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STOCK EXCHANGE

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Dear James

TRADING OF MTF SHARES: IMPACT OF PROPOSED STAMP DUTY CHANGES

Thank you for the opportunity to respond to the issues raised in Discussion Paper 07/3 (“the DP”) on the trading of multilateral trading facility (“MTF”) shares. The DP has been prompted by HM Treasury’s proposal to amend stamp duty intermediary relief so that it would apply to the trading of UK MTF shares (such as those on AIM) irrespective of whether the trades took place on an MTF or elsewhere.

As you know, AIM is the leading market in MTF shares, so the issues raised in the DP are of great importance to us. We think the FSA has undertaken important and positive work with respect to the regulatory structure between organised venues, and this is visible in the DP.

The DP also reflects the Treasury’s aim of facilitating further competition in the market for MTF shares. As you are aware, the Exchange believes competition is an essential part of London’s markets. Competition is already strong between existing venues (AIM and PLUS) and the Exchange consulted recently on rule changes to further facilitate competition between organised trading venues whilst maintaining existing regulatory standards.

Additionally, HM Treasury’s proposal would lead to the creation of an over-the-counter (“OTC”) market. This creates unique regulatory implications and we support the Treasury’s request that the FSA consider these.

The Exchange’s views

Notwithstanding our strong support for competition, we have significant concerns that the DP does not fully address the *regulatory* implications associated with the Treasury’s proposed intermediary relief change with respect to OTC trading. This

arises because the structure of the markets in MTF shares, and the way these markets are regulated, differ to those for the markets in regulated market (“RM”) shares. In particular, we retain concerns about the impact of an increase in OTC trading that we do not believe the DP addresses. Without doing so, we do not believe the FSA will be in a position to advise the Treasury on the regulatory implications of its planned changes.

Market structure

Trading in the vast majority of MTF shares is market maker-based and does not feature continuous orderbook activity. In many instances, there is a lead market maker for a given MTF share. As we explain in the annex, this may result in increased market opacity if the lead market maker chooses to operate on a less regulated, OTC basis rather than via an MTF. This may include their operating outside the UK, raising the issue of how the monitoring of the market via transaction reports would work (given other EEA competent authorities will not collect transaction reports relating to MTF shares).

Regulatory issues

With respect to regulation, shares that are listed by the UK Listing Authority (“UKLA”) and traded on an RM are subject to the UKLA’s detailed regulatory regime and trading in these shares will be subject to the extensive MiFID regime, including:

- Pan-European trading transparency (both pre- and post-trade);
- Transaction reporting; and
- Information-sharing between competent authorities.

This is in contrast to the regulatory framework for MTF shares. As such, we believe it is dangerous, and overly simplistic, to believe a MiFID-style approach to regulation can be applied to MTF share markets without careful thought.

As part of that, and as you are aware, we believe our ability to maintain effective oversight of the AIM market, and AIM companies’ disclosures, would be undermined if trading fragmented without appropriate regulatory arrangements being established. As discussed above, the proposed changes to intermediary relief would encourage this fragmentation, particularly given most MTF shares are not subject to continuous orderbook trading, such that trading could easily shift OTC.

As a result, we do not believe the FSA analysis and its proposed arrangements are sufficiently comprehensive. We are concerned, first, about the provision of appropriate trading transparency by firms that operate OTC but are not regulated by the FSA; and second, about information sharing and how it would work between OTC participants and the lead MTF operator. The FSA has offered a

partial solution to the challenges raised by fragmentation but, as we make clear in the annex, some important issues remain to be addressed.

In addition, it is important to recognise that the FSA's proposals would create an uneven regulatory playing field between organised venues on the one hand and investment firms operating OTC on the other. This means that, perversely, the FSA's proposals may serve to *distort* competition, rather than aid it.

Summary comments

In summary, we retain considerable concern that the proposals put forward by the FSA will result in an increase in market opacity and reduce the ability of the first/primary place of listing to act as frontline regulator for the shares admitted to its markets. We believe it is important for the Treasury and the FSA to consider these issues carefully before progressing further with changes that will have a fundamental impact on the markets in MTF shares. We would be happy to assist in this work in any way we can.

For the purpose of our response to the DP, however, we have answered the questions the FSA has posed on the same basis as they have been asked – i.e. on the assumption that the Treasury's proposed changes do, indeed, come to fruition. Thus all our answers in the annex should be read with this important caveat in mind.

