

Making MiFID II Work

MiFID II Liquidity Landscape: Q4 2018

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MiFID II Liquidity Landscape: Q4 2018

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MiFID II has now been in force for over a year and while implementation remains work in progress, the industry is successfully adjusting to the new liquidity landscape thus far. The challenge will be what lies ahead for the industry in 2019 given the indications from both regulators and politicians that further amendments to MiFID II are likely if current trading behaviours do not deliver the level of transparency required.

Dark trading continues to remain central for asset managers in reducing trading costs and delivering improved execution performance for end investors. While the introduction of the Double Volume Caps (DVCs) was less disruptive than first feared by some, liquidity did not return to lit continuous trading in the manner anticipated, but continues to fragment over a wider range of execution options, creating further challenges for the buy-side to uncover and access quality liquidity. These shifts in liquidity formation are set to continue during 2019 as the industry continues to evolve to the realities of MiFID II and even further potential change from the outcome of Brexit.

As DVC suspensions lifted in the last quarter of 2018, dark trading increased to 7% of overall market volumes; but as the proportion in the dark grew, the proportion traded Large-in-Scale fell. However, longer term trading behaviours are shifting as the responsibility to source liquidity sits increasingly with the buy side trader along with the obligation to evidence best execution. As a result there is a greater propensity to trade blocks wherever possible which has seen the proportion of large in scale trading maintained at ~36% of dark volumes compared to 10% in 2016¹.

The emergence of new methods of execution such as periodic auctions continued to rise in the first half of 2018, stabilizing at circa 2% of the market. Some buy-side concerns remain in relation to the levels of broker preferencing and transparency as demonstrated in Liquidnet's report². As a result, ESMA's call for evidence on periodic auctions, launched in November 2018³, signals the likelihood of further regulatory change.

Systematic Internaliser activity initially increased substantially in the first half of 2018 reaching €15.8bn. However, since August the amount executed on these venues has decreased to an average of €6.5bn in November and December. This drop in activity coincided with a continued fall in the average fill size from ~58.9k EUR in April to ~21.7k EUR in December. In the second half of 2018, the executed notional is down by 31% for interactable SI activity and 46% for non-interactable liquidity. This is likely due to improvements in classification of true SI activity reducing noise in the SINT tape, as well as brokers realigning the level of capital available within SIs as the success of individual business models become apparent. With the European Commission's recent amendment⁴ to subject SIs to the tick size regime for standard trade sizes and restrict their ability to price improve, liquidity formation within SIs is also set for further change.

The political uncertainty surrounding Brexit and the future relationship UK/EU27 will also impact the likelihood of further legislative change. There is still a question mark on whether the UK Parliament will ratify the Withdrawal Agreement in a vote expected to take place the week of January 14th. With the EU unwilling to re-open negotiations to provide legally binding clarification on the temporary nature of the backstop, both the UK and EU have accelerated their "no deal" contingency planning ahead of March 29th and the risk of liquidity splitting between the UK and the EU27 remains, ultimately making markets more fragmented and less efficient.

Political events will continue to make their mark on European markets this year. The European elections are scheduled to take place in 23-26 May, and the European Commission and the European Council terms are also coming to an end with replacements expected to be in place in the second half of 2019. With political deadlines fast approaching, legislative efforts are intensifying; **The Investment Firm Review (IFR)** looks to limit cross-border access of third country firms into the EU while the **European Supervisory Authorities (ESA) Review**⁵, proposes greater controls over third country venue access by putting in place a "reciprocal requirement" for the equivalence determination. The political outcome of Brexit along with the IFR and ESA review could dramatically change the direction of travel for EU Capital Markets paving the way for continued regulatory change in Europe under the guise of MiFID III. While the industry has successfully adjusted to MiFID II, no-one can remain complacent for what lies ahead in 2019.

The data discussed in this introduction are taken from the charts set out in the following pages unless states otherwise

