Association for Financial Markets in Europe

Briefing Note

The vital role of systematic internalisers (SIs) in European equities markets
February 2022

Executive summary

AFME believes that the Commission's proposals to impose additional restrictions on the use of SIs are damaging to asset managers/ owners and run counter to the European Union's goal of levelling the playing field amongst the various execution mechanisms. We are concerned that by limiting investors' ability to choose the type of execution mechanism that is most suitable for their specific investment needs, the overall attractiveness of European markets in the global context could be negatively impacted.

SIs are an important component of the European trading ecosystem as they provide investors with a trading service similar to the way in which banks provide loans to businesses. An SI uses its own capital and balance sheet to facilitate, more efficient and better priced execution to its clients. In turn this ultimately benefits end investors, such as pensioners and savers, who entrust their money to the SI's clients, which include asset and portfolio managers, to obtain the best possible results for them.

SIs act as a 'shock absorber' by limiting price impacts of client positions. SIs are the only trading mechanism that can provide execution against risk capital and therefore, it is vital to preserve such risk provision as part of the EU's market eco-system.

SIs are fundamentally different from trading venues as they utilise their own capital to trade with their clients and in doing so provide a bespoke facilitation role. By comparison, trading venues do not facilitate trades using their balance sheets on risk, and instead bring buyers and sellers together by providing a matching mechanism. Exchanges and other types of trading venues charge a fee for providing a multilateral facility where buyers and sellers can meet and in contrast, SIs earn profit by putting their own capital at risk.

Trading through SIs only represents 11% of the total trading in the EU. Given that SIs provide a valuable service to EU investors, which is distinct and complementary to the matching mechanisms provided by trading venues. We strongly believe that the changes proposed by the Commission are damaging to diversity and competition in European equity markets and that the EU's status a place to invest and raise capital will be diminished if implemented. With an understanding of way in which SIs function and the value that they contribute, it should be clear that the services provided by SIs need to be preserved to ensure that the EU's equity market structure meets the needs of all investors.

Overview

The Commission's MiFIR Review, in particular the Commission's proposals from last November, includes a number of changes to the SI regime. These proposals appear to be based on ill-founded assumptions for which no supporting analysis has been produced to date.

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The Commission's proposals suggest that SIs should publish quotes for sizes that are twice the standard size of orders in the rest of the market. In addition, the Commission introduces proposals to limit the ability for SIs to offer midpoint[1] prices in sizes below Large in Scale[2] through an unnecessarily complex set of rules.

It appears that these proposals are based on a misunderstanding of the role and nature of SIs and how they operate in comparison with trading venues. This briefing note seeks to provide some clarity with a precise explanation of how SIs function, the type of trading activity takes place through SIs, and the value they provide as one participant of the broader EU equity market structure.

The notion of SIs

Prior to 2007 the legal concept of SIs did not exist but there was broad acceptance of the importance of over the counter (OTC) bilateral trading. In 2007 MiFID I introduced the notion of SIs for the first time. This regime defined and introduced transparency obligations for those investment firms which regularly execute trades with clients bilaterally.

In 2018, the introduction of MiFID II saw the introduction of a Share Trading Obligation[3] (STO) and with it, the SI regime evolved into the key mechanism which covered a larger portion of market participants who conduct bilateral activity. MiFID II therefore, introduced a more detailed regulatory framework for SIs along with an updated definition:

"'Systematic internaliser' means an investment firm which, on an organised, frequent systematic and substantial basis, deals on own account when executing client orders outside a regulated market, an MTF or an OTF without operating a multilateral system"

In 2020, the European Investment Firm Review applied a new set of rules restricting SIs' ability to offer their clients the best price available by limiting their ability to execute trades at the midpoint. Such restrictions only exist in Europe, placing the region at a disadvantage compared to global markets.

The Commission's MiFIR Review (published November 2021) proposes further changes to the rules covering the SI regime by placing restrictions on the trade sizes at which an SI is required to publish quotes and the prices at which SIs can execute a trade (going beyond the changes introduced under the Investment Firm Review in 2020). AFME believes that these restrictions – which would impose an overly complicated regime - would be damaging to trading mechanism diversity and competition in European equity markets and that the EU's status as a place to invest and raise capital will be diminished if implemented.

