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Dear Brian,

Consultation on market structure and trading hours

We welcome the opportunity to respond to your consultation on market structure and trading hours.

The Quoted Companies Alliance *Secondary Markets Expert Group* has examined the proposals and advised on this response from the viewpoint of small and mid-size quoted companies. A list of Expert Group members can be found in Appendix A.

Overall, and whilst we see some merit in changes to market structure, such as a reduction in trading hours improving diversity and wellbeing, we are mindful of the potential adverse impact that this may have on liquidity for small and mid-size quoted companies. In addition, the QCA and its members are very concerned about the potential impact of CSDR on smaller companies. We are encouraged that London Stock Exchange is exploring this and we have been engaging with the relevant UK policy and regulatory bodies to identify measures that could mitigate the negative impact (outlined below).

If you would like to discuss our response in more detail, we would be happy to attend a meeting.

Yours sincerely,

Tim Ward
Chief Executive

Q1 Figure 2 in the 'Appendix' section of this document provides details of the opening hours based on continuous trading hours across several global exchanges:

a) Equity markets in Europe are open for 8.5 hours, whereas most other global financial centres are open between 5-6.5 hours. Do you consider the longer hours in Europe a benefit to liquidity?

No – we do not believe that the longer trading hours in Europe are a benefit to liquidity.

b) Alternatively, would the concentration of trading hours increase turnover and liquidity? (please cite, where possible, any studies or academic research).

We do not believe that shorter trading hours would inevitably increase the demand for any securities. However, compressing the demand into a shorter time period might improve the quality of price discovery.

Q2 Europe has the geographic advantage of "bridging" between Asian and North American markets. Figure 3 in the 'Appendix' section of this document shows how global equity liquidity is skewed towards the open and close of European trading hours. Would a reduction of trading hours reduce the interest of non-European investors in trading European equities?

As stated above in our answer to Q1b, we do not believe that shorter hours would affect the absolute level of demand for European securities.

Q3 What would be the anticipated impact for corporate issuers on European markets of adjusted trading hours?

The impact for corporate issuers on European markets of adjusted trading hours would be minor. There may potentially be some benefit when making announcements prior to market opening.

Q4 What would the implications be for equity options and futures markets if equity trading hours were shortened?

We have no comments.

Q5 Would shortened trading hours impact the participation of retail investors in the market?

Yes – we believe that shortened trading hours would impact the participation of retail investors in the market negatively. As most retail participants have other commitments throughout the working day, a reduction in trading hours would likely have a negative impact on their ability to access the market.

The implications of this of this on smaller companies, and in particular those on AIM and the NEX Exchange, could be significant. A recent study by Hardman & Co and Argus Vickers supports this[1]. The study found that UK retail investors hold around a third of AIM shares (29 per cent) and hold as much as 87 per cent of NEX shares. Accordingly, this has the potential to have a detrimental impact on the liquidity of smaller companies if there is a reduction in UK retail investors participating in the market, and in particular in less liquid stocks.

[1] Hardman & Co and Argus Vickers, January 2020, Share Ownership: For the many, not the few?, https://www.hardmanandco.com/wp-content/uploads/2020/01/Hardman-Co-Monthly-January-2020.pdf

Q6 Are there any other implications that might need to be considered when shortening market hours? (timing of Exchange Delivery Settlement Price (EDSP) auctions, impact on benchmarks, etc).

We have no comments.

Q7 Finally, considering the proposals outlined above, what would you consider to be the best choice in terms of market hours? Please answer by stating one only of A, B, C, D, or E, supporting the answer with your views.

We recognise that the proposal to change market hours with a view to improving culture and diversity is admirable and is something that the QCA and members of its Secondary Markets Expert Group would support. However, we have concerns that shortened hours could result in reduced liquidity in smaller company stocks (for reasons outlined in our answer to Q5).

If there is a risk that shortening trading hours will negatively impact liquidity, then the QCA would recommend maintaining the current hours. If it is decided to change the hours, we would suggest that an impact assessment be done first that pays particular attention to the impact on smaller companies that are already suffering from a lack of liquidity. Making changes under a pilot program may also be valid in order to examine the impact whilst retaining the ability to reverse if any unintended consequences emerge.

Q8 Prior to this consultation paper, were you aware of the auctions available for small cap securities available on SETSqx?

Yes.

Q9 Do you agree that a reduction in the number of auctions on SETSqx could provide more focused liquidity?