¹ Shape Shifting: Accessing the Dark Post MiFID II. Liquidnet, December 2017

² http://www.liquidnet.com/uploads/1805_LNU_Buy-Side_Perspectives_WEB.pdf

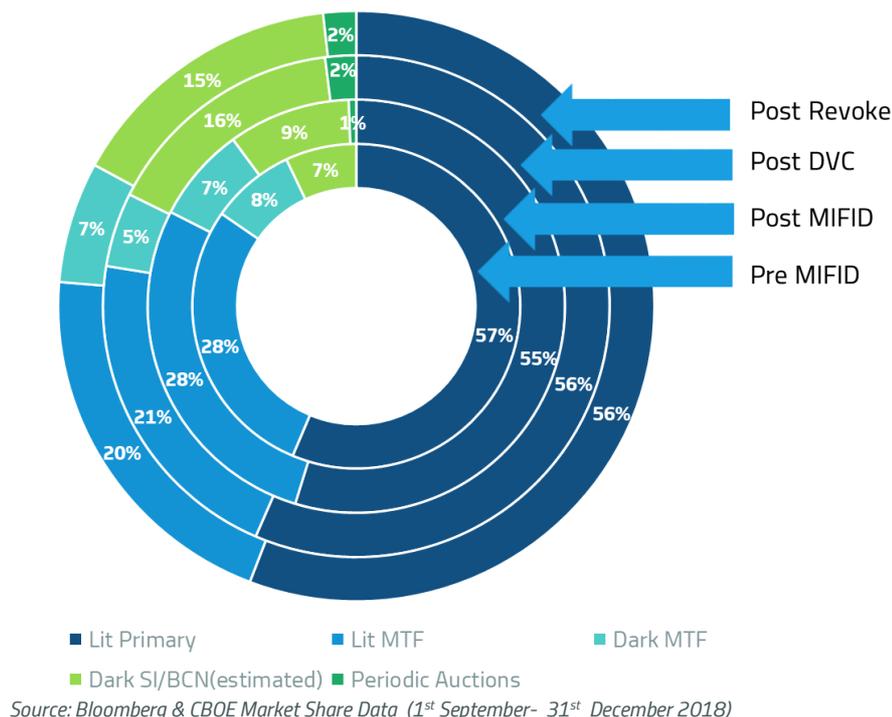
³ <https://www.esma.europa.eu/press-news/esma-news/esma-launches-call-evidence-periodic-auctions-equity-instruments>

⁴ http://ec.europa.eu/finance/docs/level-2-measures/mifir-delegated-act-2018-8390_en.pdf

⁵ <https://www.linkedin.com/pulse/brexit-100-days-counting-rebecca-healey/>

LIQUIDITY OVERVIEW

- The Lit market remains consistent ~75% of the overall market.
- Dark MTFs saw their share of the market fall to 5% during the initial suspension period. However this has increased to 7% since the first round of suspensions were lifted in September, a market share similar to post MiFID II levels before the introduction of the DVC.
- The SI market remains constant at 15%, only losing 1% market share since the first suspensions were lifted. Questions remain on what the true size of this market is given the confusion regarding addressable vs non addressable volumes, with industry participants pushing for regulatory guidance on use of the FIX MMT regime
- Similarly, after a steep increase in the first half of 2018, periodic auctions have settled into a regular size of ~1 to 1.2bn EUR per day, accounting for 2% of the market.



OVERALL MARKET VOLUMES



Source: CBOE European Equities Market Share

- After an increase at the beginning of Q4, overall market volumes decreased towards the end of the year as activity slowed down.
- October saw an increase in volumes to ~52bn EUR per day and the dark market rose to 8% of the overall, up from 6.8% in September and 4.9% in June.

SYSTEMATIC INTERNALISERS

SI Activity - Filtered & Excluding Out of Hours



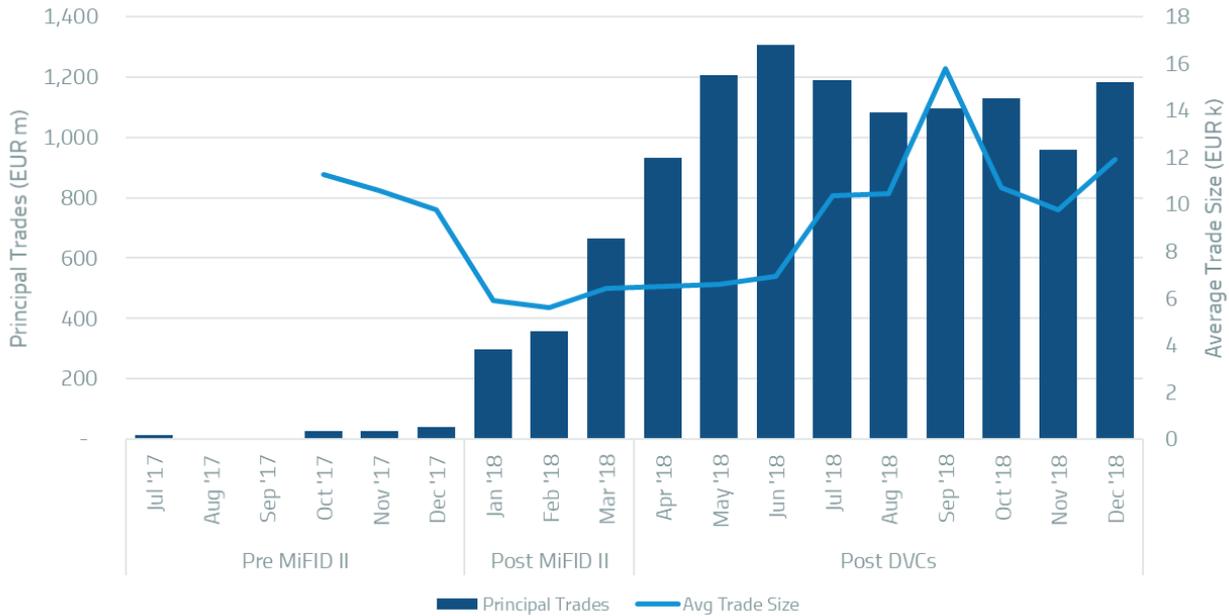
Source: Rosenblatt Securities & Bloomberg

