Liquidnet

Making MiFID II Work

MiFID II Liquidity Landscape:

Review of 2019

MiFID II Liquidity Landscape: 2019

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Heading into 2020 and despite the now supposed certainty of Brexit, European markets remain challenging. Overall equity volumes have continued their decline in 2019 and while percentages of overall dark and lit trading remain relatively static, the make-up of both strategies, together with the rise in closing and Periodic Auctions and the introduction of alternative protocols such as Request For Quote (RFQ), means that European liquidity remains fragmented and continuous lit activity is still on a downward trend.

Given the regulatory intention to increase transparency and improve investor confidence in equity markets, it is unsurprising that further regulatory adjustment to MiFID II is imminent. However, exactly *how* MiFID will be addressed becomes interesting considering possible regulatory divergence between the UK and Europe post Brexit in 2021, planned forthcoming regulatory changes to Periodic Auctions and the outcome of Swiss Equivalence on European trading.

In this state of flux, the rising importance of execution within the investment process makes the situation critical for buy-side traders to resolve. Yet declining trading volumes together with diminished commission pools is leading to further readjustment between the buy and sell-side. Staying relevant to your trading counterpart while understanding exactly how orders are executed has never been more complex, nor as necessary, to ensure delivery of best execution within the new trading landscape.

Confidence in Execution Performance

The regulatory drive to move trading back to the lit requires improving a buy-side traders confidence in a venue's pre-trade transparency and minimal post-trade reversion. A recent study by Big XYT noted the impact of price movement in dark and lit markets, illustrating why buy-side demand for dark trading continues due to the higher impact on price when trading in lit markets (see Exhibit 1).

Exhibit 1:

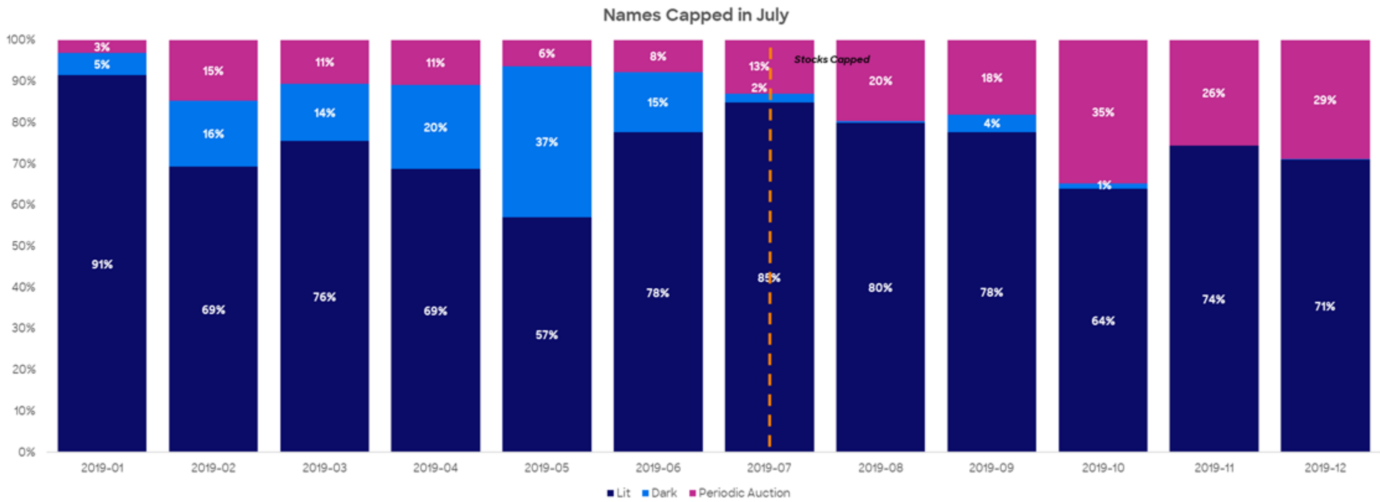
Source: Big XYT

Despite dark trading peaking at over 10% of market activity in October last year (see Exhibit 6), overall percentages of dark trading have remained between 8-9% of overall volumes through 2019 (see Exhibit 6) with the market appearing to successfully adjust to the introduction of the Double Volume Cap (DVC). In contrast. despite the regulatory intention to increase lit trading, the opposite has occurred. Prior to March 2018 when the DVC was introduced, lit volumes were consistently above 80% (see Exhibit 5). Post DVC, they vary between 64% and 77% (see Exhibit 5). However, the latest DVC data from ESMA[1] combined with their latest opinion on Periodic Auctions is likely to alter this. A further 55 instruments can no longer be traded in the dark aacorss all trading venues and 10 instruments fall under

[1] https://www.esma.europa.eu/press-news/esma-news/mifid-ii-esma-issues-latest-double-volume-cap-data-18

the 4% cap for individual trading venues, making a total of 421 instruments suspended from 14 January 2020 to 13 July 2020. While trading suspended names has currently been successfully managed by alternative execution methods such as Periodic Auctions, ESMA's Opinion will limit the conditions under which periodic auctions can operate. This matters as in some capped names, Liquidnet analysis shows Periodic Auctions accounting for a third of trading volumes (see Exhibit 2).