Naturally, if you would like to discuss our response further please do not hesitate to contact me.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Tim Rowe', written in a cursive style.

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APPENDIX

Q1: What impact do you expect the proposed modifications to the stamp duty intermediary tax regime to have on competition between trading venues?

At present, the market and regulatory environments allow for effective and dynamic competition between organised trading venues, and intermediaries trading on these venues already benefit from intermediary relief. We believe that issuers and investors are happy with the existing structure of the market. We think the only real pressure for change arises from some intermediaries who would benefit from a more intermediated market structure (i.e. one that would increase their role in these markets).

In line with this, we anticipate the proposed changes prompting a high degree of competition from those seeking to transact business OTC. Market makers who provide/support liquidity for other market participants in MTF shares may choose to transact away from an organised venue and, potentially, from overseas. As we note below, this raises the risk of trading becoming more opaque as we do not believe the FSA's proposals deal adequately with such a scenario (unlike current London Stock Exchange rules, which apply to all members irrespective of where they are located). The difference in regulatory treatment between MTFs and OTC participants would also place organised venues at a competitive disadvantage, contrary to the FSA's professed aim of enhancing competition.

In reality, a reduction in transparency and regulatory oversight brought about by a shift towards OTC trading would harm price formation and investor confidence. Further, the fragmentation of the liquidity pool would, in all probability, increase implicit costs for investors. A growth in OTC trading that was not subject to an equivalent level of transparency as that applying to MTFs would increase search and data costs for brokers attempting to obtain best execution for their clients. Given trading in many MTF shares is relatively illiquid already, it seems highly likely that the rise in implicit costs and, potentially, broker charges would more than outweigh any reduction in the fees charged by venues (our own stand at just 6p per trade).

Q2: Do you consider that there is a risk of fragmentation in MTF share trading? If so, what are the key drivers for fragmentation?

Yes, we believe there is considerable risk. However, given many market users are content with the existing market structure, we believe, as we have discussed above, that the risk arises more from the possibility that some firms and market makers will choose to transact OTC. This would allow such market makers to amend and withdraw quotes as they saw fit rather than be subject to venue rules that, in the interests of market liquidity, require market makers to maintain quotes according to established parameters (including needing to provide quotes continuously during a mandatory period each day). It might also allow them to avoid post-trade transparency requirements (depending on the requirements introduced in this regard and the jurisdiction from which the firm operated),

thereby reducing the flow of transparency information to the markets. These points add to the concerns we voice in our response to question 1.

Q3: Do you think a significant proportion of trading in MTF shares will move OTC to benefit from lower transaction costs (or opacity)? What would be the consequences if this were to happen?

It is difficult to predict the proportion of trading that would shift OTC. However, particularly with respect to shares reliant on market makers for liquidity, the proportion could be large if market makers seek to benefit from lower OTC transparency requirements. As we have noted above, we believe this is more likely to result in an overall *increase* in transaction costs than a reduction given the impact on implicit and search/data costs. Indeed, we would note that the improvements to liquidity and transparency brought about in January 2006 when the Exchange transferred the most liquid AIM shares onto SETSmm has resulted in a significant decline in average transaction costs for these shares – from 62bp in December 2005 to 35bp in May 2007. This equates to a saving for investors of just over £3 million in May alone. We believe this reflects the value to investors of a highly transparent liquidity pool.

Q4: Do you consider that a reduction in overall transparency and the fragmentation of trading data will undermine the ability of the MTF operator to effectively monitor and enforce ongoing issuers' disclosure obligations?

Yes, we have considerable concerns in this regard. For example, prompting timely issuer disclosure to make announcements (alongside dealing with queries from members about trading activity) are important, ongoing responsibilities for us that are dealt with on a real-time basis, intraday. This is essential to ensure the reputation and integrity of AIM. We are pleased to note the FSA recognises this when it observes: "it is important for MTF operators to have access to sufficient, accurate and timely information on trading activity to enable them to police ongoing disclosure obligations." Having the ability to gain a clear overview of the market is key to performing this role; allowing opacity of some trading undermines that function and the markets more generally. There is potential for considerable detriment to the markets, which should not be underestimated, if we are no longer able to undertake this task fully and efficiently. As the FSA notes in paragraph 3.25 of the DP, if MTF operators were not able to see trading from across the markets "it would make it more difficult for them to assess the orderliness of trading on their respective venue in the broader market context."

