

Global Market Structure – Europe

Execution Excellence

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MiFID II: What is new for Systematic Internalisers? Trading Obligation and Matched Principal Trading Topic 2, Update 1

Newly inserted text is underlined.

Recent [Q&A](#) published by ESMA on the ability of Systematic Internalisers (SI) to conduct riskless trading and whether such actions constitute ‘venue like behaviour’; have once again put Systematic Internalisation at the forefront of sell side firms’ MiFID II programs. Regulators’ increased oversight of SI activity is no longer limited to Matched Principal Trading (MPT), as other back-to-back riskless trading is also under the scanner.

You will recall that we pointed out the interpretational fallacy in attempting to classify MPT as ‘multilateral’ and ‘riskless’; and the impact of adopting such an interpretation on the scope of SI activity. The recently published ESMA Q&A clarifies a number of unsettled positions discussed earlier in our document on Topic 2. This document updates our earlier document on Topic 2 and reflects the current state of rules governing the SI regime.

What is a Systematic Internaliser (SI)?

- An SI is an investment firm which regularly deals on own account when executing client orders outside a trading venue (regulated market, MTF or OTF).
- SI is the capacity of an investment firm to execute orders in particular instruments and is not to be confused with trade enabling software or a trading venue.
- SI is required to publish two way firm quotes for liquid instruments for sizes up to standard market size (SMS). For illiquid instruments, quotes have to be disclosed upon request.
- Execution of client orders by SI is subject to legislative controls.

Is your firm an SI?

- A firm will become an SI in an instrument if its OTC trading is “*organised, frequent, systematic and substantial*”¹. For a relevant instrument, the legislation provides quantitative thresholds for assessing each of these criteria. “Substantial” is assessed by comparing the

¹ Article 4(1)(20), MiFID II.



- firm's volume to total EU trade volume.
- Calculations to establish whether a firm is an SI in each instrument will need to be performed at the beginning of each quarter by reference to the previous 6 months data.
- Investment firms may register themselves as SI in instruments regardless of their OTC volumes.
- Deutsche Bank plans to register as SI for all EMEA equities trading.

Quantitative thresholds for equities²:

Criterion	Description	Equities
Frequent and Systematic Basis (Liquid Instruments)	<ul style="list-style-type: none"> - Number of OTC transactions carried out by it on own account during the last 6 months when executing client orders as a percentage of the total number of transactions in the relevant instrument executed in the Union on any trading venue or OTC during the same period - Minimum trading frequency of OTC transactions during the last 6 months carried out by it on own account when executing client orders in the relevant financial instrument 	$\geq 0.4\%$ and at least daily
Frequent and Systematic Basis (Illiquid Instruments)	Minimum trading frequency during the past 6 months for transactions on own account when executing client orders (on average)	At least daily
Substantial Basis: Threshold Criterion 1	Number of OTC trades by investment firm in a financial instrument on own account when executing client orders during the past 6 months as a percentage total volume in the same financial instrument executed by the investment firm on own account or on behalf of clients and executed on a trading venue or OTC	$\geq 15\%$
Substantial Basis: Threshold Criterion 2	Number of OTC trades by investment firm in a financial instrument on own account when executing client orders during the past 6 months as a percentage of total volume in the same financial instrument in the European Union, on a trading venue or OTC (in nominal amount)	$\geq 0.4\%$

Is it true that ESMA has announced a delay to the introduction of SI regime?

- ESMA in its [Q&A](#) provides timelines for publishing the data required to allow firms to perform assessments about their SI status.
- ESMA intends to publish total EU data for the first time by August 1, 2018 for the period between January 3, 2018 and June 30, 2018 (6 months). Firms will need to perform their assessment on the basis of this data.
- For all subsequent assessments, ESMA will publish EU wide data within a month after the end of each quarterly assessment period. After quarterly data is published, firms will have 2 weeks to comply with the SI regime.
- Notwithstanding the timelines mentioned above, firms will still be able to register (opt-in) as SI in all instruments from January 3, 2018 as a means to comply with the trading obligation.
- Thus this is not so much a delay in implementation of SI rules as simply an acknowledgement of the fact that the calculations cannot be done until the data is available.