Exhibit 2: Trading patterns for capped names



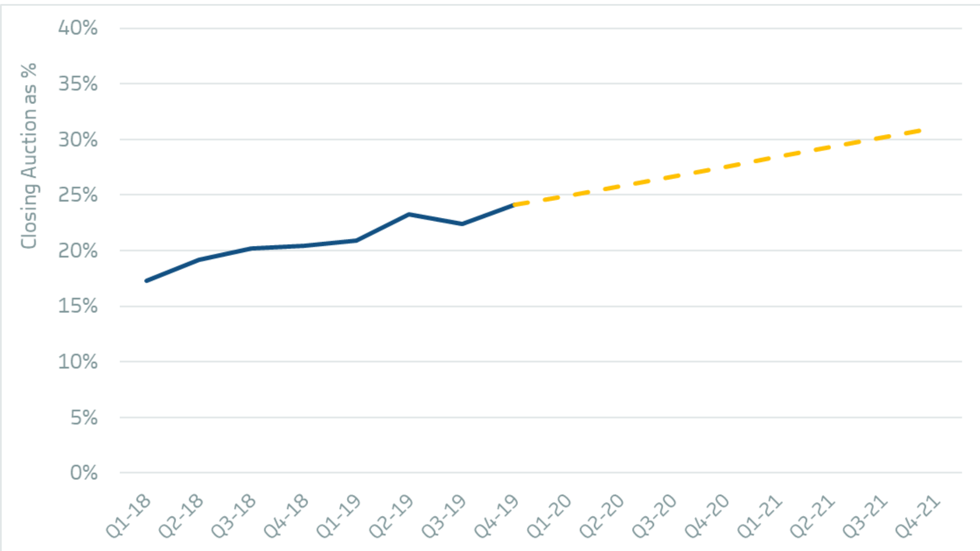
Source: Bloomberg

Under the ESMA Opinion,where the Period Auction is deemed non-price forming but eligible to operate under the Reference Price Waiver (RPW) – such as the use of pegged orders or systems that lock in prices at the beginning of an auction – the expectation is that these orders will be subject to DVC restrictions, requiring alternative execution strategies to avoid trading on lit markets. Where the activity is non-price forming and is not eligible under the RPW, such as orders using price band limitations to ensure the price remains within the European Best Bid and Offer (EBBO) it is likely that this activity will have to stop altogether. Both of which are likely to require alternative methods of execution.

Closing in on the Close

Another area of focus is the impact of the rise in closing volumes on continuous lit market activity. If the linear trend present over the past two years continues, Liquidnet analysis anticipates the closing auction will continue to rise by 3-4% each year, reaching 50% of all European trading activity within the next eight years (see Exhibit 3).

Exhibit 3: Forecast of the growth of the closing auctions



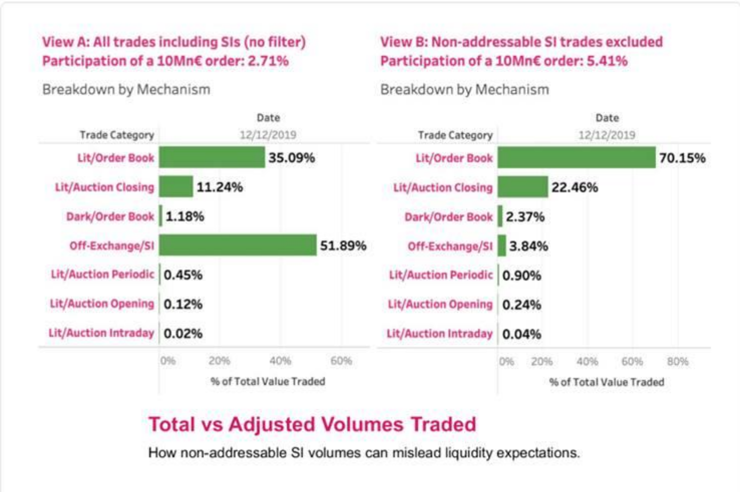
Source: Liquidnet internal data

In certain markets, volumes are climbing faster, with the Autorite des Marches Financiers (AMF) highlighting 41% of the CAC 40 was traded on the close in June 2019[2]. While the rise in closing activity is of concern in the longer term, market participants have a more pressing problem in 2020 to address how capped names will trade once Periodic Auctions are no longer admissible. Both issues will only add to the decline in continuous lit market activity requiring greater analysis to select the most appropriate execution stategy given the potential market impact.

