This paper is part of *Making MiFID II Work*—our comprehensive content, learning, and resource programme about MiFID II and its impacts on the buy-side, both in Europe and around the world.

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    or

2. Clicking on the ‘apps’ icon from within Liquidnet 5.
Executive Summary

There is an argument that MiFID II has now been implemented successfully. Liquidity formation is showing early signs of settling down after the initial dislocation, and participants are adapting trading behaviours to adjust to the new regulatory framework. However, if the European politicians’ or regulators’ objective was to move liquidity back onto lit primary exchanges, it is questionable whether this has been achieved to the extent proposed. As a result, the implementation of MiFID II looks likely to remain a work in progress for some time to come.

Although dark MTF activity has declined to an average of between 5-6%, non-LIS activity has shifted to Systematic Internalisers (SI) and periodic auctions rather than return to traditional lit exchanges in the manner intended. According to a recent speech by the AMF, neither the trading obligation nor the double volume caps (DVC) have had a positive impact on lit venues for French equities: “True lit pools now account for 46 % of total volume, the same percentage as the 2017 average.”1 It is their view that “we are far from having achieved a satisfactory outcome.”2

The challenge for the buy side is that lit markets operated by exchanges offer a wide range of order types, some of which are designed to attract high-frequency trading, creating issues for those with institutional-sized trades to execute. As such, the ability to trade Large-in-Scale (LIS) remains a critical starting point in the execution process, with the vast majority of firms interviewed for this research seeing the shift to block trading in the dark as a positive outcome of MiFID II. When trading sub-LIS, the use of periodic auctions has increased rapidly, particularly for instruments that have breached the thresholds under the double volume cap, providing an alternative lit execution method—albeit with less pre-trade transparency than traditional Central Limit Order Books. However, although periodics may offer added protection, they also make it harder to identify addressable and non-addressable liquidity and are seen by certain regulators as circumventing the original premise of MiFID II. This adds to political pressure for further regulatory scrutiny.

Interaction with Systematic Internalisers has also delivered mixed results for the buy side. Not all SI constructs operate in the same manner and the buy side needs to establish which operating model works for its flow and when. Some asset managers may feel comfortable with accessing Electronic Liquidity Providers (ELPs) directly or via their brokers, but the majority still choose to access bulge bracket SIs only at this stage. This creates potential issues for those asset managers who appear unable to qualify for certain banks’ capital, risking an increase in their execution costs as a result. In addition, other participants noted that banks’ increasing appetite for risk, in the form of rising SI activity, may lead to wider market imbalances.

During April 2018, fifty-eight representatives from asset management firms based in the UK, in Europe, and across the globe were interviewed to understand the impact of new regulations on their ability to source liquidity in European equity markets. With the regulatory focus seemingly just on price formation rather than liquidity formation, the main challenge institutional asset managers face is their need to execute in size. The ability to achieve best execution when considering the ‘parent’ order is far more valuable than any marginal price improvement at a ‘child’ fill level, particularly given the latest focus on best execution and the importance of taking all trading costs into consideration, implicit as well as explicit. Despite the political pressure for further regulatory change, respondents were keen to stress the need to base any decisions on empirical datasets to understand the impact ahead of implementation.
Key highlights:

1. Just 19% of respondents see the introduction of DVCs as negatively impacting their performance given the introduction of new alternatives to trading in the dark.

2. Eighty-eight percent see the resulting increase in Large-in-Scale activity in the dark as a positive development post MiFID II.

3. For 68% of buy-side respondents, periodic auctions are considered a useful market construct post the introduction of the DVC. However, there is recognition that the regulatory framework around periodic auctions may need to be adjusted.

4. Just 12% of respondents believe that MiFID II has increased the level of volume transparency in periodic auctions.

5. There are concerns regarding the ability to establish what is legitimate addressable liquidity, and over half of the fifty-eight respondents are in favour of transparency around broker-preferencing.

6. Fifty-four percent of respondents are in favour of implementing a minimum order size in periodic auctions and 49% of respondents a minimum pre-matching period based on the liquidity of the instrument.

7. Sixty-five percent of respondents believe they can choose whether their broker routes to its SI or onto the open market, but a third remain unsure of routing practices given their inability to monitor broker routing effectively.

