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London Stock Exchange Group

AFME, CBOE and LSE Paper on the application of the tick size regime

7 September 2018

AFME, CBOE and the London Stock Exchange Group (the Organisations) believe that tick sizes have an important role to play in the financial markets. Appropriately calibrated tick sizes must allow for the efficient formation of prices in comparable mechanisms (to ensure there is an appropriate level of liquidity) whilst seeking to minimise the bid-ask spread (to ensure fairness to end investors). On this basis we believe that changes to the tick size regime must be viewed holistically and so the Organisations are providing consolidated comments on the Investment Firm Review, ESMA Q&A on tick sizes and ESMA Consultation on RTS 11. Our view is that

- trades executed on systematic internalisers (SIs) or trading venues that are above Large in Scale (LIS) or that are non-price forming should not be subject to the tick size regime;
- for all sizes of order, mid-point should remain a valid execution price, permitted to trade at a half tick, both on trading venues and SIs; and
- Competent authorities should ensure that an appropriate tick is applied to third country shares.

IFR Review and ESMA Q&A on tick sizes

The Organisations are supportive of the intention to ensure that comparable market mechanisms be required to quote at round ticks. However, we strongly believe that modifying the tick size regime as proposed by the European Parliament's Draft Compromise K relating to Article 61 would:

- serve no benefits according to the purpose of the tick size regime
- artificially constrain actual price formation and market transparency
- risk arbitrarily and materially penalising one investor over another where both parties would be satisfied by a mid-point execution
- require venues to round mid-point orders up or down to the nearest tick to the disadvantage of either the buyer or seller

We therefore request that the European Parliament's Draft Compromise K relating to Article 61 on changes to MiFIR/SIs is amended to reflect that trades that are above LIS or are non-price forming will not be subject to the tick size regime when executed by SIs or on trading venues (please see Annex 1 for our proposed amendments). We have also suggested changes to the ESMA Market Structure Q&A that will be required to support the amendment. We set our arguments for this position below.

Level playing field between SIs and trading venues

- The Organisations support a level playing field between SIs and trading venues and are of the view that the tick size regime should not be applied to LIS/non-price forming activity on either mechanism.
- We note that the current draft of the amendments on tick sizes within the Investment Firm Review and its related justification does not achieve the stated aim of levelling the playing field between trading venues and SIs. The justification associated with amendment 27 states "that systematic internalisers should be subject to the tick size regime when **dealing** [*emphasis added*] in all sizes"[1]. Nonetheless, while trading venues must ensure that all orders entered onto its systems comply with the tick size regime, they may still conclude transactions at the midpoint, e.g. for negotiated trades. This not only puts SIs at a disadvantage, but it also deprives investors from access to meaningful and differentiated risk liquidity that may not be available on a trading venue.
- It is essential that institutional and retail investors seeking execution of orders can do so at the mid-point of the Bid-Ask spread. The mid-point is understood and accepted globally as a fair execution price, and European markets would be materially harmed (and out of step with global markets) should the ability to execute at the Midpoint be constrained. Requiring compatible market mechanisms to ensure appropriate price formation at round ticks whilst also allowing the conclusion of trades at a non-round tick is beneficial to end investors. It allows for efficient price formation whilst reducing the bid-ask penalty on investors (which penalty is magnified for larger trades).

Purpose of the Tick Size Regime

- The purpose of the tick size regime is to ensure orderly and transparent trading takes place on trading venues through promoting the effective formation of prices on displayed order books. It also helps to maintain a reasonable depth of liquidity whilst allowing spreads to fluctuate.
- Therefore, the tick size regime's relevance is principally to order book driven markets which are pre-trade transparent (e.g. on venues that accept orders with a specified limit price), and to alternative trading mechanisms (such as SIs trading below LIS) that are comparable/competitive to such order book driven markets (e.g. accessed by market participants alongside (or as an alternative to) pre-trade transparent order books in the course of executing).
- Over applying the tick size regime arbitrarily risks and unnecessarily penalises investors (which include pension funds) in certain transactions.
- Requiring orders/quotes as well as executions on tick would lead to unintended consequences for end investors as execution will have to be rounded to the nearest tick with some investors gaining and others losing, depending on how the rules were applied.