What is the Trading Obligation?

- Article 23 of MiFIR mandates that shares tradable on an EU trading venue may only be traded on regulated markets, MTFs, equivalent third country venues or by SIs.
- The regulation provides two exceptions to this rule: (i) if the trades are "non systematic, ad-

² Article 12, [Delegated Regulation](#).

- hoc, irregular and infrequent*³ or (ii) if the trades are carried out between eligible and/ or professional counterparties and do not contribute to the price discovery process.
- Level 2⁴ text provides an exhaustive list of trade types that will be considered not contributing to the price discovery process, including- (i) transactions executed by reference to volume weighted average price or time weighted average price, (ii) constituent transactions of a portfolio trade consisting of five or more different shares, (iii) securities financing transactions. Full list available in Appendix.

What is Matched Principal Trading (MPT)?

- MiFID II defines MPT as *“a transaction where the facilitator interposes itself between the buyer and the seller to the transaction in such a way that it is never exposed to market risk throughout the execution of the transaction, with both sides executed simultaneously, and where the transaction is concluded at a price where the facilitator makes no profit or loss, other than a previously disclosed commission, fee or charge for the transaction”*⁵.
- Any MPT will be subject to Trading Obligation. When conducted under the rules of an MTF or regulated market, they are likely to be executed as “on exchange, off order book” using Negotiated Trade waiver. However, this avenue may not always be available for MPT as Negotiated Trade waiver is subject to volume caps.
- By definition MPT is bilateral, thus implying that an SI is permitted to undertake MPT.
- This leaves systematic internalisation as the primary means of execution of MPT.
- ESMA has categorically stated that an SI may not undertake MPT on a non-occasional basis because it amounts to bringing together third party buying and selling interests – an activity that needs authorisation as a trading venue. Therefore, it would not be incorrect to assume that the authorities have accepted the notion that MPT by SIs is indeed ‘multilateral’ and ‘riskless’⁶. Why the regulators would allow SIs to undertake allegedly ‘multilateral’ activity even on an occasional basis is anybody’s guess.

Why were the policymakers concerned?

- Policymakers raised an issue at a potential loophole in the framework whereby high frequency market making firms could register as SIs which would then be interconnected in a network. Regulators were concerned that such arrangements would allow SIs to cross client orders via MPT or execute other back-to-back riskless transactions and operate in functionally the same way as a trading venue.
- Recital 19 of the Delegated Regulation briefly alluded to this possibility and warned SIs against acting as de-facto venues: “Pursuant to Directive 2014/65/EU, a systematic internaliser should not be allowed to bring together third party buying and selling interests in functionally the same way as a trading venue. A systematic internaliser should not consist of an internal matching system which executes client orders on a multilateral basis, an activity which requires authorisation as a multilateral trading facility (MTF). An internal matching system in this context is a system for matching client orders which results in the investment firm undertaking matched principal transactions on a regular and not occasional basis.”

³ Article 23(1), MiFIR.

⁴ Article 2, RTS 1, See Appendix.

⁵ Article 4(1)(38), MiFID II.

⁶ This is not a belief that we would necessarily agree with as brokers usually take on full counterparty risk for the life of each of the trades through to settlement and are exposed not just to counterparty but also operational risk plus, if either of their clients should default, then they would take on market risk.

- Broad policy direction is that SIs should not be “functionally similar to a trading venue” and should undertake MPT only on an “occasional basis”. The [Q&A](#) elaborates on what criteria ESMA will use to assess arrangements “functionally similar to a trading venue” and “occasional and not regular basis”.
- The EC in response to this issue, on June 20, 2017 launched a [consultation](#) to seek industry feedback on its proposed amendment to the definition of Systematic Internalisers. The (proposed) amendment restricts the scope of the phrase ‘dealing on own account’ to exclude de facto riskless back-to-back transactions in a financial instrument. Participants have time until July 18, 2017 (4 weeks) to respond to the consultation.