The value of SIs

<u>Why are SIs valuable to European equities markets?</u>

SIs provide investors with a trading service similar to the way in which banks provide loans to businesses. An SI uses its capital and balance sheet to facilitate an efficient and bespoke service which leads to better priced investment transactions to its clients. In turn this benefits end investors, such as pensioners and savers, who entrust their money to the SI's clients to obtain the best possible results for them.

[1] Midpoint refers to the price between the best bid and offer price (with the best bid price being the highest binding bid price available and the best offer price being the respective binding lowest offer price).
[2] Large in Scale refers to trades that meet a pre-determined volume threshold which is deemed to be large enough so that pre-trade transparency requirements do not apply. This is applied under Article 7(1), RTS 1 of MiFID II.
[3] The share trading obligation is set our under Article 23 of MiFIR and requires that investment firms undertake trades in shares on a trading venue or an SI unless the trade is characterised as being non-frequent or carried out between non-professional counterparties and no contributing to price discovery.

By providing access to liquidity and offering balance sheet to clients, SIs act as a 'shock absorber' for end-users by limiting price impacts of client orders. SIs are the only trading mechanism that can guarantee execution against risk capital and it is vital to preserve such risk provision as part of the EU's market eco-system in order to ensure that investors varying needs can continue to be met. This is further explained below.

The functioning of an SI

<u>What does an SI do?</u>

SIs are execution platforms which allow investors to trade outside a regulated market or multilateral trading facility (collectively referred to as trading venues). When executing a trade against an SI, an investor is trading bilaterally with an investment firm who operates the SI. Therefore, the SI is a counterparty to the transaction, the counterparties are known to each other, as is the counterparty risk.

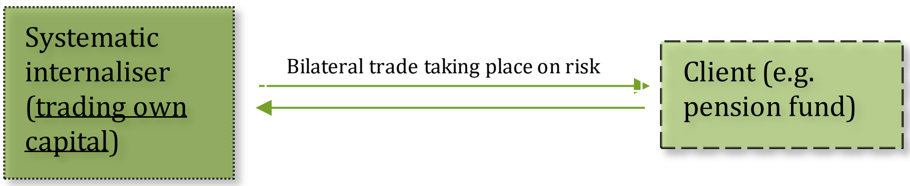
In equities markets, policymakers' intention was that SIs should operate on a level playing field with trading venues[4], SIs therefore are required to provide public quotes[5] in volumes up to 10% of standard market size[6] (SMS). These quotes are known as "firm quotes" which means that they are tradeable for any clients who interact with the SI in question. AFME is supportive of ESMA's initial recommendation to increase SI quoting sizes up to 100% of SMS, however we fear that the Commission's subsequent proposal to increase SI quoting sizes to 200% of SMS have not undergone any impact analysis and could lead to wider spreads or some SIs withdrawing from quoting in certain stocks.

SIs are also required to submit the relevant post-trade report for this type of venue in line with the transparency requirements set out in MiFID II, which includes details on the trade such as price, volume, and trade type. Combined with the provision of pre-trade quotes, this means that SIs provide a full suite of pre- and post-trade information relating to the price and size of executed trades below SMS, comparable to activity conducted on public venues.

<u>How are SIs different to trading venues?</u>

It is important to understand that SIs are fundamentally different from trading venues and therefore act as a complement to the trading venue ecosystem. SIs utilise their own capital to trade bilaterally with their clients and in doing so they, provide a bespoke service by taking on risk to facilitate their client's needs.

Figure 1 – example of bilateral SI trade



By comparison, trading venues do not facilitate trades using their balance sheets and instead bring buyers and sellers together by providing a matching mechanism. With this model, the exchange does not take on any risk and instead provides a commercial service (earning fee revenue) by acting as a multilateral facility where

[4] Recital 18, MiFIR
[5] Public quotes refers to the price and volume an SI is willing to buy or sell a stock.
[6] Standard market size is used to represent the average value of transactions in a given share.

buyers and sellers can meet anonymously. Exchanges are sometimes referred as "lit" venues as orders placed on an exchange's order book can be seen by all market participants.