A New Opportunity for SI?

Despite continued focus from the sell-side on increased use of risk capital, this has yet to play out in an increase in SI executions. Overall activity has dropped significantly since April 2019 averaging EUR 122.4bn in the last two months of the year, with the average execution size continuing to fall to around EUR 15.6k in November (see Exhibit 8). Greater focus on the definition of addressable and non-adressable liquidity within Systematic Internaliser (SI) performance calculations could contribute to a better understanding and subsequent improvement in SI execution quality. Including all reported trades in execution performance can lead to a different assumption of liquidity versus removing non-addressable SI executions which alters volume participation levels. A recent study by Big XYT demonstrated the difference in perception for an institutional order size of €10mln Munich Re shares traded on December 12th 2019. Including all trades, the example order represented 2.71% of the days reported turnover, but by removing non-addressable liquidity, the percentage of daily turnover rose to 5.41% requiring a doubling of volume and target participation to complete the order with necessary minimal impact (see Exhibit 4).

Exhibit 4: Total versus adjusted volumes traded



Source: Big XYT

Understanding true levels of SI activity will become more important during 2020 given the increase in the number of European SIs registering versus last year and how these will operate in a post Brexit environment. Article 4(1)(20) of MiFID II[3] reiterates that SI trading activity should be characterised by risk-facing transactions that impact the profit and loss account of the firm, if the regulators were to see the use of SIs as a means to match orders across jurisdictions, this will likey draw further scrutiny and potential regulatory tightening of the SI regime across Europe.

Regulatory Divergence

Given the current stance between the UK Government and the EU27 regarding the future trading relationship, there is a strong possibility of further legislative change and an increased likelihood of divergence between the two jurisdictions. The Statutory Instrument means the UK will onboard all MiFID and MiFIR under the European Union Withdrawal Act (EUWA)[4] however this also gives ministers powers to *"prevent, remedy or mitigate any failure of EU law to operate effectively or where they believe market integrity could be compromised, potentially resulting in greater regulatory divergence between the EU and the UK post Brexit*". Where the UK FCA does not agree with ESMA's approach to

[2] https://www.amf-france.org/en_US/Actualites/Communiques-de-presse/AMF/annee-2019?docId=workspace%3A%2F%2FSpacesStore%2F069eedf2-1029-4872-82bd-9aaf053e1af4
[3] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN
[4] https://www.gov.uk/government/publications/draft-markets-in-financial-instruments-amendment-eu-exit-regulations-2018/markets-in-financial-instruments-amendment-eu-exit-regulations-2018-explanatory-note

the STO, DVC or Periodic Auctions, a different set of rules could emerge, potentially damaging to European liquidity formation as European firms continue to depend on access to capital and infrastructure in London. A situation that could become even more interesting when taking into consideration the outcome of Swiss Equivalence.

Following the loss of Switzerland's equivalence status in June 2019, European traders can only trade Swiss equities on the SIX Swiss primary exchange via a recognised broker, or through an SI operating in the EU. Historically, approximately 20% of Swiss equities[5] were traded on MTFs, which were forced to delist post the decision and the volume moved to the SIX Swiss primary. The debate at the time focused on the impact of a loss of competition which would widen spreads and drive up trading costs.

According to SIX, the reverse has occurred. While spreads widened over July and August in September, blue chips narrowed from 4.0 bps in June, to 3.6 bps in September and small and mid-cap Swiss stocks narrowed from 20.4 bps in June to 18.9 bps in September[6]. In addition, the order-to-trade ratio declined significantly following non-equivalence from seven in June to four in September, concentrated liquidity giving rise to greater certainty of execution[7].

Ensuring this type of solid secondary market activity during continuous trading is exactly what European policy makers are aiming for. Removing noise from the order book also leads to a decline in the cost of trading as spreads tighten. However, not all activity has gone to the lit. SIX Swiss Exchange's dark venue, SwissAtMid has absorbed all the dark flow in Swiss equities that was previously traded across other dark pools and increased the proportion trading LIS[8]. However, there is no guarantee that Europe will be able to replicate the same outcome as Switzerland. According to Liquidnet analysis, 23% of all order flow incorporated a European entity, with 76% seen as International flow and 1% European activity only[9]. Add in the potential for Switzerland to reach an equivalence deal with the UK and these percentages could shift further still. The deciding factor will be the extent to which flow currently based in the UK will be incorporated under the "chain of execution" and will be required to trade on European venues only. This is includes UCITS or AIFMD providing MiFID II services or delegating portfolio management to a MiFID II firm which de facto become subject to the EU27 STO, and it is anticipated that UK asset managers with UCITS licence will likely shift order execution to EU venues. Even if the European firm in question is trading via a UK broker, those operating under a European MiFID II licence will have to execute on an EU venue under the EU STO "chain of execution" rule.