Consideration of the relevance of the tick size regime to different transaction types:

1. Point in time execution below SMS and in multiples of SMS but below LIS
    - Provision of liquidity (by banks, and by market making firms) which can be accessed alongside (or as an alternative to) pre-trade transparent order books in the course of executing. This trading activity generally takes place in sizes similar to Standard Market Size (SMS) and above, but only in very rare circumstances in sizes larger than LIS.
    - Multilateral trading venues that bring together buyers and sellers. Where the spread is an odd number of ticks apart, this can result in executions at a mid-point that is on a half tick.

[1] European Parliament Draft Report on the proposal for a regulation of the European Parliament and of the Council on the prudential requirements of investment firms and amending Regulations (EU) No 575/2013, (EU) No 600/2014 and (EU) No 1093/2010 (COM(2017)0790 – C8-0453/2017 – 2017/0359 (COD))

In respect to these executions, a harmonised tick-size regime, which permits execution at half-tick where it represents the mid-point for both trading venues and SIs, will ensure a level playing field between comparable/competitive market mechanisms while also ensuring that neither buyer nor seller is disadvantaged by forcing venues to clamp mid-point orders to a full tick.

2. Point in time execution above LIS
    - Provision of risk capital to fill large orders where a client seeks immediate execution in a size greater than can be achieved via order books.
    - Large transactions negotiated between investors away from a displayed order book.
    - Equity Capital Markets activity (e.g. placements, Accelerated Bookbuilding) conducted after market hours.

In respect of these executions the tick regime should not apply, for the following reasons:

a) Applying the tick size regime to these executions forces disadvantaging investors:
    i. Applying a tick size regime will not contribute to the price discovery process for LIS trades and may actually inhibit appropriate price formation between SIs and clients agreeing trades in large sizes.
    ii. The ability to execute LIS trades on a sub-tick basis provides meaningful price improvement for clients trading in large sizes which brings benefits to end investors. Removing this capacity would amount to the regulation enforcing a bias against end investors (e.g. pensioners' funds) who wish to trade in larger sizes. Indeed, some investors would lose whilst others would gain, depending on how rounding rules were applied.

3. Average Price Executions
    - Provision of guaranteed risk-execution at a benchmark price (e.g. VWAP).
    - Institutional investors such as pension funds and savers' fund managers may wish to use a benchmark such as the volume weighted average price (VWAP) to achieve an execution. For example if they are moving into a stock in size (e.g. because it is included in an index that the fund has to track, or they have determined it would offer investors meaningful upside), they will want to ensure that it is bought for their savers at a fair price over the course of a certain period (e.g. a day or two) without their intention to enter into the stock moving the market and penalising those pensioners/savers. In those instances, they will request that their broker enters the market and starts buying up the stock incrementally, tracking available liquidity at the average price of that liquidity at any given point in time. To ensure savers are not penalised they may ask their broker to guarantee that the stock will be executed at the VWAP. This will typically be undertaken by brokers in their capacity as an SI and, because it represents an average price of available liquidity, will in most cases not be at a round tick.

In respect of these executions, the tick regime should not apply, for the following reasons:

a) Guaranteed benchmark executions, and other non-price forming transactions reflecting an average price achieved in the market naturally result in executions that do not conform to a tick table.
b) As for 2 above, a restriction to round ticks on these executions forces favouring of one set of investors and disadvantaging another and imposes on these investors needless cost, while providing no benefit to market transparency (e.g. having to round a guaranteed VWAP execution up or down to the nearest tick).
c) These reports are not price-forming, as they typically duplicate executions or hedging activity already undertaken and subject to the pre- and post-trade transparency regimes.

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ESMA Consultation on RTS 11

The Organisations are supportive of the intention driving the changes proposed to RTS 11 and believe that tick sizes for third country shares should take into account liquidity on third country venues where appropriate to ensure that European investors trading on EU venues should not be penalised by having to trade at wider spreads compared to investors that trade away from EU venues.