Q5: Do you consider that fragmentation is likely to lead to an overall reduction in the transparency of MTF share market?

Yes. The FSA makes a proposal in the DP to extend the MiFID post-trade transparency regime to OTC trading in MTF shares. That might help to reduce the negative impact on transparency of fragmentation, but it would not address transparency of trading by firms that were not FSA authorised or that occurred in other jurisdictions. The impact on pre-trade transparency would also be negative,

although, as noted above, it is difficult to quantify the scale of any shift towards OTC trading, which will differ from stock to stock. But some increase in opacity and an associated loss of market efficiency is inevitable given that virtually all trading in these shares is currently subject to the transparency requirements set by the MTF operators. There will also be a 'free rider' problem, as those trading OTC may be able to see a level of detail with respect to trading undertaken on MTFs that they are not required to provide themselves. This obviously raises an issue of fairness to those who trade in transparent environments and does not provide for fair competition between organised trading venues and OTC market makers.

A further concern is that the impact of fragmentation on transparency may affect the international investor base of some AIM shares. Many overseas participants choose to invest in larger, more liquid AIM securities. If trading in such securities shifts OTC these investors may find it harder to enter and exit investments as they are less likely to have established relationships with market makers. This may undermine their confidence in the market and reduce their willingness/ability to participate.

Q6: If so, do you consider that it could potentially impair the quality of price formation, reducing market confidence and investor protection?

Yes. Price formation relies on fair and equal access to accurate and timely trading information. Reducing this has negative repercussions for the prices obtained by investors and the certainty they can have that the price they have received is a fair one. This inevitably undermines market confidence, which has a knock-on effect on issuers' ability to raise capital. This has repercussions for the City and the UK economy more broadly as AIM is a key centre for capital-raising.

Q7: Do you consider that existing risks with respect to market conduct are not likely to increase materially and therefore do not require mitigation?

No. The reduction in transparency that would arise from the changes being envisaged would clearly increase the risk of abuse as the probability of detection would decline. The FSA receives transaction reports but many investigations (by both the FSA and venue operators) are still prompted by reports of unusual trading from market participants. This reporting is invaluable but is likely to be undermined if the level of market transparency declines. Furthermore, the FSA will only receive transaction reports from the firms it authorises and, even then, only with respect to their UK-based trading (there will be no transaction reports submitted for trades in MTF shares undertaken by UK firms' EEA branches).

Q8: Do you believe that greater freedom to trade MTF shares will lead to some trading moving outside the UK where there would be no transparency or transaction reporting requirements?

We believe there is a significant risk of a shift of business to other jurisdictions as participants seek to take advantage of the lack of regulation abroad of trading in

AIM and PLUS shares. This clearly raises risks for market efficiency as there will be no transparency requirements around trading outside the UK. The availability of opaque trading environments may also increase the probability of abusive activity taking place.

Q9: Are there any other issues or risks that we have not outlined in Chapter 3 which you believe we should consider?

We would highlight two additional points, which are generally subsets of issues the FSA has identified. One is the detail that would be provided in OTC trade confirmation contract notes. Clients may want to know where their trade has been executed but contract notes for OTC trades may not make this clear. The other issue we would highlight – and one that applies to both MTF shares and RM shares – is how trading halts and suspensions would be organised so that they would be effective if a significant proportion of total trading took place OTC. Organising halts/suspensions between organised, multilateral venues does not pose the same challenges as achieving the same with respect to OTC trading.

Q10: Of the two options we outlined to deliver effective primary market oversight and competition between trading platforms, which do you believe would be the preferred solution? Please outline reasons.

We do not think that either option, individually or in combination, provides a satisfactory solution given the difficulties of their application to OTC trading. Having said that, in relation to organised venues, we believe the options presented in the DP would be better used in combination.

Whilst option 1 may theoretically involve issuers having to meet varying requirements from different venues, if they chose to be admitted to just one or two additional venues we do not believe the costs would be material. Furthermore, the current arrangements in place for the AIM shares admitted to PLUS work adequately, and we do not believe the FSA should close this route to existing or future venues who wish to offer this service. Indeed, we believe this is broadly similar to the AIM Primary Registered Organisation regime on which the Exchange consulted recently, which received market support.