Yes – we believe that a reduction in the number of auctions on SETSqx could provide more focussed liquidity as spreads would become narrower.

Q10 If you agree with question 9, which of the current SETSqx auctions would you remove? (08:00, 09:00, 11:00, 14:00, 16:30). 08:00 and 09:00 are currently the auctions with the lowest liquidity.

We would remove 08:00 and 11:00 from the current SETSqx auctions. Having fewer auctions would help concentrate liquidity and improve price formation.

Q11 Please propose any other actions London Stock Exchange should consider in order to promote greater liquidity in SETSqx auctions.

In order to promote and increase liquidity in SETSqx auctions, we propose that the minimum volume requirement – currently set at 50 per cent of EMS – is removed, or at a minimum, reduced.

Q12 Are you aware of MQAT and the securities it applies to?

No.

Q13 In your experience, has MQAT fulfilled its purpose? Please provide comments/examples/explanation.

We have no comments.

Q14 Are there any other actions London Stock Exchange should consider which would promote greater liquidity for small cap securities on SETS?

We have no comments.

Q15 Are you concerned about the potential impact of CSDR on the liquidity of small cap securities? Please explain.

Yes – as we have stated publicly and discussed with the London Stock Exchange Group on a number of occasions, we are highly concerned about the potential impact of CSDR on the liquidity of small-cap securities. If implemented unchanged, its introduction is likely to have a significant impact on the ability of smaller quoted companies to raise capital, as well as on the functioning of capital markets for these companies in the UK.

Under the current model, market makers provide an essential function for smaller companies with less liquid securities as they provide liquidity when there is an imbalance between buyers and sellers. This model ensures the provision of continuous liquidity, investor confidence and access to capital markets for smaller companies.

However, CSDR threatens this model through the introduction of a fining regime which requires market participants to deliver securities by the intended settlement date or face penalties with an enforced and expensive buy-in process. These penalties will impact market makers to such an extent that making markets in less liquid securities becomes uneconomical. As a result, market makers are forced to widen spreads significantly or withdraw from making markets in a potentially significant number of illiquid securities. CSDR, therefore, will have severe implications on liquidity for smaller quoted companies, as well as leading to greater price volatility.

The prospect of reduced liquidity, higher price volatility and wider spreads are not only major disincentives for investors, but will also discourage companies seeking a listing, further increasing the decline in use of public equity markets.

Q16 If yes, have you engaged in any form of discussions with regulators on this topic? What feedback have you received?

Yes – we have engaged with HM Treasury, the Bank of England and the FCA on several occasions since 2012 to raise our concerns. Most recently, we have engaged with the regulators alongside members of our Secondary Markets Expert Group from Winterfloods, Peel Hunt, Shore Capital and finnCap. In doing so, we held a roundtable with the regulators and gave detailed briefings on the potential impact of CSDR on market liquidity and the consequential impact of less liquid quoted companies, as well as set up workshops for the regulators in order for them to better understand the role of market makers and how CSDR will affect smaller quoted companies and their own business models. Following these engagements, we submitted a paper in conjunction with Charles Russell Speechlys to the regulators setting out the issues in detail, as well as outlining potential legal and market-led solutions. The paper is under discussion with the regulators.

At present, the regulators have acknowledged our concerns on the impact on liquidity for smaller quoted companies, but they have not yet proposed any solutions.

Q17 What actions might be considered to help address a potential impact to liquidity? What can London Stock Exchange do to help? For example: support improved securities lending, work with CSDs to improve auto-borrow facilities, etc.

We have the following points to raise regarding actions that might be considered to help address a potential impact to liquidity:

Market-led solutions

We believe that the UK should take the opportunity provided by Brexit to amend CSDR so as to:

- Provide that the failure penalties will not apply in the context of SME/illiquid shares;
- Provide a lighter-touch version of the failure penalties for market markers making markets in SME/illiquid shares (i.e. with some removed or lessened);
- Make buy-ins optional in the case of SME/illiquid shares; or
- Provide bespoke Settlement Obligations with much longer deadlines.

Alternative solutions

- As Article 7(7) of CSDR states that "if the buy-in fails or is not possible, the receiving participant can choose to be paid cash compensation or to defer the execution of the buy-in to an appropriate later date", participants could agree at the beginning of the process that, should a buy-in fail, the receiving participant will defer the execution of the buy-in rather than receive cash compensation.
- As the buy-in process does not preclude the possibility of the counterparties to a transaction bilaterally agreeing to cancel the transaction, it may be possible for market markers to introduce provisions into the contracts with their clients saying that the parties agree that transactions will be terminated before any breach of the Settlement Obligation.
- There could be a choice for markets makers' counterparties to opt out of the failure penalties.