8. Forty-one percent are unable to track in real time the FIX data which denotes when a broker is routing to their internal SI.
Making Auctions Work

The meteoric rise in periodic auction activity to over €1 billion notional value traded per week has been argued by some as inevitable given the introduction of the double volume cap (DVC). The regulatory requirement to trade on lit venues once the DVC threshold has been triggered has resulted in the creative adaptation of the traditional auction model. Periodic auctions provide the ability to trade on the open order book but with necessary additional protection. This is illustrated in the recent rise in the value of capped versus non-capped stocks in Turquoise Periodic, Bats Periodic and Posit Auction since the introduction of the DVCs, and more recently Sigma X. €30.6bn was traded in periodic auctions in capped stocks since the introduction of the first round of the DVCs versus €13.7bn in non-capped stocks (see Exhibit 1).

Exhibit 1: Rise in the use of periodic auctions – capped versus non-capped activity

Providers of periodic auctions believe they offer a true price formation process in which all submitted orders are used to determine a single equilibrium match price, executed at or within the European Best Bid and Offer (EBBO). However, while closing auctions display the indicative executable price and size, periodic auctions are triggered only once matching orders are present. No information is visible prior to the initiation of a call period unless there is a match, and while this limits the risk of negative market impact, it creates potential challenges in establishing what is truly addressable liquidity.

The recent speech by the AMF⁴ emphasises these transparency challenges compared to trading on a continuous lit order book where orders are matched immediately. The French regulator sees the surge in periodic auction activity as closely linked to the DVC implementation, having been included in marketing collateral as a response to the suspension of dark trading⁵. While periodic auctions are considered lit trades, in the AMF’s view levels of transparency are very limited, the duration of auction is unknown, and contribution to price discovery is near zero. The AMF also voiced its concern that trades executed via periodic auctions which carry the same member as a seller and a buyer flag are in fact pre-arranged trades. The CBOE, in contrast, claims that broker priority allocations in its periodic auction represent just 30% of their activity⁶. The questions to answer are how exactly the broker preferencing works in practice, and whether even 30% is considered too much for European regulators given the regulatory requirement to improve transparency and move OTC activity onto fully lit exchanges.

⁴ http://www.amf-france.org/Actualites/Prises-de-paroles/Archives/Annee-2016?doid=workspace%3A%2F%2FspacesStore%2F11466bcc-5522-4004-92cb-8bd81c57624e&xtor=RSS-1
For buy-side respondents, nearly 70% consider periodic auctions a useful market construct post the introduction of the DVC (see Exhibit 2). Accessing periodics enables the buy side to achieve price improvement when trading sub-Large-in-Scale to ensure that costs are reduced for end investors: for example, when trading large baskets with multiple instruments which individually need to be traded sub-LIS; or rebalancing portfolios when a buy-side asset manager is looking to redeem for Fund A and invest for Fund B. Here, if Fund A is looking to sell and Fund B is looking to buy and both orders are submitted, Funds A and B can either trade with each other; alternatively, if there is a better price available in the auction, the client will automatically receive price improvement, again providing a better outcome for the end-investor.

However, many share the AMF’s frustration with the perceived lack of pre-trade transparency. Just 15% of respondents believe that MiFID II has increased the level of transparency in periodic auctions for price; and only 12% believe there is greater for volume transparency (see Exhibits 3 and 4).

“Given the existing regulations restricting dark trading, Periodics are useful”

“We don’t use Periodics at the moment as it is difficult to identify what is attainable liquidity”

“Without knowing the level of addressable liquidity, any price transparency is meaningless”
Alternatives

The AMF noted in its recent speech its appetite to implement some fine-tuning of MiFID II via quick fixes to technical errors in the ESMA Q&A in relation to both periodic auctions and Systematic Internalisers (SI). The options for periodics appear to be either to ban broker-priority, pegged order types or to implement minimum order requirements such as a pre-matching period. The frequency of trading with micro-second pre-matching is viewed by some regulators not as auction activity, but rather a means of facilitating pre-arranged crosses, similar to the now-banned Broker Crossing Networks.

