November 30, 2017

MiFID II: Systematic Internalisers: Tick Sizes and Price Improvement

Bulletin 2

What has happened?

On November 9, 2017 ESMA launched a public consultation on proposed amendment to RTS 1 to clarify that Systematic Internalisers' (SI) quotes should reflect the price increments applicable to EU trading venues. Stakeholders are invited to provide feedback and submit their responses on the proposal by January 25, 2018.

In this note we shall look at past developments and the potential future impact of the proposed amendment.

SI Quoting Obligations

- Level 1 text on SI quotes: For liquid equity and equity like instruments traded on European trading venues (TOTV instruments), SIs are required to publish two way firm quotes on a regular and continuous basis during normal trading hours. SIs may choose the size(s) at which they wish to quote provided the minimum quote size is at least 10% of Standard Market Size (SMS) and the maximum quote size is 100% of SMS. For illiquid instruments, SIs are required to disclose their quotes to clients on request.[1]

  SIs are allowed to update their quotes at any time provided it is consistent with the firm's intention to trade with its clients. Price improvement where prices better than the published quotes are provided to clients is permissible in "*justified cases*" so long the improved price falls in a close range to "prevailing market conditions" or within SI's spread.[2]

- Level 2 text on SI quotes: Article 10, RTS 1 requires that SI quotes should reflect "prevailing market conditions" referencing the most relevant market in terms of liquidity (reference market). Reflecting "*prevailing market conditions*" means that SI quotes should be close in price, at the time of publication to quotes of equivalent sizes for the same financial instrument on the reference market.

Legislation does not constrain SI quotes to adhere to the tick size regime. It only requires SI quotes

[1] Article 14(3), MiFIR.
[2] Article 15(2), MiFIR.

to reflect “prevailing market conditions” with respect to the reference market.

FESE’s Submissions

The debate about subjecting SI quotes to the tick size regime started as early as 2014 when the Federation of European Securities Exchanges (FESE) responded to ESMA consultation on Level 1 MiFIR provisions. In their response, FESE urged ESMA to make SI quotes subject to the harmonised tick size regime, asserting that it was required to ensure a *“level playing field”* for trading venues and SIs. FESE observed that if SIs’ quotes are not required to comply with the tick size regime, their clients could receive quotes which are only a fraction of the tick better than available on the reference market. They concluded that this ability to offer marginally better prices compared to those available on trading venues without incurring the costs of concluding that transaction on the venue, would make SIs the preferred destination for SORs and they claim that this would damage the market structure. Relevant extracts from FESE’s response are quoted below:

“We are also concerned that SIs will be able to execute at any price that means that they are not in line with the harmonized tick size and they may price improve over bid and offer prices posted on regulated markets and MTFs at virtually no cost because also their quotes do not need to meet the minimum tick size. We therefore suggest that applying a harmonized tick size regime to SIs to ensure a level playing field between RMs, MTFs and SIs.”

ESMA Q&A on Price Improvement

To address the concerns of market operators, ESMA issued a Q&A[3] on October 3, 2017 to clarify the meaning of “*justified cases*” in the context of price improvement[4]. ESMA stated that it considers price improvements “*justified*” only if such improvements aid efficient valuation of instruments and maximise benefit for the end clients/investors[5]. In this context, *“ESMA notes that marginal price improvements on quoted prices would challenge the efficient valuation of equity instruments without bringing any real benefits to investors.”*

On this basis, their view is that price improvements are only justified where they are meaningful and <u>reflect the minimum tick size</u>. It is not explicit what “reflect the minimum tick size regime” means; but it is reasonable to believe that a price improvement must be at least 1 tick or at mid price. Relevant text quoted below:

As a consequence, and to ensure that price improvements do not undermine the efficient pricing of instruments traded, price improvements on quoted prices would only be justified when they are meaningful and reflect the minimum tick size applicable to the same financial instrument traded on a trading venue.”

ESMA also clarified that the requirement to reflect tick sizes is only applicable for quotes that SIs publish and it does not affect their ability to quote any price level when dealing in sizes above . Relevant extract of the Q&A below:

“This is without prejudice to SIs’ ability to quote any price level when dealing in sizes above standard market size.”