Option 2 would eliminate the duplicative regulatory costs faced by issuers, to the extent they were material, but would instead impose a cost on the new venue. Careful analysis is still needed to ascertain how this option would work in practice and – crucially – who would meet the associated costs, which should not be underestimated. We discuss these points in our responses to questions 11 and 12.

Importantly, neither option discusses how monitoring would operate with respect to trades undertaken on an OTC basis. We are surprised by this; the Treasury's proposed changes that prompted the DP focus on extending stamp duty intermediary relief from trading on MTFs to *OTC activity*. As a result, we would have expected the DP to discuss the potential for a significant increase in OTC

trading, and to focus strongly on the associated regulatory challenges and possible solutions. It cannot be assumed that OTC trading will not form a significant proportion of total trading. As a result, we believe considerable further work needs to be done on the regulatory implications of the proposed tax changes before the FSA provides the Treasury with its views.

Q11: If Option 2 is your preferred option, what kind of information and cost sharing arrangements should be put in place to ensure it is both effective and fair for the lead market and other trading platforms wishing to offer secondary trading? Should general principles governing connection arrangements and costs be developed?

Notwithstanding our comments that we feel the two options could work in tandem, we feel it important to provide a response to this question.

The primary consideration is that, for the lead venue to monitor the markets adequately, it would need a real-time feed of trading data into its surveillance systems from all other venues. This would allow for consistent monitoring of trading, irrespective of the venue on which the trade took place. It would not be adequate for us to receive the standard tape of data that is published to the market as a whole as it would not feed into our surveillance systems properly. Using such a feed would undermine our monitoring capability and, by extension, the confidence investors could have in the markets.

As a secondary consideration, it is worth noting that the lead venue would need a *richer* data set than that available on a standard market tape, including, for instance, the details of unpublished block trades. Otherwise, the ability to monitor market activity would be damaged.

We note the FSA supports the notion of feeds that meet the lead market's technical requirements in paragraph 4.15 of the DP. However, this emphasises the problem associated with monitoring OTC trading. Whilst not explicitly discussed in this part of the DP, proper market monitoring would require that OTC participants provide a feed to the lead market as well. This feed would also need to be tailored to the lead market's requirements if optimal market monitoring were to be undertaken.

Furthermore, it should not be for the lead market to incur the costs of building such connections – it would be a perverse set of circumstances if an incumbent venue had to incur a direct cost in order to facilitate a new entrant providing it with competition. Rather, we believe the alternative venues should incur the cost of building a feed to the lead market (including testing costs) and the costs associated with the lead market providing sufficient capacity in its systems to handle any increase in the total volume of trade data it monitored.

Beyond these points, however, it is difficult to determine whether general principles governing connection arrangements and costs should be developed. This needs to be subject to a feasibility study aimed at determining the

ease/difficulty with which such principles could be established in what might be very complex, technical circumstances.

Q12: Are the costs of connecting data feeds into the system of a primary market overseer significant? Please explain why.

Precise figures depend on circumstances but our experience of linking our own trading system into our surveillance system is that the costs are likely to be significant. We believe the initial cost of connecting another venue's feeds to our surveillance systems would be a significant six-figure sum, but we cannot be more precise at this time. The costs are made up of (and vary according to) a number of elements, including:

- Establishing the physical link itself;
- Preparing any converters required to translate the data format used by one venue into that needed for the surveillance systems of the other;
- Undertaking user acceptance and conformance testing the connection prior to its going live to ensure it is robust;
- Building capacity in the lead market's surveillance system to allow for its projected additional workload (plus prudent headroom).

There would also be ongoing costs to maintain and, if necessary, upgrade the link and the capacity of the surveillance system.

Q13: Is there a different approach you believe we should consider to deliver effective oversight of primary market for MTF shares and competition in secondary trading? If so, please elaborate.

No – we agree with the FSA that the options presented in the DP are those that merit consideration, and that they are not mutually exclusive: a combination of the two could be used going forward.

Q14: Do you agree that detailed MiFID pre-trade transparency requirements would not be appropriate for MTF shares at this stage and that it would be better if MTFs established their own pre-trade transparency regime?

No, we believe that a regime at least broadly in line with the MIFID requirements for RM shares should be introduced. This already exists in the organised, multilateral venues and it would be a perverse outcome if the FSA's review were to result in a reduction in transparency. Pre-trade transparency is an important component for investors, including retail, in assessing market conditions, particularly with respect to less liquid securities. Where the nature or structure of the market is such that providing such transparency would be difficult, MiFID provides appropriate exemptions. These provisions could easily be adjusted and

implemented for MTF shares to ensure that, allowing for market structure etc, investors had broadly comparable access to pre-trade transparency.