How regulators are able to firm up periodic auction activity is potentially restricted by the fact that auction constructs are already available on lit primary exchanges. Intraday auctions can be triggered during periods of volatility, and daily closing auctions are available to provide certainty on closing prices. While all auctions have three phases—a call period when orders are submitted, a price formation phase, and an allocation period where orders are matched—closing auctions provide indicative price and volume with the full order-book depth displayed throughout the auction (or the surplus available at that price). In contrast, periodics only provide indicative price and volume, but no information is made available prior to the initiation of a call unless there is a match. Call periods for closing auctions happen during the same five-minute period each day, whereas periodic auctions have differing randomised call periods to prevent price manipulation at around one hundred milliseconds or less. Some also have a minimum call period to allow sufficient time for algorithms to respond to any changes in indicative prices and volumes; either an auction price is created and published at the start of the call period and locked throughout the auction, or the price evolves throughout the auction as participants change, remove or add orders. The price is then determined at the end of the auction based on all the submitted orders.

A key complaint is that while Closing Auctions use price/time priority, the majority of periodic auctions allow broker priority. This allows opposing orders sent by the same broker to be matched during the execution phase, moving the allocation logic from price/size to broker/price/size/time.

While broker-priority matching is available even on some lit exchanges, this can create challenges for asset managers. If trading volume includes non-addressable liquidity, this has implications for best-execution analysis as well as preventing order execution; but it is the lack of transparency into the process that creates concern. Not all broker preferencing is immediately apparent, with some periodics only implementing broker-preferencing after the auction process is complete. Lack of transparency in the different periodic auction protocols has led to over half of the fifty-eight respondents being in favour of greater transparency around broker-preferencing (see Exhibit 5).

The extent to which periodic auctions are price-forming is also of concern to the regulators. Periodics continue to utilise the reference price without contributing to price formation, and some argue that this disadvantages European national exchanges which are required to provide greater transparency in fully-lit order books.

**Exhibit 5: Would transparency over broker-preferencing remove the challenge of non-addressable liquidity with auctions?**

- Yes: 51%
- No: 19%
- No view: 30%

Source: Liquidnet market structure commentary

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"Yes, transparency over broker-preferencing could help, though this will highlight reaction speed and latency issues"

"Even if the broker-preferencing is transparent, it doesn’t necessarily make it more addressable"
New alternatives include Request For Quote (RFQ) models where traders can request a quote from potential counterparties, based on a ‘one-to-one’, ‘one-to-many’, or ‘all-to-all’ model depending upon the situation and the trader’s preferences. A quote manager handles the requesting and responding quotes via algos with individual participant groupings so they only RFQ each other, although quotes can be accepted manually or automatically if requested criteria are met. Trading as RFQ price formation can be created outside the midpoint of the displayed quote, is bilateral and pre-trade transparent at the point of trading, and is not eligible to be capped as per the European Commission RTS. There have been regulatory questions raised around bilateral activity on a multilateral platform. This was initially resolved last year for non-equity instruments by permitting RFQ-for-one but appears now to be back on the agenda for some regulators. It was noted that this model would also benefit from utilising the reference price waiver, relying on price formation in the lit environment by other venues and participants in a similar manner to periodics.

The French regulators’ suggestion to curtail the potential negative impacts of periodic auctions by imposing a minimum order size and pre-matching period based on the liquidity of the instrument appear to be in line with the majority of respondents. However, imposing a minimum number of participants in an auction received a more muted favourable response (see Exhibits 6, 7 and 8). Implementing a pre-matching minimum period would allow institutional order-flow the opportunity to dynamically adjust to market data and potentially create more liquidity as a result.

Exhibit 6, 7 and 8: Should a periodic auction require a minimum order size / pre-matching period / number of respondents based on the liquidity of the instrument?

Order Size
- 35% Yes
- 54% No
- 11% No view

Pre-Matching Period
- 49% No
- 28% Yes
- 23% No view

Number of Respondents
- 49% No
- 28% Yes
- 23% No view

Source: Liquidnet market structure commentary
For the European Commission, the analysis on periodic auctions needs to be more granular, such as focusing on what level of information has to be provided pre-trade. For example, whether to publish the indicative price and volume only, or whether to include the unmatched quantity also; and secondly, if the surplus is published throughout the day, what impact this would have on the lit order book.

The Commission is also reviewing whether periodic auction protocols should be able to lock a price throughout the auction, or if the price should be allowed to change throughout the call period as participants add, amend or remove orders. It is also reviewing whether the tie-breaker of the auction should be the ability to maximise volume and minimise surplus, rather than matching at mid, or whether the mid-point should be dynamic to move in line with the BBO throughout the call period.