We believe that that the methodology utilised should not allow:

- individual NCAs to veto or, through lack of engagement in the process, prevent the adoption of a tick size that accounts for third country venue liquidity for such shares; or
- an instance in which a share traded in the same currency on multiple venues in the EU could have a different tick size depending on the venue;

as that would be detrimental to investors choosing or being required to trade on European trading venues. Such an outcome would also lead to implementation problems for firms that send orders to trading venues.

On that basis, we believe that the risks highlighted above are likely to materialise if option (d) is employed. We consider that an option more akin to option (a) is adopted to ensure consistency. The absence of a regulation-enforced tick size table should not prevent the relevant Competent Authority from applying a tick table as the Competent Authority can look to the tick table that is adopted by the venue that primarily trades the relevant third country share.

Conclusion

- Application of the tick size regime is only relevant to a subset of executions, namely below SMS or in multiples of SMS but almost always below LIS (see 1 above).
- Application of the tick size regime should be understood as permitting execution at half tick, where it represents the mid-point for both trading venues and SIs. This will allow for a level playing field between comparable/competitive market mechanisms while also ensuring that neither buyer nor seller is disadvantaged by forcing venues to clamp mid-point orders to a full tick.
- Application of the tick size regime to remaining executions types will force the favouring of one set of investors and disadvantaging another, resulting in detrimental execution outcomes for end investors.
- We support a level playing field between SIs and trading venues, recognizing the range of activities SIs perform is not only comparable to lit order books, but also other LIS market models. As such, we are of the view that the tick size regime should not be applied to LIS or non-price forming activity in any context.

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ANNEX 1

<u>AFME proposed changes to Draft Compromise K (amendments in red):</u>

DRAFT COMPROMISE K

Article 61 - Changes to MiFIR/ Systematic Internalisers

Bold/italics text represents changes to the Commission proposal.

Article 61 - paragraph 1 - point - 1 (new)

The title of Title III is replaced by the following:

"TRANSPARENCY FOR SYSTEMATIC INTERNALISERS AND INVESTMENT FIRMS TRADING OTC ***AND TICK SIZE REGIME FOR SYSTEMATIC INTERNALISERS***"

Article 61 - paragraph 1 - point - 1a (new)

The following Article 17a is inserted:

Article 17a

Tick sizes

Systematic internalisers' quotes below large in scale, price improvements on those quotes and execution prices shall comply with tick sizes set in accordance with Article 49 of Directive 2014/65/EU unless the conditions set out in Article 15(3) apply.

Article 63 - paragraph 2a (new)

Notwithstanding paragraph 2, Article 61(1), point -1 (new) shall apply 20 days after publication of this Regulation in the Official Journal of the European Union.

Recital 42a (new):

(42a) With the aim of guaranteeing a level playing field and promote the transparency of the European market, Regulation (EU) No 600/2014 should be amended to subject systemic internalisers' quotes below large in scale, price improvements and executions prices to the tick size regime ~~when dealing in all sizes~~.

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ANNEX 2

AFME proposed changes to ESMA Market Structure Q & A (amendments in red):

Question 6

Does the minimum tick size regime under Article 49 of MiFID II apply to all orders for which a pre-trade transparency waiver can be granted in accordance with Article 4 of MiFIR?

Answer 6

Article 49 of MiFID II requires trading venues to adopt minimum tick sizes in relation to equity and certain equity-like instruments. RTS 11 specifies the minimum tick size regime which applies to those instruments depending on their liquidity and price level. 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. The application of the tick size regime would include, for example, limit orders resting on an order book ***and*** orders held in an order management system ~~**as well as LIS orders pegged to the mid-point in a lit order book (in practice those LIS orders can only be pegged to the mid-point where the spread consists of an even number of ticks).**~~

However, the minimum tick size regime would not apply to transactions executed in systems that match orders on the basis of a reference price as per Article 4(1)(a) of MiFIR***, to orders executed under the LIS waiver as per Article 4(1)(c) of MiFIR*** or to negotiated transactions as per Article 4(1)(b) of MiFIR.

Question 11

How should venues apply the tick size regime to mid-point peg orders where the mid-point referred to is at a half-tick?

Answer 11

Requiring venues to round mid-point orders up or down to the nearest tick would disadvantage either the buyer or the seller. Accordingly, mid-point peg orders should be permitted to rest and trade at a half tick where that reflects the mid-point of the BBO being used.

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