders. SEAQ Crosses includes a simpler price determination mechanism and a new closing cross, using the end-of-day price. It introduces some of the benefits of order-driven trading to SEAQ, including full pre-trade and post-trade anonymity, as orders participating in the crosses are not revealed to the market. The service covers all SEAQ 250 stocks (ex-cluding reserve stocks) not currently traded on SETS.

International Retail Service

The International Retail Service was designed specifically to meet private client-broker needs to offer retail investors significantly lower cost trading and settlement of non-domestic securities. The service supports trading in major European and US blue-chips, using sterling prices. Prices are generated by market-makers, known as committed principals, who provide guaranteed liquidity in sizes to facilitate retail order flow. The service is operated by LSE and provides settlement within CRESTCo.

The new service provides easy access for trading in international securities. Trade execution is through LSE, so there is no need to access foreign markets directly, helping to lower the cost of cross-border trading. There are no additional service charges for existing customers, and settlement is at UK levels for retail brokers. In addition, the domestic information feed carries these prices at no additional cost. ■

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