We have the following points to raise regarding actions that London Stock Exchange (LSE) can do to help address a potential impact to liquidity:

- The LSE could consider introducing compulsory stock-lending, so that CSDR-regulated late settlements would be replaced by LSE-regulated securities loans. If each UK market introduced a compulsory stock lending system whereby the relevant market administered a central stock lending facility through which participants (including market makers) could borrow stocks at reasonable rates then market makers would be able to borrow the relevant shares and deliver them to the relevant participant in order to satisfy the Settlement Obligation.

Q18 Finally, the introduction of MiFID II caused concerns for the quantity and quality of research on small cap securities because of changes in the rules for payment of research. Do you think this has been the case? And has this had an impact on liquidity?

Yes – we believe that since its introduction, MiFID II has exacerbated the reduction in both the quantity and quality of research on small-cap securities. As a result, we believe this has had an adverse impact on liquidity within small-cap securities.

As a general comment, we note that independent research on small and mid-size quoted companies is essential for increasing their visibility and stimulating trading in their shares. Research eases price discovery and enhances liquidity, which in turn reduces the cost of capital for companies and encourages and enables their growth.

MiFID II has undoubtedly further reduced the amount of research on small-cap securities. The percentage of investors that believe that MiFID II has had a negative impact on liquidity for small and mid-cap stocks has grown from 54 per cent in 2017, to 63 per cent in 2018 and reached 79 per cent in 2019[2]. Less research and fewer brokers participating in the small-cap company segment of the market has led to lower liquidity, greater share price volatility and higher bid-offer spreads. This has resulted in increased costs associated with raising finance coupled with reduced institutional access. It is often the case that smaller companies are only covered by their own broker, and in some cases, the research that they pay for. The results of the QCA/Peel Hunt *Mid and Small Cap Survey* exemplify this point, with 54 per cent of the companies surveyed having either one broker or no broker at all[3].

Q19 Are there any actions London Stock Exchange could take to improve liquidity in the Intraday Auction, such as bringing the uncross time forward to 12:00 to facilitate the use of this time as a "strike price" for benchmarking purposes?

We have no comments.

Q20 Does the Intraday Auction provide a useful liquidity event for small cap or less liquid securities?

No.

Q21 Should London Stock Exchange discontinue the Intraday Auction altogether?

Yes.

Q22 Currently, during all other auctions, London Stock Exchange publishes both Level 1 (top of book) and Level 2 (full order depth) data, whereas only Level 1 data is provided during the Intraday Auction. Which Level of data do you feel is most appropriate for auctions? a) Level 1 or b) Level 1 and 2? Please provide explanation for your choice.

We believe that b) Level 1 and 2 is the most appropriate for auctions. The provision of additional information is useful as it improves the quality and effectiveness of decision making and therefore price formation as well.

[2] Quoted Companies Alliance and Peel Hunt, 2020, Mid and Small Cap Survey, https://www.theqca.com/article_assets/articledir_395/197511/To%20Be%20or%20Not%20To%20Be_QCA%20PeelHunt%20Survey%20Booklet%202020.pdf

[3] Ibid.

Appendix A

The Quoted Companies Alliance *Secondary Markets Expert Group*

Jon Gerty (Chair)	Peel Hunt LLP
Mark Tubby (Deputy Chair)	finCapp PLC
John Beresford-Peirse	Hybridan LLP
Jasper Berry	W.H. Ireland PLC
Andrew Collins	Charles Russell Speechlys LLP
Miles Cox	Hybridan LLP
Sunil Dhall	Peel Hunt LLP
Nick Dilworth	Winterflood Securities Ltd
Fraser Elms	Herald Investment Management Ltd
William Garner	Charles Russell Speechlys
Mitchell Gibb	Stifel
Keith Hiscock	Hardman & Co.
James Lynch	Downing LLP
Jeremy Phillips	CMS
Jack Phillips	Cenkos Securities Plc
Katie Potts	Herald Investment Management
Simon Rafferty	Winterflood Securities Ltd
James Stapleton	Winterflood Securities Ltd
Stephen Streater	Blackbird PLC
Peter Swabey	ICSA