Finally, the Commission is also planning to review broker-preferencing; whether to allow an allocation logic that moves from the usual price/time/size sequence to a price/broker/size/time or to price/size/broker/time, which would give preference to better priced and larger orders, reducing broker-preference only to time; or whether to remove broker-preferencing altogether.

Whatever changes are implemented, respondents emphasised the need to have multiple methods of execution available to them, given the wide variety of orders, differing market conditions as well as execution objectives they need to meet to ensure they are able to deliver best execution for end-investors.

**Solving SI**

Activity in SIs has seen a steady rise since the start of MiFID II which on initial reading appears to correlate somewhat with the decline in off-exchange activity (XOFF) (see Exhibit 9). Yet, even after filtering the activity, SI activity is significantly above what was understood to be BCN activity, pre-MiFID II. While filtered SI flow has levelled off to between €8bn and €9bn a day, this represents an average of 13% of market volume since the introduction of the DVC.

However, although buy-side respondents noted the benefit of accessing certain SIs, confusion continues to frustrate many with regards to the true figure of SI activity, the continued lack of transparency within the SI regime as to its various constituents, and the interaction between each SI as well as the type of activity they trade.

**Exhibit 9: SI activity with conditional code filtering and excluding out-of-hours prints**

![SI activity with conditional code filtering and excluding out-of-hours prints](source: Rossenblatt Securities & Bloomberg)
Currently, SIs only have to trade report to an Approved Publication Arrangement (APA) under the waiver SINT (Systematic Internaliser Negotiated Trade). This potentially provides asset managers with less visibility into which SIs are gaining market share, and in which instruments, for the purposes of implementing best execution under MiFID II, in comparison to the level of pre-trade transparency on lit MTF venues and post-trade transparency on dark MTF venues. The use of Market Identifier Codes (MICs) or Legal Entity Identifiers (LEIs) as identification is required for transaction reports to the regulator but not trade reports for publication, with arguably less transparency than the broker dark pools’ use of FIX message tags 29, 30 and 851. In the ESMA Q&A there was a suggestion that MIC codes would need to be provided to asset managers to complete RTS 28 best-execution reports. However, it appears some brokers will instead act under “receipt and transmission” rules, meaning they will only need to disclose their activity as a broker, and not how much of the activity has been transacted on an SI at a fill-by-fill level.

Furthermore, there are conflicting industry legal opinions as to what should or should not be reported as true SI activity; technical trades which should be flagged as transactions not contributing to price formation (TNCP) versus those which should be identified as XOFF. The regulators see these as merely incorrect reporting issues, but there is growing industry recognition of the importance of consensus around the identification of addressable and non-addressable OTC/SI liquidity. Current FIX market model typology (MMT) industry standards are to identify the following trades as non-addressable SI liquidity:

- Non price-forming trades
- Trades not contributing to the price discovery process
- Technical trades
- Ex/Cum or special dividend
- Duplicative trade reports
- Trades with conditions
- Give-up/Give-in trades

While the regulatory intention was for market participants to be able to select an SI for its execution capability and then trade directly, the lack of transparency is leading to nearly 90% still choosing to access SIs via their brokers rather than elect to trade with an SI directly (Exhibits 10 and 11).

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**Exhibit 10 and 11: SI interaction – method of interaction: direct or via a broker / Bank vs ELP**

<table>
<thead>
<tr>
<th>Direct or via broker</th>
</tr>
</thead>
<tbody>
<tr>
<td>Broker</td>
</tr>
<tr>
<td>IT Provider</td>
</tr>
<tr>
<td>Direct</td>
</tr>
<tr>
<td>MTF RFQ</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Bank vs ELP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not at all</td>
</tr>
<tr>
<td>Banks SIs only</td>
</tr>
<tr>
<td>Bank SIs and ELPs</td>
</tr>
</tbody>
</table>

Source: Liquidnet market structure commentary

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“*I am aware if I switched the SI on or not, but cannot see where it is routing live.*”

“*Yes, we are aware, but it is hard to police or monitor.*”

“*Onward routing no, we only have the tags they pass back and what they tell us they’re doing in general.*”

“*Brokers ask for permission ahead of time in our general settings, but we can’t police an individual trade route.*”

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Utilising brokers offers asset managers the ability to trade against a variety of different liquidity within bulge-bracket organisations from principal SI to central risk books which could create block-trading opportunities based on multiples of average order sizes as well as direct algorithmic flow. In contrast, ELP SIs can offer bespoke feeds to individual clients based on their liquidity needs; this may be more appropriate for more sophisticated trading organisations, hence a smaller proportion engaging with ELP SIs at this stage.