While UK politicians claim to have delivered Brexit, the impact on European trading is far from complete and the industry is set for a challenging start to the new decade, requiring the buy-side to potentially stay abreast of regulatory changes in two jurisdictions as well as adjust to shifting liquidity patterns and whichever venues and execution strategies benefit from the diverging regulation.

While some assume confidence will return to European markets once Brexit is resolved, the reality is that financial services negotations on the future relationship may need to be extended beyond 2020. Secondly, structural changes are taking place where active asset managers are choosing to trade less frequently, concerned of the impact of turnover on performance. In such a potentially complex trading environment, selecting the most appropriate counterparties, as well as understanding trading protocols and most appropriate routing practices to ensure delivery of Best Execution, as well as maximising any alpha opportunities available will become the main focus for the European buy-side trader for the year ahead. The only certainty is further change is ahead.

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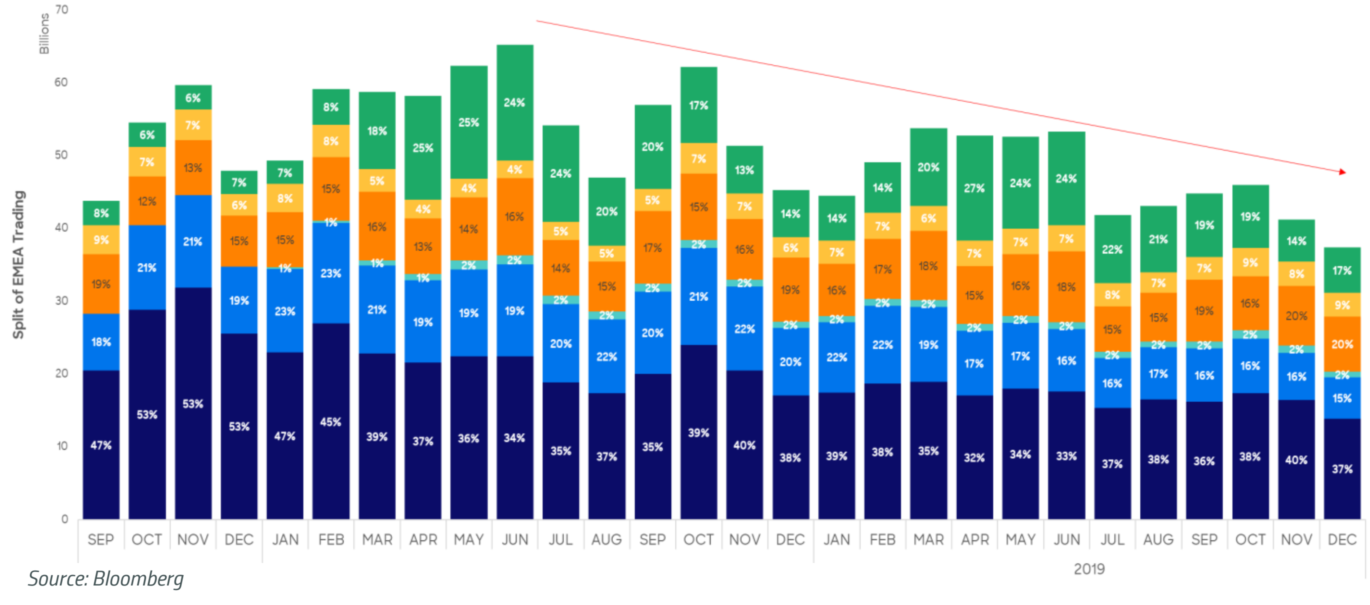
[5] Impact of non-equivalence on Swiss equity trading, SIX Securities & Exchanges, October 2019
[6] Impact of non-equivalence on Swiss equity trading, SIX Securities & Exchanges, October 2019
[7] Impact of non-equivalence on Swiss equity trading, SIX Securities & Exchanges, October 2019
[8] Impact of non-equivalence on Swiss equity trading, SIX Securities & Exchanges, October 2019
[9] Liuqidity Landscape Q1 2019

LIQUIDITY OVERVIEW

Exhibit 5:

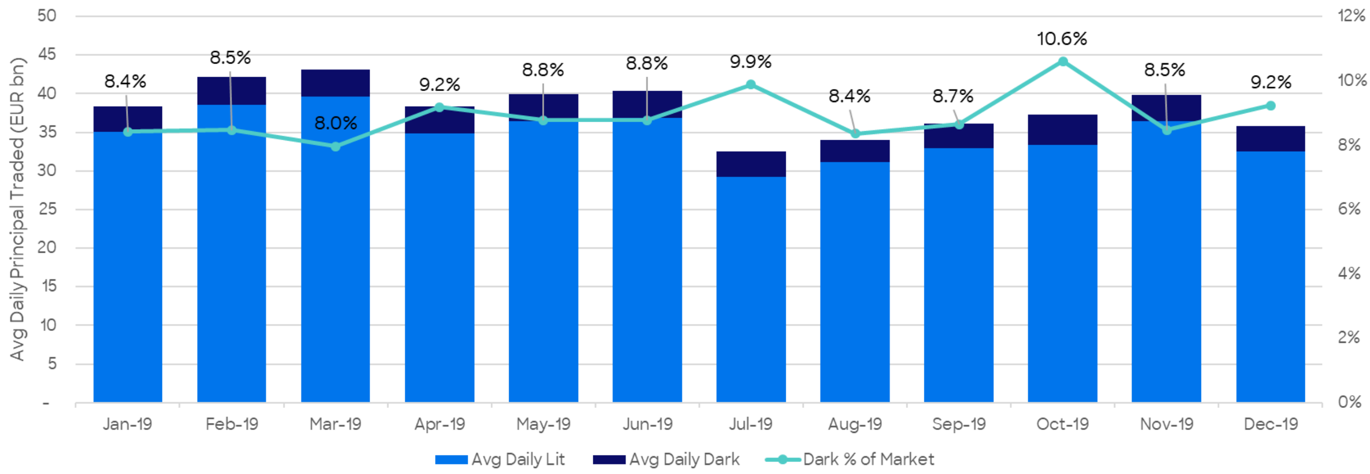


Source: Bloomberg

- Overall European equity volumes have been in decline since June 2018, with the greatest decline being SI activity and Lit MTFs.
- The change in SI activity can be attributed to a market-wide recalibration of what should be included in SI activity in relation to addressable and non-addressable activity, seeing SI market share decline from a peak of 27% market share to just 17%.
- For lit MTFs, once accounting for 22% market share, declining to 15% in December, the reasons are more mixed with some MTF's chosing to alter rebate models, although a noteable exception is Aquis Exchange which has seen its market share increase from 1.5% at the start of 2018 to 2.9% in 2019
- Overall activity in Periodic Auctions maintain their 2% market share but activity in capped names is significantly higher (see Exhibit 2)

OVERALL MARKET VOLUMES

Exhibit 6:



Source: CBOE

- Overall market volumes remain low despite a slight increase in the last quarter of 2019 averaging ~EUR 37bn in July and August and picked up slightly in September as activity has slowed down over the summer.
- Dark market as a percentage of the Lit remains above 8%. However, it is worth noting that this includes LIS activity accounted for around 39% of dark volumes in Q4 2019 (Exhibit 7).

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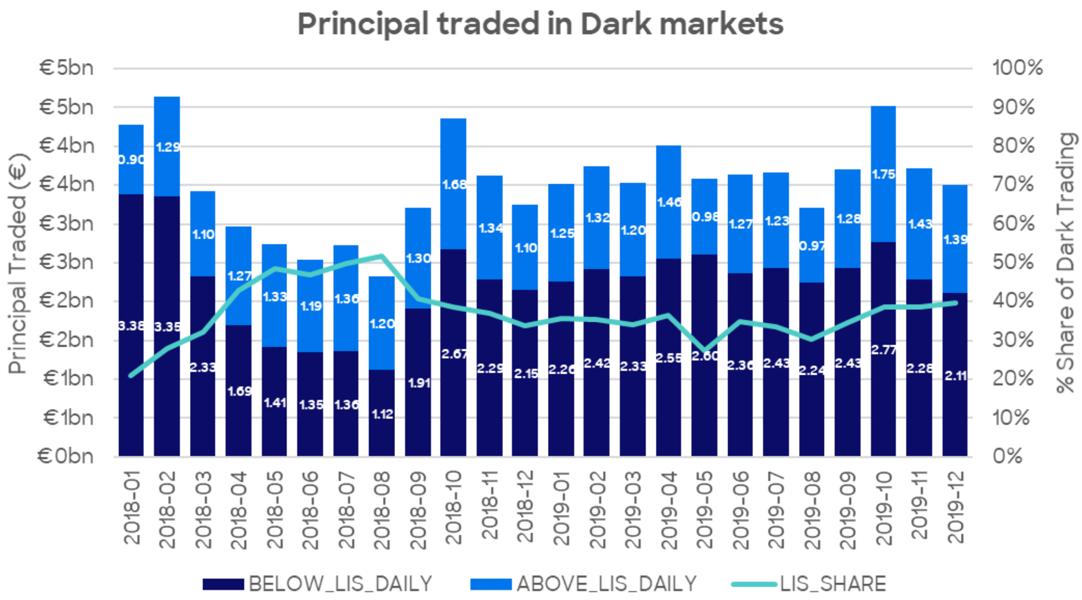
LARGE-IN-SCALE (LIS)