[What arrangements will be viewed as “venue like” by ESMA?](#)

ESMA is of the view that the following will be viewed as “venue like” activity by SIs:

- Arrangements that go beyond the bilateral interaction between the SI and a client aimed at ensuring that the SI de facto does not undertake risk facing transactions. This would include situations where an SI has agreements with other liquidity providers so that the SI could enter into a riskless back-to-back transaction with one of the liquidity providers whenever a transaction is executed with a client, or where it would only execute one transaction contingent on another one. Similarly, arrangements where liquidity providers stream quotes to SIs which could be forwarded by SIs to its clients to be executed against, resulting again in no risk back-to-back transactions which could involve multiple parties.
- Any arrangement, facility or system (including voice and electronic) which is designed to facilitate MPT on a regular basis, as opposed to ad-hoc transactions. ‘Systems’ will have a broad meaning to include arrangements underpinned by technological developments to increase speed and efficiency with legal agreements in place in between the SI and liquidity providers.
- Transactions arising from bringing together multiple third party buying and selling interests executed OTC outside the rules of a trading venue.

ESMA have also clarified that this does not preclude SIs from hedging the positions arising from the execution of client orders so long as they are not behaving as de-facto trading venues. SI activity will not be seen as multilateral where hedging transactions are executed on a trading venue.

[How will “occasional and non-regular basis” be assessed?](#)

An SI would be deemed to be not engaging in MPT on an occasional basis and non-regular basis if it meets any of the following:

- The investment firm operates a system (automated or not) intended to match opposite client orders or a system which is aimed at increasing opportunities for matching client orders. However, if the investment firm “accidentally” receive two opposite matching buying and selling interests, it may match them without being classified as a de-facto venue but it should not have systems in place aimed at increasing opportunities for client order matching;
- When executing client orders, non-risk facing activities accounts for a significant and recurring source of revenue for the investment firm; or
- It markets or promotes its MPT activities.

Global Market Structure- EMEA

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

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

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- [Topic 3 MiFID II](#) – Best Execution
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- [Topic 5 MiFID II](#) – Research Unbundling
- [Topic 6, Update 1 MiFID II](#) – Impact on Non-Equities
- [An Overview of MiFID II](#)
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Appendix

Transactions not contributing to the price discovery process- Article 2, RTS 1

A transaction in shares does not contribute to the price discovery process where any of the following circumstances apply:

- (a) the transaction is executed by reference to a price that is calculated over multiple time instances according to a given benchmark, including transactions executed by reference to a volume-weighted average price or a time-weighted average price;
- (b) the transaction is part of a portfolio trade;
- (c) the transaction is contingent on the purchase, sale, creation or redemption of a derivative contract or other financial instrument where all the components of the trade are to be executed only as a single lot;
- (d) the transaction is executed by a management company as defined in Article 2(1)(b) of Directive 2009/65/EC of the European Parliament and of the Council, or an alternative investment fund manager as defined in Article 4(1)(b) of Directive 2011/61/EU of the European Parliament and of the Council, which transfers the beneficial ownership of shares from one collective investment undertaking to another and where no investment firm is a party to the transaction;
- e) the transaction is a give-up transaction or a give-in transaction;
- (f) the purpose of the transaction is to transfer shares as collateral in bilateral transactions or in the context of central counterparty (CCP) margin or collateral requirements or as part of the default management process of a CCP;
- (g) the transaction results in the delivery of shares in the context of the exercise of convertible bonds, options, covered warrants or other similar derivatives;
- (h) the transaction is a securities financing transaction;
- (i) the transaction is carried out under the rules or procedures of a trading venue, a CCP or a central securities depository to effect a buy-in of unsettled transactions in accordance with Regulation (EU) No 909/2014 of the European Parliament and of the Council.

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