Those buy-side firms accessing SI venues through brokers have the option to request best execution or toxicity analysis on the SI, as per other venues accessed. The publication of RTS 27 on June 30th may also help the buy side to better understand how each SI interacts and how they are accessed by their brokers, detailing average fill sizes and quality of execution. Clearly, it will depend on the individual asset manager and their technology capability as to the buy-side firms’ ability to derive value from RTS 27 datasets. This in turn will likely influence whether they choose to access an SI running pure market-making strategies for best price on a continual basis, versus accessing a broker SI with principal positions which may offer larger size.

Some buy-side asset managers have decided to limit their activity to either the sell side (ELPs) or a single SI interaction, or not engage with SIs at all at this stage. Visibility into data and performance remains critical to buy-side confidence, with 38% of respondents not seeing an improvement in price transparency and a further 40% believing it was too early to tell from the data currently available to them (see Exhibit 12).

The most important factor in the selection process will be the ability to access accurate and transparent data. Not only does the buy side need to establish which operating model works for its flow, it needs to understand when it is suitable; sub-LIS versus above-LIS ELP and broker SI flow can have very different profiles, which also impacts performance. This is also not static information; ESMA will publish the first SI denominator—the total number and volume data—for the first half of 2018 on August 1st; then firms will be obligated to undertake SI status if their liquidity breaches a certain threshold. This will then be updated on the first day of November, February, May and August each year to adjust the SIs on the 15th of each month.

Exhibit 12: Do you believe that MiFID II has increased the level of price transparency in SIs?

![Exhibit 12: Do you believe that MiFID II has increased the level of price transparency in SIs?](source: Liquidnet market structure commentary)
Initial thoughts appear to be that liquidity from ELPs is less than previously forecast, and that is being provided to the bulge-bracket brokers who are then passing it on to the clients of their previous crossing networks. At a recent industry conference, an estimation was made that ELPs represent 2–3% of market share, which would leave banks’ SIs with 80% of the total SI activity as a natural way to connect in-house liquidity; this can then be delivered to clients with superior fill-rates and quality above the liquidity brokers are able to provide through lit exchange trading. Regulators are reviewing intra-group, back-to-back trading offsetting the risk nature of an SI. The question is whether the SI model is behaving bilaterally or multilaterally, bringing together buying and selling interests in functionally the same way as a trading venue, as per the restrictions outlined in the Delegated Regulation. Sell-side participants argue that bulge-bracket SIs are a natural conduit between the ELPs and lit venues rather than creating links of multilateral liquidity. Just over one third of participants noted their ability to quantitatively assess performance, which has an impact on confidence levels and certainty over the execution quality received (see Exhibits 13 and 14).

Exhibit 13 and 14: Do you assess execution based on quantitative or qualitative analysis? / Have you encountered differing quality of execution between ELP SIs and bank SIs

![Exhibit 13](image1)

![Exhibit 14](image2)

Source: Liquidnet market structure commentary

While 65% of respondents believe they can choose whether their broker routes to its SI or onto the open market, it is difficult for some to police (see Exhibit 15). Although brokers may ask for permission ahead of time, the buy side often struggles to monitor individual routing practices: 41% respondents are unable to track the FIX data which denotes how a broker is routing to an internal SI (see Exhibit 16), and just 38% know if the broker SI is onward routing to an external SI (see Exhibit 17).
While several respondents are becoming comfortable with how they can engage with SIs and are satisfied with the trading performance they see, almost half still have concerns that the SI construct may lead to cherry-picking of buy-side flow (see Exhibit 18).

Exhibit 18: Do you have concerns that the SI construct will lead to cherry-picking of buy-side flow?

Source: Liquidnet market structure commentary
The reality is that not all SI constructs will operate in the same manner and the buy side will need to establish which operating model works for its flow and when. Regardless of whether an asset manager is routing to a broker SI or an ELP, institutional asset managers need to consider performance at the parent order level not just at the individual child fill level to decide routing practices. Performance will vary due to differences in how brokers’ algorithms and SORs work, individual technology stacks as well as their interaction with other SIs. The risk of ‘blind’ pinging where an SI sends orders without first consuming price feeds risks creating unnecessary information leakage if there is no liquidity that can be executed against. Hence it is essential for buy-side firms to understand how they are interacting with the SI as well as how the SI works within the market eco-structure. Any lack of transparency into this process increases concerns of supposed toxicity. As a result, nearly 80% of respondents are unable to tell whether there is increased toxicity on SI venues (see Exhibit 19).