Exhibit 7:

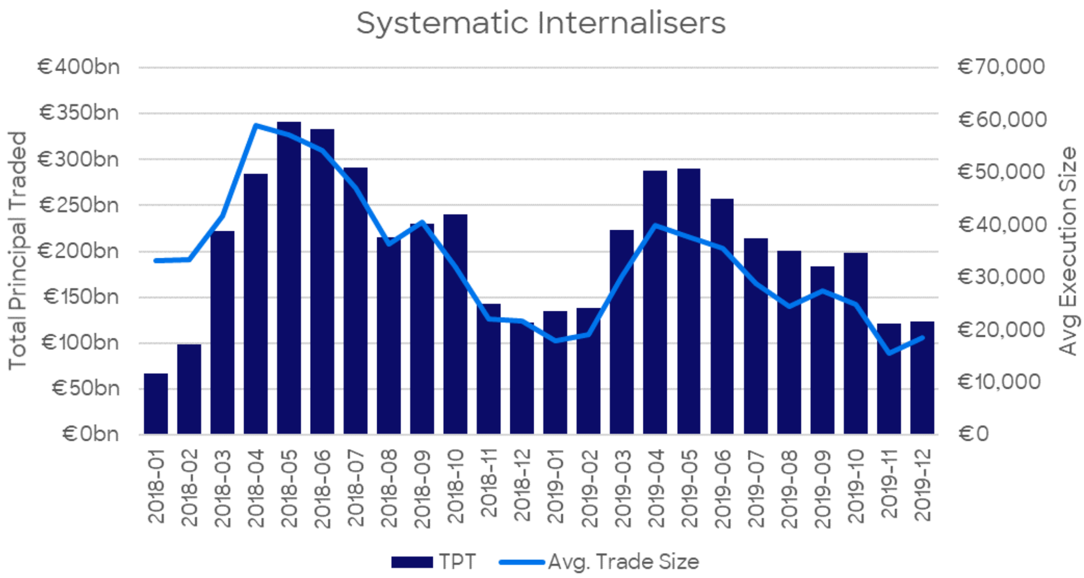


Source: Bloomberg

- LIS trading still accounts for around 39% of the dark market. LIS in notional terms is fairly consistent between EUR 1.40bn and 1.75bn per day for the last quarter of 2019.

SYSTEMATIC INTERNALISERS

Exhibit 8:

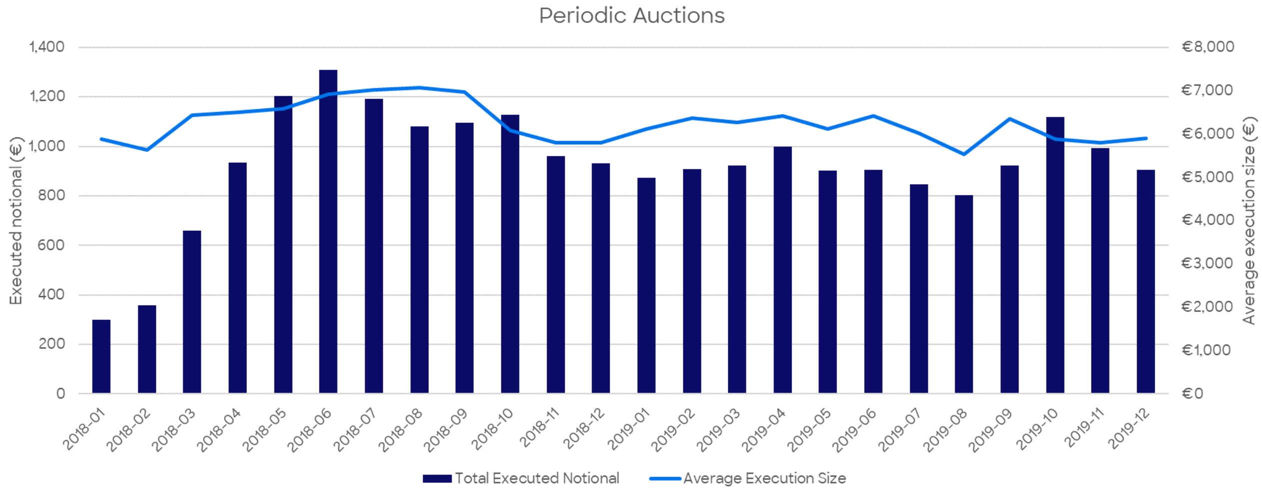


Source: Bloomberg

- SI activity had picked up again since March 2019 averaging EUR 199.4bn in Q3 2019 but declined to EUR 122.4bn in the last two months of the year.
- Coinciding with the drop in activity in the last quarter there was a continued fall in the average execution size to EUR 15.6k in November, which rose again to EUR 18.6k in December.
- One to watch is the regulators' response to the SI market share since the implementation of MiFID II. Any activity that is not in the spirit of MiFID II - such as back to back trading or SIs operating a system that brings together third party buying and selling interests – will alarm regulators and could result in further tightening of the construct in Europe.

