DMO PROPOSALS ON THE STRUCTURE OF THE SECONDARY MARKET FOR GILTS

PROGRESS REPORT 2: SEPTEMBER 2001

Introduction

On 23 June 2000, the DMO published its response to its consultation paper on the structure of the secondary market for gilts, the 'response paper'; the original consultation paper was published on 24 January 2000. This was followed by further consultation with the GEMMs on various aspects of the proposed quote obligations; the scope and outcome of those consultations was outlined in the first progress report, published in August 2000. The key issue that remained unresolved at that time was the manner in which the intra-GEMM market would be delivered. In order to resolve this issue, a joint DMO/GEMMA e-trading working group was convened.

2. The remit of the working group was to investigate the various ways in which this market could be delivered and identify the optimal method for the market, minimising the risk of any possible fragmentation. This report describes the group's investigations and outlines its recommendation, which was accepted by the GEMMs on 17 September 2001.

3. The working group will continue to work towards implementation of the proposed changes as soon as possible. A date for full implementation of the mandatory quote obligations will be published once it has been identified.

Background

4. The issue of whether the market should be delivered over one designated platform, provided by one broker, or whether a GEMM could meet its obligation by providing a price on one of a number designated platforms provided by multiple brokers is complex. In the responses to the original consultation paper, some GEMMs indicated that using a single platform could be simpler and save on resource costs. For example, they would only have to build an interface with one system rather than, potentially, building an interface with many systems. Other GEMMs noted that using multiple platforms meant that there would be an alternative trading-venue available in the event of a system failure. This approach would also maintain competition in the provision of these trading systems, so that the GEMMs would not be locked into technology that might become redundant in the future. In the

response paper, published in June 2000, the DMO indicated a preference for the latter approach, if practicable, as it would avoid the creation of a monopoly supplier of electronic broking services.

The working group's recommendation

5. The working group initially identified three possible ways in which the market might be delivered. It explored these options with a number of interested parties. Briefly these three options were:

(a) to identify a central platform that would amalgamate all trading information onto one system, on which all the IDBs and all the GEMMs would participate. This would bring the benefits of just having one interface for the GEMMs to maintain but would also allow continuing competition amongst the IDBs;

(b) each GEMM would deal directly with each IDB, again preserving competition in the provision of broking services

and

(c) to identify just one IDB to which the GEMMs would supply their prices, thereby conferring a monopoly position on one broker.

These options were set out in an open invitation to potential system providers that was issued in September 2000. A fuller description of each approach is contained in the Annex to this paper.

6. Over the course of the following months the working group discussed these options with a number of interested parties. It reported back to the GEMMs on the progress of these discussions in January 2001 where the first option was identified as the preferred model, if it were possible to provide it at a reasonable cost.

7. The working group then held further discussions with a number of parties to allow it to identify the costs involved in the provision of the first option more precisely.

8. On the basis of all the information and representations received, the group concluded that pursuing the first option would result either in fragmenting the market (with the possible loss of the IDBs), an outcome that this option was intended to avoid, and/or in unacceptably high costs, in light of the possible life-span of the system.

9. Therefore, the group recommended that the display and monitoring of mandatory quotes be directed to any recognised IDB (current or future), with GEMMs using, as necessary, existing aggregation applications (without further increasing costs), to manage the information flows.

10. Under this option, which is the second identified above, each GEMM would have the choice of sending their mandatory quotes to any of the recognised IDBs. This could be done directly or routed through an aggregator. As is the case now, all the GEMMs would have access to all the recognised IDBs and the prices displayed on their screens. Each GEMM would, if necessary, be independently responsible for finding an external aggregator or developing an in-house aggregator to deal with the information flows.

11. This solution preserves competition among the existing (and any future) IDBs. As all GEMMs will have access to all IDBs (and there is a continuing incentive for the IDBs to remain in the market), fragmentation should be avoided under this proposal. Neither should there be major expenditure required, either for the GEMMs or the DMO, in providing this solution.

