



MAY 2020

**QUANTIFYING SYSTEMATIC
INTERNALISERS' ACTIVITY: THEIR
SHARE IN THE EQUITY MARKET
STRUCTURE AND ROLE IN THE PRICE
DISCOVERY PROCESS**

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EXECUTIVE SUMMARY

As the new regulatory framework on markets in financial instruments (MiFID II) enters its third year of implementation, the European Commission is completing its technical reform under its Refit programme. In its report drafted for this purpose, the ESMA suggests that systematic internalisers (SI) no longer be included in the share trading obligation. To enable a greater volume of orders to contribute to the price formation process, MiFID II imposes an obligation to trade shares on regulated markets (RMs), multilateral trading facilities (MTFs) or on systematic internalisers, which are investment firms that execute client orders on own account outside "traditional" trading venues. The Autorité des Marchés Financiers (AMF) has therefore decided to study the role of systematic internalisers in the market of French shares from three angles: their weight in the current market structure, their contribution in terms of pre-trade transparency and price formation and, lastly, the quality of their prices compared with those of Euronext Paris.

WEIGHT OF SYSTEMATIC INTERNALISERS ON THE MARKET

In the first months that followed the entry into force of MiFID II on 3 January 2018, the market share of SIs rose to more than 30% of volumes traded, raising many questions as to the role of these participants in market structure and subsequently in price formation (see chart 1). Two years on, after clarifications of transaction reporting confirmed suspicions that the weight of these market participants had been over-estimated, the market share of SIs is now valued, depending on the month, at between 15% and 20% of total amounts traded in shares, which is still higher than expected.

To better understand the role of SIs in market structure, we need to differentiate between their activity that contributes to price forming and their activity relating to technical transactions. The regulatory reporting format requires that this be mentioned specifically when transactions are reported. If we consider this differentiation and if we exclude intra-group SI transactions, the study shows that the proportion of amounts from SI transactions that contribute to the price forming process and is accessible to client accounts did not represent more than 8% to 10% of total trading volumes of French shares in the first quarter of 2020 (see Chart 4). The rest of this study is based on this scope, which is more representative for the market.

OVERVIEW OF STAKEHOLDERS

In the first quarter of 2020, there were 36 active systematic internalisers on the French equity market, observed through transaction reports. They were made up of 28 investment bank SIs (Bank SI) and 8 high-frequency traders (Electronic Liquidity Provider SI or ELP SI). Bank SIs account for 76% of volumes while ELP SIs account for 24%. However, of the 65% of volumes from SIs executed during the Euronext continuous trading phase (i.e. before the fixing of closing), the proportion of ELP SIs rises to 37% (see Chart 5).

The analysis of the breakdown of the amounts traded by the two SI categories shows that ELP SIs focus on small transactions (mostly under €50,000), while Bank SIs are used more for larger transactions of more than €200,000 (see Chart 7).

CONTRIBUTION IN TERMS OF PRE-TRADING TRANSPARENCY

MiFID II requires that systematic internalisers publish bid and offer prices for a size at least equal to 10% of the standard market size (SMS) for liquid shares and equity-like instruments (such as ETFs and certificates). The standard market size is €10,000 for nearly all the 150 French securities that fall within the scope of the study. However, SIs are free to propose to their clients, in addition to their public quotes, bilateral quotes that are not subject to pre-trade transparency when they are higher than the SMS.

In September 2019, on average, most systematic internalisers proposed a public quote for a size representing between 15% and 40% of the standard market size, i.e. between €1,500 and €4,000. This may seem paltry

compared with the liquidity that is potentially accessible at the best price on Euronext during this period (€40,000 on the average).

Nevertheless, this publicly offered liquidity does not reflect the reality of the amounts traded since a large portion of SI transactions are not subject to pre-trade transparency requirements. If we compare data from public quotes and transaction reporting, it emerges that transactions subject to pre-trade transparency requirements represent only 22% of the amounts traded by SIs during the continuous trading phase, i.e. only 1.4% of the total amounts traded on the market during this period. The contribution of SIs with respect to transparency is therefore very limited.

PRICE IMPROVEMENT OFFERED COMPARED WITH EURONEXT

To examine the quality of the prices proposed, based on data from the first quarter of 2020, the study compares the range proposed on Euronext to the prices executed on SIs at the same period. Nearly all the amounts declared by ELP SIs fall within the spread proposed on Euronext Paris, with the exception of transactions that are above the block transaction threshold (large-in-scale transactions). Since Bank SIs carry out more voice broking with their clients, and mostly handle large volumes, their prices diverge more frequently from the continuous listing of the benchmark market.

Of the amounts executed on SIs where the price falls within the Euronext spread (i.e. half of price forming volumes excluding intra-group), 54% are executed at the same price as the price available at the same time in the French order book. The remaining 46% are executed at an improved price (with respect to the study scope, a tick size, which is the minimum difference between two successive prices offered on a market. In this specific case, this is a tick size of €0.05 or €0.01) that can range from one-tenth of a tick to several ticks. 12% of this amount involves a significant improvement (i.e. higher than one tick, see charts 16 & 17).

It is the ELP SIs that proportionally aggregate most of the amounts traded with an improvement in price (see chart 20).

COMPLIANCE WITH THE FUTURE TICK SIZE REGIME

MiFID II has established a tick size regime, calculated according to equity liquidity and prices. This regime has harmonised quotes on “traditional” trading venues and will be extended to SIs by the end of June 2020. Thanks to the study, it has been observed that nearly 40% of volumes traded on SIs are traded at a price that will no longer be possible after the tick size regime has been applied to SIs (see Chart 11).

Moreover, with the extension of the regime to systematic internalisers, most of the price improvements mentioned above, because regarded as non-significant, will no longer be possible: 43% of improved prices were lower than one tick and were not compliant with the tick size regime in the first quarter of the year.

QUALITY OF PRICES OFFERED FROM THE CLIENT'S PERSPECTIVE

To assess the quality of SIs from the client's perspective, a study was proposed on the price trend observed on the French equity benchmark market (Euronext Paris) around an SI transaction. The study, which was performed on the basis of SI transactions regardless of their counterparty, highlighted rather diverse price reversion levels among the various market participants (see Chart 21). However, as we have mentioned above, prices offered by SI may vary depending on the client. This analysis, which is an essential component of the best selection process, must therefore be made by each participant based on their own trading prices or the prices that they receive from the SI, if applicable.