



**London**  
Stock Exchange

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5 November 2008

**For the attention of the  
chairman/senior partner/compliance officer,  
all member firms**

**N35/08**

## **STOCK EXCHANGE NOTICE**

### **SECOND CONSULTATION ON RULE CHANGES RELATING TO MEMBER AUTHORISED CONNECTIONS**

#### **Introduction**

1. The Exchange issued Stock Exchange Notice N05/08 in May of this year to consult on changes to the Rules of the London Stock Exchange (“the rules”) to govern member firms providing customers with direct technical connections to TradElect<sup>®</sup>, known as “member authorised connections” or “MAC”. The responses to the consultation were extremely informative and the Exchange would like to thank those parties who responded.
2. In light of the responses and subsequent dialogue with the Financial Services Authority (“FSA”), the Exchange has amended some aspects of the proposed new rules and guidance relating to member authorised connection. The Exchange understands the FSA will be providing its public view on MAC-style connectivity models in the near future.
3. Attachments 1 and 2 set out the proposed revisions in tracked and untracked form. Attachment 3 sets out the revised due diligence declaration the Exchange would require from member firms wishing to provide a customer with a member authorised connection.

#### **Significant changes to the rules**

4. The most significant changes from the previous consultation are summarised below.

#### Member firms’ MAC customers

5. The Exchange has amended the definition of member authorised connection to make clear that only non-member firms will be allowed to become MAC customers. In addition, member firms should be aware that only the legal entity named as the customer in its declaration of due diligence will be permitted to use a MAC connection to submit orders to TradElect<sup>®</sup>. Should other companies within the customer's group wish to connect directly to TradElect<sup>®</sup> a separate request should be submitted by the relevant member firm following appropriate due diligence.

#### Controls over MAC customers' order flow

6. Some member firms asked for further information on how they should apply order entry controls to MAC order flow. Whilst the Exchange views it as the responsibility of the member firm to judge how best to control customers' order flow, some additional information has been included in the revised guidance. The Exchange has noted, for instance, that it is aware of independent software vendors ("ISVs") that have indicated that they can assist member firms in this regard. Whilst the Exchange cannot recommend particular service providers, it will be publishing a list of such ISVs on its website. In addition, guidance has been added to note that member firms may install a dedicated order management system to control MAC order flow at the Exchange's Primary Data Centre (under a 'hosted' solution).

#### Due diligence

7. In response to member firms' requests, the Exchange has expanded the guidance on due diligence for MAC. Some member firms asked which individuals at a prospective MAC customer should have an understanding of the Exchange's rules and be judged to have adequate knowledge and experience to be provided with a member authorised connection. This is for a member firm to judge but the Exchange has suggested in the revised guidance that the head of trading, the head of compliance and those responsible for signing off trading algorithms should be included.
8. The Exchange has also amended the requirement regarding member firms' statements of due diligence. As part of submitting a due diligence declaration, member firms will now need to include a systems diagram showing how the MAC customer will connect to the Exchange and where within this connection the member firm's controls will reside. In addition, firms must provide the Exchange with a clear and concise explanation of how the controls will operate and the Exchange will subsequently visit the member firm to discuss those controls and the firm's due diligence. This process is aimed at giving the Exchange sufficient comfort regarding the overall adequacy of the member firms' controls. The Exchange will not provide formal endorsement of the controls or due diligence but will exercise its right to refuse a member authorised connection if it believes the steps the member firm has taken are insufficient.
9. In addition to the above points, the Exchange has acknowledged in the guidance that a member firm may be able to judge the suitability of a customer

to have a member authorised connection by carrying out an assessment within its existing due diligence framework. It is for member firms to decide whether their existing due diligence frameworks are sufficient or whether MAC-specific due diligence processes need to be introduced.

#### Use of customer information

10. The Exchange is conscious that some member firms had concerns about providing information on their prospective MAC customers to the Exchange. The Exchange has therefore added guidance to make clear that this information is required only for regulatory purposes and will not be put to commercial use.

#### **Other issues arising from responses**

11. One member firm asked whether the provision of a member authorised connection to a customer was compatible with best execution requirements. Whilst it is for member firms to assess the regulatory implications of providing customers with such connectivity, the Exchange is of the view that MAC and best execution are compatible given customers of authorised firms have the right to specify on which venue they want their trades executed.
12. The Exchange was also asked how transaction reporting would operate for trades executed via a member authorised connection. Transaction reporting should be handled by member firms through their usual arrangements and the Exchange will provide member firms with the standard confirm messages when a trade takes place (be it via MAC or otherwise). The Exchange will not be changing its own transaction reporting service on account of the introduction of MAC.
13. Finally, some member firms asked whether their MAC controls would be subject to Exchange conformance testing. Conformance testing focuses on whether a member firm's systems are compatible with the Exchange's systems. It does not extend to testing whether the controls within the member firm's systems are appropriate to meet the requirement of the rules, given its trading profile, and customer order flow, and the Exchange will not be changing the scope of its conformance testing with regard to this.

#### **Rules consultation**

14. The Exchange is consulting on the rules changes set out in the Attachment for a period of four weeks. Reviewers are therefore asked to provide any comments or feedback on this consultation by 3 December 2008.
15. Any comments or queries on this Notice should be addressed to Tim Rowe, Trading Services, telephone +44 20 7797 3468 (STX 33468) email: [trowe@londonstockexchange.com](mailto:trowe@londonstockexchange.com).

Nick Bayley  
Head of Trading Services

This Stock Exchange Notice will be available on the website at  
<http://www.londonstockexchange.com/en-gb/products/membershiptrading/rulesreg/stockexnotices/stockexchangenotices2008.htm>

Calls to London Stock Exchange plc may be recorded to enable the Exchange to carry out its regulatory responsibilities.