However, our greater concern is with respect to transparency for OTC trading. As presented, it seems that the FSA's proposals could encourage the development of OTC 'dark pools' of liquidity that would not offer pre-trade transparency at all. This would increase market opacity and, if the market were to fragment and a significant proportion move to dark pools, overall efficiency would be harmed.

Q15: Do you agree that the MiFID detailed post-trade transparency requirements would be appropriate for MTF shares? Please explain why.

Yes, broadly speaking we believe the MiFID post-trade transparency regime would be appropriate for trading in MTF shares. However, it may need some adjusting in certain respects. For instance, the level of liquidity in many MTF shares is such that MiFID's deferred publication regime for larger trades might need to be reviewed before it was applied to MTF shares.

However, our greatest concern, as already mentioned, is the impact on market transparency of a shift towards OTC trading. The FSA makes clear in the DP that it is broadly averse to the idea of MTF operators having rules that require their members to report trades to the MTF or a competing MTF on which the share in question is admitted to trading. We understand the FSA's thinking in this area but even if the FSA were to extend MiFID's OTC transparency regime to MTF shares the requirements would not apply to market participants that chose to conclude trades outside the UK. This is where the FSA's argument that it sees no reason to differentiate its transparency requirements between RM shares and MTF shares runs into some difficulty: the regime for RM shares applies across Europe but this is not so with respect to MTF shares. This presents a risk of regulatory arbitrage between jurisdictions. As a result, we would advocate the retention of requirements within MTF operators' rulebooks that all members' trades be reported to the market (via the MTF in question or some other mechanism) to help overcome this problem.

Q16: We outlined two broad approaches to achieve an adequate degree of post-trade transparency across market and ensure consolidation of information. Which of the two options expressed do you support and why?

The transparency currently delivered via AIM is broadly similar in terms of detail to that prescribed by MiFID. Importantly, however, it applies to *all* our members – irrespective of where they are located and by whom they are authorised. We are concerned that the regime being proposed by the FSA will, by necessity, apply only to those firms the FSA authorises. Approximately 12% of the Exchange's members are not regulated by the FSA. Obviously, trading by such firms undertaken OTC would not be subject to the FSA's proposed regime.

As a result, we believe it is important for us to retain our own rules regarding transparency. This will ensure proper provision of transparency from all members,

irrespective of the location of the firm or the trade. If the FSA retains a desire to introduce transparency requirements of its own, we would propose these work alongside our own rules in the interests of broad market transparency and confidence.

With that in mind, we would be content with a combination of the two options, such that the FSA would implement option 1 to cover post-trade transparency for FSA authorised firms and MTF operators would retain parallel rules to cover their members.

Q17: Are the costs associated with Option 1 significant? Please explain why.

We have no comment to make on this question as it is really one that needs to be answered by the affected firms.

Q18: Are there any other solutions you believe we should consider?

As noted in our response to question 16, we believe it important to retain our own rules so that all members continue to be required to meet the same high standards of transparency. However, if the FSA is keen to adopt its own requirements, a viable route forward to deliver sufficient transparency and protect market integrity would be a blend of options 1 and 2, combining FSA and MTF rules.

Q19: We outlined two broad approaches to ensure that there are orderly secondary markets in MTF shares and there is a suitable framework to deter and detect market abuse. Which of the two options expressed do you support and why?

We would support option 1: as the FSA notes, this largely maintains the existing practice with respect to monitoring for market abuse. However, the FSA states in paragraph 4.38 that it would take “a more active role in monitoring the wider market, including the OTC space”. Further clarity is required as to what this would mean in practice, particularly given the risk of trading shifting into OTC space, where it is unclear who would adopt the role of monitoring for abusive behaviour.

Q20: Are there any other solutions you think we should consider?

As noted in our response to question 19, some solution needs to be developed for the identification of market abuse in OTC space. Hence the importance of the FSA clarifying the “more active role” it envisages for itself.

Q21: Do you think that we should initiate a project to investigate the cost and benefit of the FSA undertaking full responsibility for real-time market monitoring of secondary trading across the whole market over the medium term?

No - we believe sufficient work has been done in the past with respect to this to conclude that the FSA undertaking full responsibility for real-time market monitoring would not be feasible.