

Narrowing the spread activity – what members may wish to think about



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i. Background

Under the London Stock Exchange's ("the Exchange") Rules, it is prohibited to "do, or attempt, any act or engage in any course of conduct, which constitutes or is likely to constitute market abuse under UK MAR" – Rule 1400.4.

The Exchange is not a competent authority and does not offer advice on MAR/UK MAR, however, where a particular risk type has come to the Exchange's attention, it would like to share that risk type with member firms, so that they may consider it when designing and developing their market abuse control framework.

The Exchange has been reviewing member firms' controls with respect to a specific type of activity, colloquially known as "narrowing the spread". This refers to a scenario where small order(s) are placed that substantially narrow the bid-offer spread to either to the buy or sell side; this has the impact of moving the Exchange mid-price up or down respectively.

Guidance to Rule 1400 of the Exchange's Rules highlights that:

"A member firm submitting an order to the trading system is responsible for that order under the above Rule. This applies whether the order is submitted by the member firm itself or has been automatically routed from a third party (whether another member firm or not).

Certain trading practices that exploit the commitment given by firms that act as RSPs are considered to be detrimental to the fairness and integrity of the Exchange's markets and should be discouraged. For example, an order is entered onto the order book with the intention of creating a new best

price, away from generally accepted trading levels, for the principle purpose of executing a larger order against an RSP by virtue of the RSP's previous commitment to deal on the basis of the current best order book price.

...

Where a firm deals in a manner similar to that described above (regarding the commitment given by firms that act as RSPs) on behalf of a customer, the firm will not be in breach of the Exchange's rules per se. However, although the Exchange's rules do not specifically require a firm to establish the motives behind a customer's trade, if the Exchange becomes aware that a firm is knowingly engaging in such a trading strategy on behalf of a customer, the Exchange will conduct an investigation and consider whether disciplinary action or a referral to another regulatory body is appropriate."

Whilst the Guidance refers to RSP liquidity, activity being undertaken to entice preferential pricing on alternative venues or other off book trading mechanisms is relevant for the purposes of this note.

ii. Narrowing the spread – a walkthrough

a. Step 1: on-book – narrowing the spread

As an example, a small buy order for 5 shares is entered on-book at a price of 10.5 (moving the book from 9-11 to 10.5-11). The mid-price now moves from 10 to 10.75.

b. Step 2: off-book – trading in larger size in contra direction

The Activity would potentially allow the market participant to execute trades with OTC brokers (including leveraged products) using the mid-price of securities listed on Exchange as a reference price. Using the same example in step (a), that same participant now can sell the equivalent of 20,000 shares via a contract for difference ("CFD") at 10.75.

c. Step 3: market reversion

Once the larger sell trade(s) have been undertaken, the small orders that remain on the Exchange order book can now be cancelled. On occasion, the small orders will go on to trade as they are traded against aggressively by a separate participant. Simply because these small orders have gone on to trade does not necessarily mean that they cannot be manipulative, in the context of the risk position being taken on-book versus the amount of risk potentially being taken away from the Exchange.

d. Step 4: repeat in other direction

Utilising the same example, a small sell order for 5 shares is now entered on-book at a price of 9.5 (moving the book from 9-11 to 9-9.5). The mid-price now moves from 10 to 9.25. The same participant now buys (and closes) the equivalent of 20,000 shares via a CFD at 9.25. The 5-share order is then deleted. Assuming these prices are in GBX (pence), the CFD trading outlined would realise a profit of £300.

The below "Graphic 1" denotes how the Activity can look on a spread graph if it repeats back and forth for a longer period, and by doing so could substantially increase the associated off-book profits.



Graphic 1 shows approximately a 15 minute time frame along the x-axis. Price is represented by the y-axis. The blue area reflects the best bid in the market, the red area reflects best offer. The yellow line reflects the mid-price.

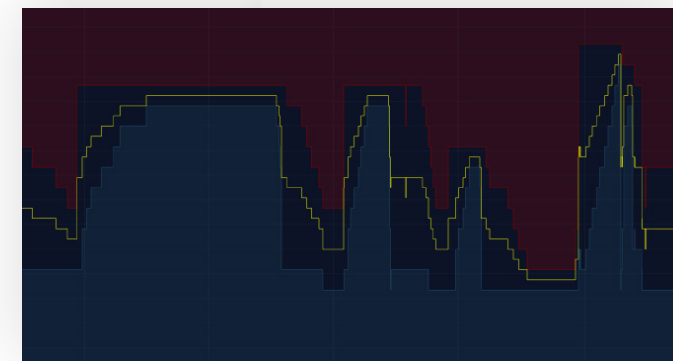
iii. On-book Activity – members' controls

Whilst the Exchange operates a Minimum Quantity at Touch functionality in selected sectors of non-FTSE350 equity securities on SETS, whereby an incoming passive order must be at least 40% of the security's Exchange Market Size (EMS) to set a revised Best Bid/Offer (BBO), firms who have not already done so may wish to design specific post-trade controls to identify this type of Activity. Members have on occasion pointed out that it can be difficult for them to distinguish legitimate small order activity from the Activity.

Below is a practitioner's perspective that members may consider in the design of their control framework for helping identify the on-book Activity. Firms should take their own steps and advice to ensure that they comply with MAR/UK MAR.

- The more significantly the spread is narrowed, the higher the off-book profit can be. Looking at instances where the spread is narrowed by a minimum of 50% may help identify potentially material instances of the Activity.
- The on-book order size will likely be a fraction of other on-book orders in that security. Whilst the following does not have to be the case for the Activity to be profitable, one member noted to us that a transaction could raise concerns: *"If the cost to execute is more than the value of the orders, therefore there being no economic rationale for the order, or trade if it executes."*
- To undertake the Activity, the spread can be narrowed in different ways:
 - a. One small order which is fully responsible for narrowing the spread (see Graphic 1);
 - b. Multiple small orders which are placed at increasing (bid) or decreasing (offer) levels, which have the overall effect of narrowing the spread more tightly with each small order; or
 - c. Order amendments, whereby the order is amended to increasing (bid) or decreasing (offer) levels which leads to the overall effect of more tightly narrowing the spread.

The spread for conditions b. and c. may look something as follows ("Graphic 2") on a Price/Time graph, where you can see bids and offers being entered or amended to higher (bid) or lower (offer) levels:



Graphic 2 shows approximately a 20-minute time frame along the x-axis. Price is represented by the y-axis. The blue area reflects the best bid in the market, the red area reflects best offer. The yellow line reflects the mid-price.

- The end investor undertaking this Activity on-book may have limited trading history in the same security previously.
- Securities that have a relatively wide and stable spread are most helpful to the Activity being successful. This is because there is less anticipated market risk for the end investor, i.e. there is less possibility that the market moves significantly when they are long or short the CFD.



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