ESMA Consultation on Tick Sizes

Despite having issued the Q&A, ESMA has launched the consultation on further amendments just weeks before the MiFID II implementation date and reopened the wording of the Level 2 text to deliberation. ESMA proposes the following amendment to Article 10, RTS 1 (proposed changes in **bold**):

“The prices published by a systematic internaliser shall reflect prevailing market conditions where they are close in prices to quotes of equivalent sizes for the same financial instrument on the most relevant market in terms of

---

[3] Q 24, pg 50.
[4] *Ibid*, note 2.
[5] Article 17(3), MiFIR.

liquidity as determined in accordance with Article 4 for that financial instrument ***and where the price levels could be traded on a trading venue at the time of publication”***

An interesting point to note is that ESMA’s intention to apply tick size to SI quotes is not explicit in their proposed wording. ESMA does not reference Article 49, MiFID II or RTS 11 which introduces the harmonised tick size regime for trading venues; instead, ESMA seems to want SI quotes restricted to “*price levels that could be traded on a trading venue at the time of publication*”.

The current obligation on SIs is to publish quotes such that they ‘reflect’, but not necessarily ‘equal’ the prevailing prices on the reference market. The legislators’ intention to introduce the tick size regime for SI quotes could have been served better if the amendment allowed SIs to quote better prices only if the quoted price was at least one whole tick better than the price available on the reference market. Rather than propose such an alternative interpretation, the proposed amendment seems to confine SI quotes to only those prices that can be traded on any one trading venue at the time of quote publication. Insertion of the new wording, therefore, could be interpreted to potentially restrict SIs from offering prices better than the best price available on all trading venues considered together; or in other words, SIs could be precluded from quoting within European Best Bid and Offer (EBBO) even if the quoted price is one whole tick better.

ESMA on Scope of Tick Size Regime

Article 2, RTS 11 states that the tick size regime is applicable to orders submitted on a trading venue; but does not restrict the price levels, including quotes, at which those orders can be executed. ESMA reiterated this position in their Q&A on tick sizes, published on December 19, 2016:

[**Emphasis** Supplied]
“As the aim of the minimum tick size regime is to ensure the orderly functioning of the market, its application ***extends to all orders submitted to trading venues****…. However, since* ***the tick size regime applies to orders and not to the execution price of transactions, it is therefore possible for a transaction to take place at a price between two ticks****. This is the case if this price is derived from other prices that otherwise comply with the minimum tick size.”*

In order to accommodate the application of tick sizes to SI quotes, ESMA released a further Q&A on November 15, 2017, countering their previous position on this aspect. ESMA’s latest Q&A calls for understanding Article 2, RTS 11 in the “*broadest sense*” so as to facilitate the application of tick sizes to SI quotes. See the relevant extract of the Q&A below:

“Does the mandatory tick size regime apply to both orders and quotes?

Yes, the minimum tick size established under Article 49 of MiFID II and further specified in ***RTS 11 should apply to both orders and quotes.*** *This regime is meant to create a level playing field between the different trading venues and* ***the reference to “orders” in Article 2 of RTS 11 should not be interpreted as restricting the application of the tick size regime to only certain types of trading systems but, on the contrary, should be understood in the broadest sense.”***

Open Questions

- Transactions on a trading venue can be concluded at a sub tick level, e.g. mid-price. Does that mean that where the spread is one tick, SIs have the ability to quote the mid-price if circumstances justify a mid-price execution?

- Does the indirect application of the tick size regime and reference to “a trading venue” rather than “the most relevant market in terms of liquidity” suggest that rather than quotes being constrained by the tick size table, the application of the new text may prevent SI quotes inside EBBO even when the improvement is one whole tick?

Deutsche Bank
Global Equities

Global Market Structure- EMEA

Stephen McGoldrick
stephen.mcgoldrick@db.com
+44(20)754-75552

Gargi Purandare
gargi.purandare@db.com
+44(20)754-70168

Previously published documents in the MiFID II Equity Series:

- Directory of Documents
- An Overview of MiFID II
- Topic 1, Update 1, MiFID II – Trade and Transaction Reporting
- Topic 2, Update 1, MiFID II – Trading Obligation and Matched Principal Trading
- Topic 3 MiFID II – Best Execution
- Topic 4, Update 1, MiFID II – Direct Electronic Access, Algorithmic Trading and Self-Assessment
- Topic 5, Update 1, MiFID II – Research Unbundling
- Topic 6, Update 1, MiFID II – Impact on Non Equities
- Topic 7, MiFID II – Extraterritoriality
- Briefing Note – Transparency for Equity Derivatives
- Briefing Note – Changing Landscape of Equity Trading
- Briefing Note – Amendment to Definition of SI and Industry Response to EC Consultation
- Briefing Note – Trading Capacities under MiFID II
- Bulletin 1: Share Trading Obligation

Disclaimer

Quantitative models, processes and parameters are subject to amendment, modification, adjustment and correction at Deutsche Bank's discretion, and may incorporate Deutsche Bank's qualitative judgment. Deutsche Bank will from time-to-time run or update such models at its discretion. Clients are responsible for making their own determination as to the suitability and appropriateness of such models for their investment objectives.