Next steps

12. The precise specification of the quote obligations needs to be finalised. The DMO is preparing a proposal for discussion; this will be presented to the GEMMs in the near future.

13. Each GEMM will need to establish the ability to generate prices automatically (by building an Automatic Order Generator (AOG)) and establish the necessary communication links with at least one IDB. Many GEMMs already supply prices from an AOG to other European fixed income electronic trading systems; it will hopefully be straightforward to modify these processes for the gilts market. Similarly, many of the GEMMs already have the necessary links to some of the existing IDBs in place.

14. The DMO will also need to discuss and finalise its reporting requirements with the IDBs, who will report on behalf of the GEMMs, to ensure effective monitoring of the obligations once they have been introduced.

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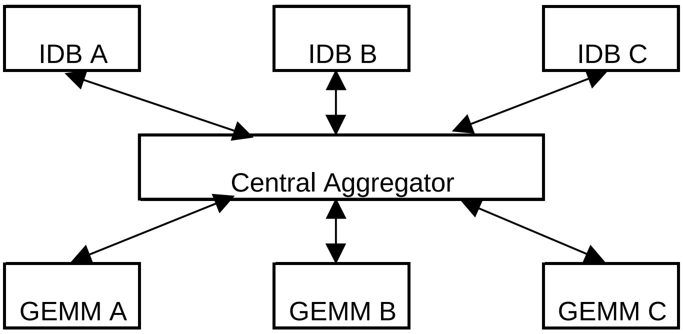
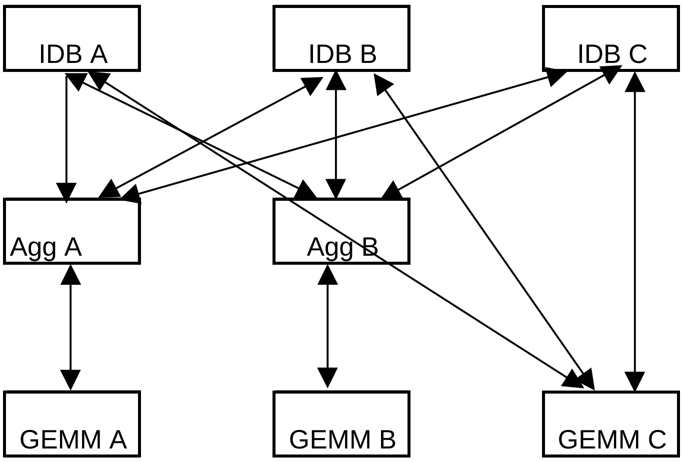
Annex: Platform provision – the options

Option (a)



Under this option, each GEMM would input trades directly to the central platform or call an IDB to do so on their behalf. Every trade entered would be associated with one of the IDBs. Each IDB would receive information on all the trades associated with them – similar to the subset of information they receive today – allowing them to continue to offer a value-added service in broking “off-the-runs”, switches and other contingent trades. This requires that the central aggregator can interpret information where it is fed directly in through an automatic order generator and channel it back to the appropriate broker.

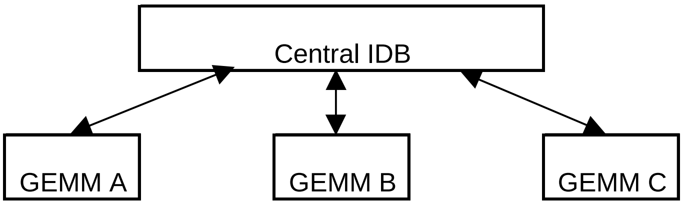
Option (b)



Under this option, each GEMM would have the choice of sending their mandatory quotes to any recognised IDB. This could be done directly or through an aggregator.

As is the case now, all the GEMMs would have access to all the recognised IDBs and the prices displayed on their screens. Each GEMM would, if necessary, be independently responsible for finding an external aggregator or developing an in-house aggregator to deal with the information flows.

Option (c)



Under this option, a single IDB would be granted a mandate to provide the service. All the GEMMs would provide all their mandatory quotes (and any other prices by choice) to this central broker.