Exhibit 19: Have you seen increased toxicity on SI venues?

4% Yes
18% No
78% Too early to tell

Source: Liquidnet market structure commentary

What Next for SIs?

The AMF recently published a study into the impact it had seen from SIs in French equity markets. In 2017 pure OTC trades accounted for 40-50% of the volume traded with marginal SI activity. By March 2018, OTC activity had declined to just 11% while SI volumes soared to 32%, with most SI trades corresponding to a smaller tick size than the one imposed on lit markets. Similar to their views on periodic auctions, the AMF has expressed its desire to see a “carefully coordinated review of SIs operations”. In particular, it noted the differences in average trade sizes and commented on the difficulty in understanding how HFT firms are adopting the SI construct.

Activity in SIs provided to the Commission illustrates that under-SMS (Standard Market Size) trading is ~60% of the overall volume in SIs, and 36% is done both sub-SMS and sub-tick. This has led to concerns from politicians and regulators that SIs are wrongly rewarded for taking risks. As such, the SI is currently under review by the ESMA Task Force Working Group to implement the tick size for sub-SMS as per the recent study by the AMF into the tick size regime in France13. A proposal to implement the tick size regime to all SIs above and below SMS as well as to LIS models operating a mid-price crossing is also being discussed by the EU Parliament.

Buy-side respondents argued that extending the tick size obligation to SIs and preventing mid-price crossing will not prevent the buy-side from trading on SIs, but will benefit market makers who can capture the spread, and negatively impact the end-investor who will be forced to pay the spread.

The recent study by the AMF detailed the impact of the tick size regime for more than five hundred stocks traded on Euronext Paris from December 2017 to January 2018. The findings indicated that increments that are too small are insignificant and lead to continual minor price improvements, creating noise in the order book and leading to a deterioration of price formation. While respondents were sympathetic to this view, the suggestion was to make tick size increments possible rather than just meet the tick size regime. This also need not be limited to SIs or MTFs; some asset managers indicated that they would be happy to pay a higher fee to
exchanges if they could cross at the mid. While sub-tick price improvement was important for a third of respondents, the transparency exemptions were of greater value given the size of order most institutional asset managers need to execute. Again, the type of flow, market conditions, and the urgency of execution will translate into different requirements depending on the individual order as well as the individual firm.

Exhibit 20 and 21: How important are advantages the SIs enjoy when trading on principal such as sub-tick improvements / transparency exemptions on quotes above SMS?

Source: Liquidnet market structure commentary

The challenge is that the SI construct covers all types of broker price-forming and non-price forming activity and there is a risk in grouping all this activity together with different options in the provision of risk—from ELP liquidity in small size with a tight spread to large volume activity—as well as how this risk is unwound. Ensuring greater transparency in the SI regime will regulate the SI regime through better natural selection—those SIs that provide best execution will see volumes rise, those with higher reversion will decline.
Next Steps for the Industry

To improve investor confidence in European financial markets, regulators continue to focus on greater transparency throughout the investment process. However, increased transparency in and of itself will not automatically deliver better performance for end-investors.

The ability to trade in the dark will remain central to asset managers with institutional order flow to execute given their need to execute in size. The ability to achieve best execution when considering the ‘parent’ order is far more valuable than any marginal price improvement at a ‘child’ fill level—particularly when considering the importance of taking all trading costs into consideration, implicit as well as explicit. Although the percentage of Large-in-Scale trading has increased sharply from 5% in 2016 to over 50% today, dark MTF activity only represents between 5-6% of daily order book notional, versus an average of 10% pre-MiFID. Dark volumes have fallen but the proportion traded LIS has increased to meet the buy-side need to trade in the dark in size (see Exhibit 22).