This document is intended for information purposes only and does not create any legally binding obligations on the part of Deutsche Bank AG and/or its affiliates ("DB"). Without limitation, this document does not constitute an offer, an invitation to offer or a recommendation to enter into any transaction. It does not constitute a recommendation or endorsement by DB of any investment, trading strategy or algorithm and should not be relied upon by you to make a determination as to whether or not to invest or to use any strategy or algorithm.

When making an investment decision, you should rely solely on any specific final documentation relating to a transaction and not the summary contained herein. DB is not acting as your legal, financial, tax or accounting adviser or in any other fiduciary capacity with respect to any proposed transaction mentioned herein. This document does not constitute the provision of investment advice and is not intended to do so, but is intended to be general information. Any product(s) or proposed transaction(s) mentioned herein may not be appropriate for all investors and before entering into any transaction you should take steps to ensure that you fully understand the transaction and have made an independent assessment of the appropriateness of the transaction in the light of your own objectives, needs and circumstances, including the possible risks and benefits of entering into such transaction. For general information regarding the nature and risks of the proposed transaction and types of financial instruments please go to www.globalmarkets.db.com/riskdisclosures. YOU SHOULD ALSO CONSIDER SEEKING ADVICE FROM YOUR OWN ADVISERS IN MAKING ANY ASSESSMENT ON THE BASIS OF THIS DOCUMENT. If you decide to enter into a transaction with DB, you do so in reliance on your own judgment. The information contained in this document is based on material we believe to be reliable; however, we do not represent that it is accurate, current, complete, or error free. Assumptions, estimates and opinions contained in this document constitute our judgment as of the date of the document and are subject to change without notice. Any projections are based on a number of assumptions as to market conditions and there can be no guarantee that any projected results will be achieved. Past performance does not guarantee or predict future results. This material was prepared by a Sales or Trading function within DB, and was not produced, reviewed or edited by the Research Department. Any opinions expressed herein may differ from the opinions expressed by other DB departments including the Research Department. Sales and Trading functions are subject to additional potential conflicts of interest which the Research Department does not face. DB may engage in transactions in a manner inconsistent with the views discussed herein. DB trades or may trade as principal in the instruments (or related derivatives), and may have proprietary positions in the instruments (or related derivatives) discussed herein. DB may make a market in the instruments (or related derivatives) discussed herein. Sales and Trading personnel are compensated in part based on the volume of transactions effected by them. DB seeks to transact business on an arm's length basis with sophisticated investors capable of independently evaluating the merits and risks of each transaction, with investors who make their own decisions regarding those transactions. The distribution of this document and availability of these products and services in certain jurisdictions may be restricted by law. You may not distribute this document, in whole or in part, without our express written permission. DB SPECIFICALLY DISCLAIMS ALL LIABILITY FOR ANY DIRECT, INDIRECT, CONSEQUENTIAL OR OTHER LOSSES OR DAMAGES INCLUDING LOSS OF PROFITS INCURRED BY YOU OR ANY THIRD PARTY THAT MAY ARISE FROM ANY RELIANCE ON THIS DOCUMENT OR FOR THE RELIABILITY, ACCURACY, COMPLETENESS OR TIMELINESS THEREOF.

Deutsche Bank AG ("the Bank") is a joint stock corporation incorporated with limited liability in the Federal Republic of Germany. It is registered in the Commercial Register of the District Court, Frankfurt am Main under number HRB 30 000.

The Bank is authorized under German Banking Law (competent authorities: European Central Bank and the BaFin, Germany's Federal Financial Supervisory Authority) and, in the United Kingdom, by the Prudential Regulation Authority. It is subject to supervision by the European Central Bank and by the BaFin, and is subject to limited regulation in the United Kingdom by the Financial Conduct Authority and the Prudential Regulation Authority. Details about the extent of the Bank's authorization and regulation by the Prudential Regulation Authority, and its regulation by the Financial Conduct Authority, are available from the Bank on request.

The Bank is registered as a foreign company in the register of companies for England and Wales (registration number FC007615).

Under its European Passport, the Bank carries on banking and investment services in the United Kingdom through Deutsche Bank AG, London Branch ("London Branch") and is also authorized to provide such services into the United Kingdom from Germany and from its other EEA branches.

Deutsche Bank AG, London Branch is registered as a branch in the register of companies for England and Wales (registration number BR000005). Its registered address is Winchester House, 1 Great Winchester Street, London EC2N 2DB.

In addition to its above authorisations, the Bank is authorised by the Financial Conduct Authority to carry on investment services in precious metals.

London Branch is listed as a member firm of the London Stock Exchange.