PERIODIC AUCTIONS

Exhibit 9:

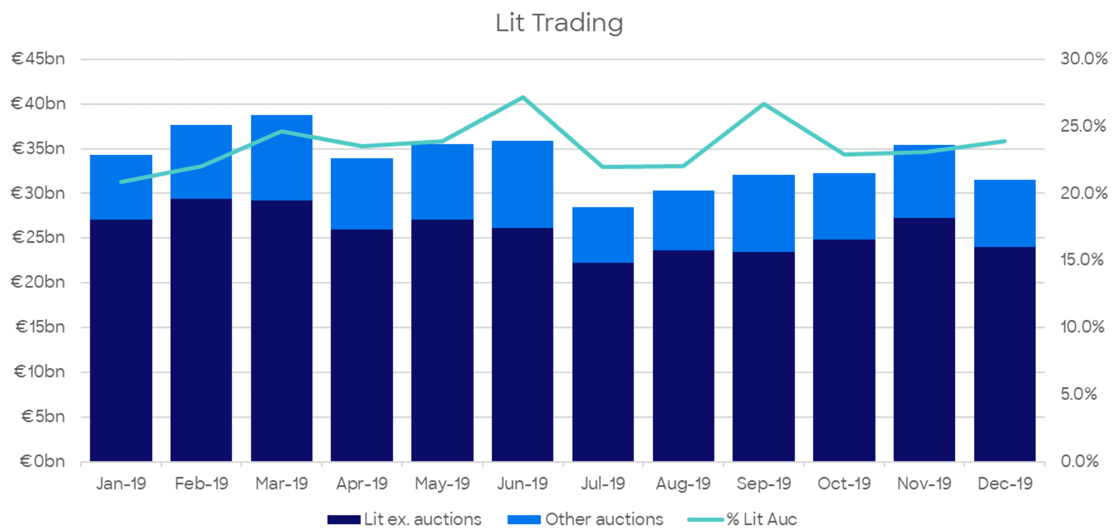


Source: Bloomberg

- Periodic Auctions have plateaued in recent months under EUR 1bn per day, down from the highs of EUR 1.3bn in June 2018 and the average execution size remains stable around 5.8k EUR.
- Although the share of periodic auctions remains low, representing around 2% of total volumes, regulators remain concerned that the construct is being used to circumvent the DVCs. When looking at trading patterns for stocks that were capped in July 2019, prior to the introduction of the caps the share of periodics in those stocks is marginal at 8% in June 2018, which rapidly increased to 13% in July once the caps were enforced with a peak at 35% in October 2019 (see Exhibit 2).

LIT VENUE AUCTIONS

Exhibit 10:

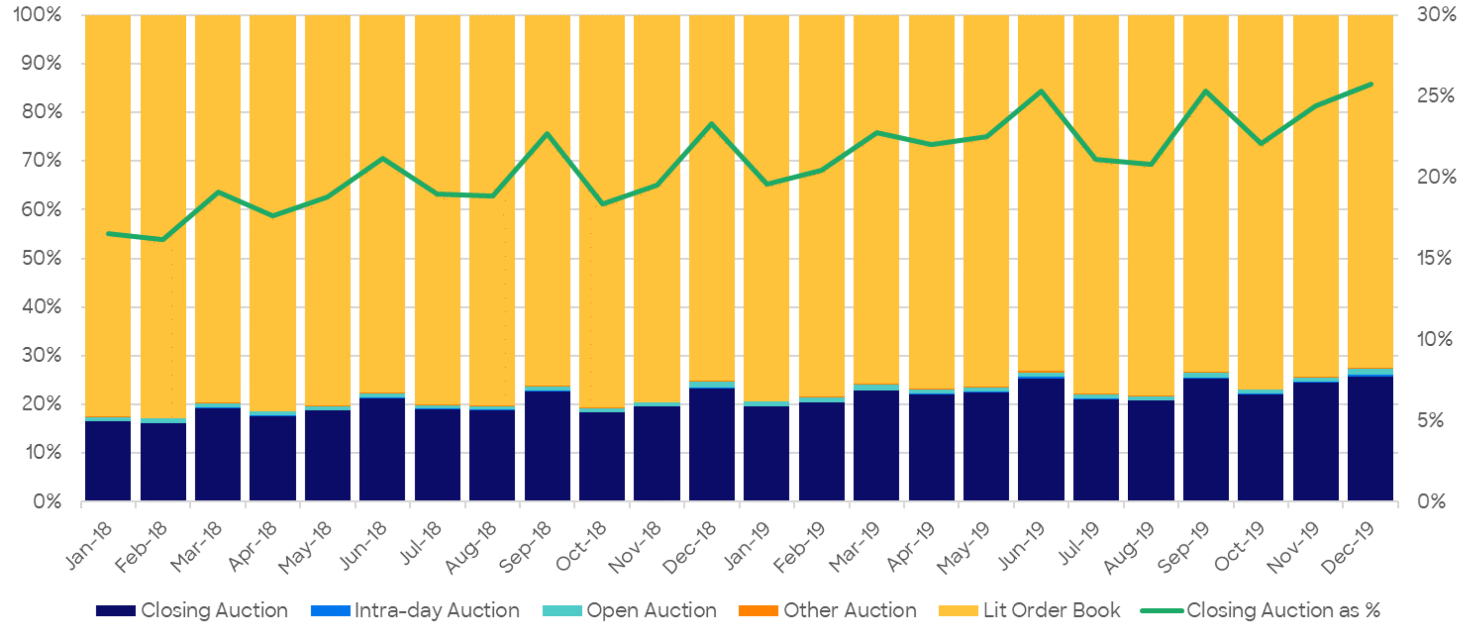


Source: CBOE

- Lit auctions remain stable consistently representing an average 23% of lit market volumes
- Q4 2019 has also seen the ADPT fall in lit trading

CLOSING AUCTIONS

Exhibit 11:



- Closing auctions have continued to grow over the last 18 months peaking 25% of lit market volumes in June, September and December 2019.
- While the success of these auctions is the direct result of the growth of index investing and ETFs, participants are also obligated to access auctions when trading VWAP.
- Given the rise in activity, it is likely that we will see greater regulatory intervention. The recent study by Autorité des Marchés Financiers (AMF)[10] illustrated that the proportion of shares traded at the close has increased significantly, reaching 41% of the volume traded on Euronext Paris for CAC 40 stocks in June 2019. While the AMF cite the rise in trading activity on the close is due to an increase in passive management, the desire to avoid HFT, and a rise in algorithimic trading, they also note the increase in best execution obligations under MiFID II to provide end investors with greater transparency regarding transaction costs and market impact may be encouraging more at close activity. Any reliance on closing auctions creates operational risks for traders, with the AMF noting a 9% increase in Suez Environment during the closing auction in May 2018 which incurred a trading loss of EUR 2.2mln.

[10] https://www.amf-france.org/en_US/Actualites/Communiques-de-presse/AMF/annee-2019?docId=workspace%3A%2F%2FSpacesStore%2F069eedf2-1029-4872-82bd-9aaf053e1af4

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Rebecca is considered to be one of Europe's leading industry voices on market structure, regulatory reform, and financial services technology. She has authored a plethora of qualitative research reports and commentary covering the impact of market regulation on all asset classes, changing market structure and developments in dark pools, HFT, and surveillance. She joined Liquidnet in July 2016 to use her 20 years' experience to collaborate and deliver insightful reports for both the European equities and fixed income markets. Rebecca is also Co-Chair of the FIX Trading Community's EMEA Regulatory Subcommittee. She has held prior roles at TABB Group, Incisus Partners, the British Embassy in Bahrain, Credit Suisse, Goldman Sachs International, and Bankers Trust International.

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Gareth heads up the Execution Consulting team for Liquidnet EMEA. Gareth has provided Execution Consulting & TCA services to clients for more than ten years, most recently at Bank of America Merrill Lynch where he was responsible for the TCA service, and before that as part of ITG's Post Trade Analytics team, providing third party TCA consulting services.

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Joe has almost ten years experience working in electronic trading in both London and Dublin. Before joining Liquidnet Joe worked at ITG in varying differnet roles, most recently sitting on the Algorithmic trading desk, providing insights on algorithmic and SOR trading strategies.

CHARLOTTE DECUYPER, MARKET STRUCTURE AND STRATEGY ANALYST, LIQUIDNET EMEA

Charlotte joined Liquidnet in May 2017 to work with Rebecca Healey on EMEA market structure and deliver research and insights about the European financial markets. Charlotte joined from Reed Exhibitions where she was a mergers and acquisitions analyst. Prior to Reed Exhibitions, Charlotte held a role at The Boston Company Asset Management in Boston.

To stay up to date with the latest information and to get more of a deep-dive into the detail, please contact **mifid2@liquidnet.com.**

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