Figure 2 – example of a typical trade flow when trading an exchange

Trading activity through SIs

<u>What type of trading takes place on an SI?</u>

The distinction between the way in which trading venues and SIs operate dictates the type of trading that takes place on each type of execution platform. Although SIs are understandably required to provide pre-trade quotes up to 10% of SMS, in practice most trades through SIs are larger when compared to trading venues. This is because SIs provide bespoke liquidity which is responsive to clients' needs meaning that they can offer varying types of liquidity including the capability to trade in larger sizes without a detrimental price impact. This means that trade sizes executed through SIs tend to be larger with ESMA estimating the average trade size through an SI to be €26,000 compared to €6,500 on a trading venue[7]. This is useful for institutional investors (e.g. pension funds) who tend to trade in size. In addition, trading with a known counterparty further reduces the risk of exposing the institutional investor's investment strategy to the rest of the market which reduces their trading costs.

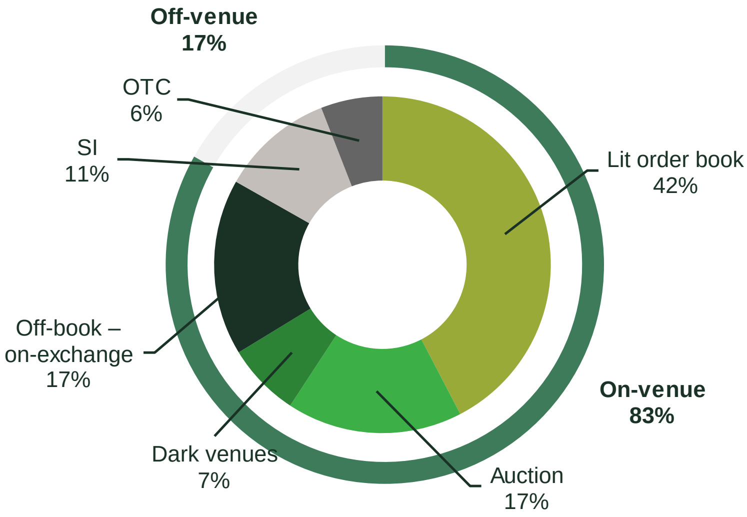
As trade sizes increase, lit order books become less suitable execution destinations, mainly because the order would be conspicuous to other market participants (including market participants who utilise high frequency trading strategies). Such market participants would seek to profit from their knowledge of the order and cause prices to move against the investor. Thus the resulting cost of trading is significantly increased. Consequently, trading venues operating CLOBs tend to match trades in smaller sizes and offer immediacy of execution. This might provide a beneficial service to high-net-worth investors who typically deal in those smaller sizes when compared to an institutional investor.

<u>How much trading activity takes place through SIs?</u>

There is debate among market stakeholders surrounding how to quantify addressable liquidity in equity markets. Consultancy firm Oxera conducted analysis[8] on market share across different types of execution venue and found that 11% of trading activity takes place through SIs. Oxera's analysis (using data provided by Big XYT[9]) identifies "addressable" trading activity by removing trading activity that is technical in nature and not informative when analysing the trading and liquidity landscape.

[7] P.25 ESMA Annual Statistical Report on EU Securities Markets, 2021.
[8] https://www.afme.eu/Portals/0/DispatchFeaturedImages/European%20equity%20liquidity%20landscape%20Q1%202021%20(1).pdf
[9] Big XYT is an independent data provider who supply data and analytics relating to equities trading. Big XYT's clients include leading exchanges, trading venues, investment banks, asset managers, ETF issuers and regulatory bodies.

Figure 3 – Oxera analysis on the share of European trading volume by trading mechanism, Q1 2021:



AFME also produces quarterly analysis which provides updated analysis on market share across different types of execution venue[10]. Our members' experience is in keeping with the figures provided by Oxera, SIs represent a small proportion of overall trading activity and should be seen as a complement to trading venues rather than a substitute.

Conclusion

By trading with their own capital – typically in larger sizes - SIs provide a valuable service to EU investors which is distinct and complementary to the matching mechanisms provided by trading venues. The Commission's MiFIR Review proposals threaten further restrictions on the minimum size at which an SI is required to publish quotes and SIs' ability to execute a trade at the mid-point between the best bid and offer (going beyond the changes already introduced under the Investment Firm Review in 2020).

AFME believes that these restrictions are damaging to diversity and competition in European equity markets and that the EU's status a place to invest and raise capital will be diminished if implemented. With an understanding of way in which SIs function and the value that they contribute, it should be clear that the services provided by SIs need to be preserved to ensure that the EU's equity market structure meets the needs of all investors.

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[10] https://www.afme.eu/Publications/Data-Research