The argument for trading institutional-sized orders in the dark is a clear one, to protect the end-investor from negative market impact due to unnecessary information leakage. However, the argument for trading sub-LIS orders in the dark may be just as valid for those asset managers looking to improve execution performance for a portfolio rebalancing or when facilitating institutional crosses. The reality is that asset managers need multiple methods of execution available given the variety of orders, differing market conditions, and execution objectives required. Hence the rise in use of periodic auctions and SI as alternative methods of sourcing liquidity. The bigger issue for the buy-side is greater transparency around broker-preferencing, as well as SIs; when are participants interacting with genuine bank principal risk only versus ELP.

As politicians and regulators focus on the use of these constructs as potential circumvention of MiFID II, the wider question is why institutional asset managers continue to avoid trading on primary lit exchanges. Anything short of an outright ban on trading away from lit primary exchanges is unlikely to be effective given the industry’s innovative response to any regulation that is introduced. Yet, to implement such a ban would be anti-competitive in nature and in contrast with the central premise of MiFID II.
The need for asset managers to find volume rather than only focusing on price means that the buy side continues to embrace sell-side functionality that pieces together the necessary liquidity it seeks. This is not new. Broker Crossing Networks (BCNs) often had flow which did not interact with other BCNs, and bulge bracket firms relied on SOR and HFT to ‘knit’ this liquidity together. Matching this flow without the need for an intermediary through the restriction of broker-preferencing could be beneficial. However, any broker interaction, either via periodics or using SIs, needs to be more transparent in how the underlying trading construct operates in practice for the buy side to feel confident of meeting best-execution obligations.

If the regulatory intention remains to move trading away from the dark and back to the lit, then European exchanges must also focus more on improving the quality of liquidity on lit order books; perhaps a reduction in fees relative to liquidity provision, or specialist market making schemes for small cap stocks to focus on the provision of liquidity. The challenge for the regulators is that there is currently little incentive for exchanges to alter the services they offer, given the continued focus on data revenues rather than liquidity provision. There is a risk that MiFID II is focusing on scale alone which could potentially lead to higher dealing costs for the real retail investor; those who invest pensions and other savings into collective investment schemes managed by asset managers. If ESMA were to implement a consolidated tape, this would reduce the need for many asset managers to subscribe to bundled data services they no longer require or accept the need to purchase multiple connections. Competitive forces would then force exchanges to lower data costs to similar levels to the US. Implementation of global standard practices could also create greater transparency in how addressable liquidity, be it in periodic auctions, Reg NMS in the US, or other practices in Asia can be delivered to the market.

With European markets appearing so overly complicated, there is a tendency for some European officials to look to the US markets as having the correct balance between dark and lit trading, with 75% of volumes in the lit and Automated Trading Systems (ATS) in the US capped at 5% per stock. However, in the US there are dark order types even in the lit markets, such as on Nasdaq, where mid-price matching is allowed. Perhaps the playing field could be levelled for both exchanges and MTFs by allowing lit exchanges to operate mid-point match order types in a similar manner to the Nasdaq mid-point match. Trading on lit exchanges is likely to increase faster if there are incentives to be able to trade in a manner that reduces the cost to the end-investor (such as a mid-point match) rather than restricting trading activity in its entirety.

Resolving these issues matters as any future liquidity challenges are likely to be impacted further by the fallout from Brexit. Currently, as the share trading rules apply, European MiFID II firms will not be able to trade with UK-based SIs or MTFs if no equivalence agreement is reached. There is also a risk for US ATSs in that the EU Parliament wants to have a say on equivalence and will restrict this to registered exchanges only. This could limit European MiFID II firms to accessing liquidity on European registered venues only. There is a secondary impact on periodic auction MTFs and SIs based currently in UK. While most firms have already put in place Brexit planning, licences are still being granted by EU member states under the ESMA European Supervisory Authority (ESA) review. These may or may not be approved by national regulators as many of them are unfamiliar with the manner in which periodic auctions can operate.

In short, even once the periodic auction and SI debate is resolved, MiFID II is far from complete and the regulatory work will continue regardless of the Brexit outcome. What is emanating from the buy-side community is a period of reflection to collect and evaluate empirical data over a period of time before implementing further regulatory changes. In the meantime, there is more that the industry can do today to improve their ability to deliver value for end-investors. Primary exchanges making the lit a more attractive place to trade might just be the start.
About the author

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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 research and insights for both the European equities and fixed income markets. Rebecca is also Co-Chair of the FIX Trading Community’s EMEA Regulatory Subcommittee, dedicated to addressing real business and regulatory issues impacting multi-asset trading in global markets. 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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