- SI activity grew steadily in the first half of 2018 reaching 15.8bn EUR in June, however since August 2018 the amount being executed on these venues has fallen to 6.5bn EUR in November and December.
- Coinciding with the drop in activity has been a continued fall in the average execution size from ~58.9k EUR in April to ~21.7k EUR in December.

SI (SINT, BATF) Changes June - November, 2018			
	Trades	\$ Notional	\$ Avg. Trade Size
Interactable	585,032	- 129,630,062,719	- 22,043
	8%	-31%	-36%
Non-Interactable	- 453,333	- 304,195,320,245	- 68,839
	-12%	-46%	-39%

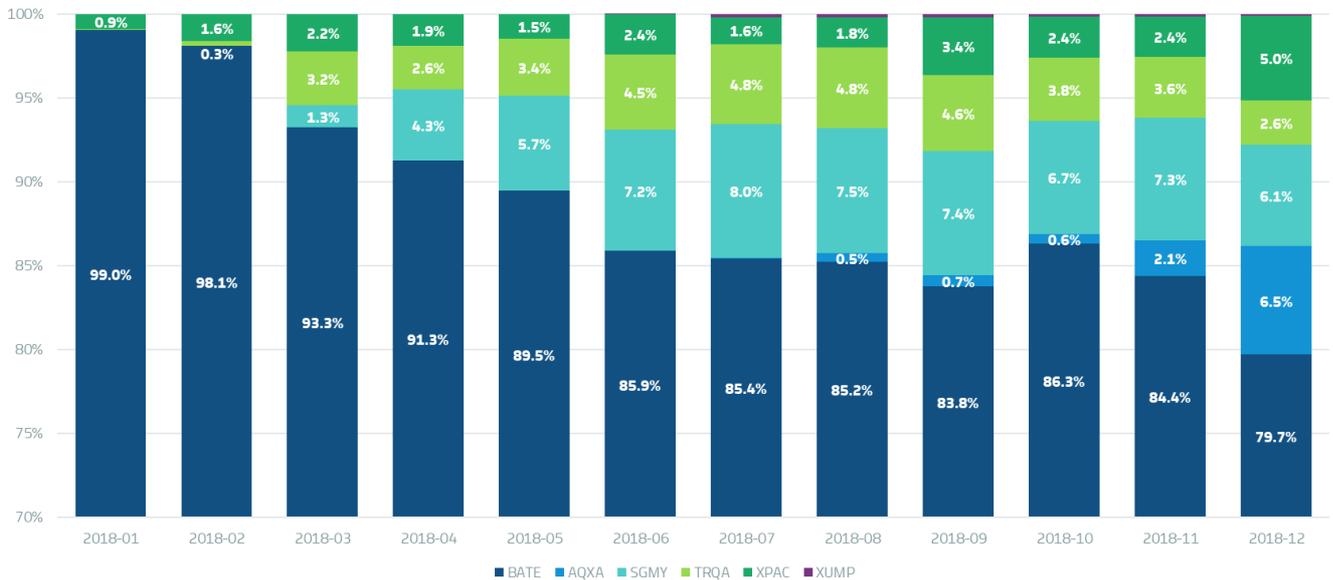
- While the number of trades has risen by 8% for interactable liquidity between June and November, the executed notional is now down 31%. For non-interactable liquidity the decrease reaches 46% as the classification of true SI activity improves.
- With the DVC suspensions being revoked for some names it remains to be seen whether the overall activity on SIs will fall as market participants return to dark MTFs or whether they will remain the significant part of the market that they have become.

PERIODIC AUCTIONS



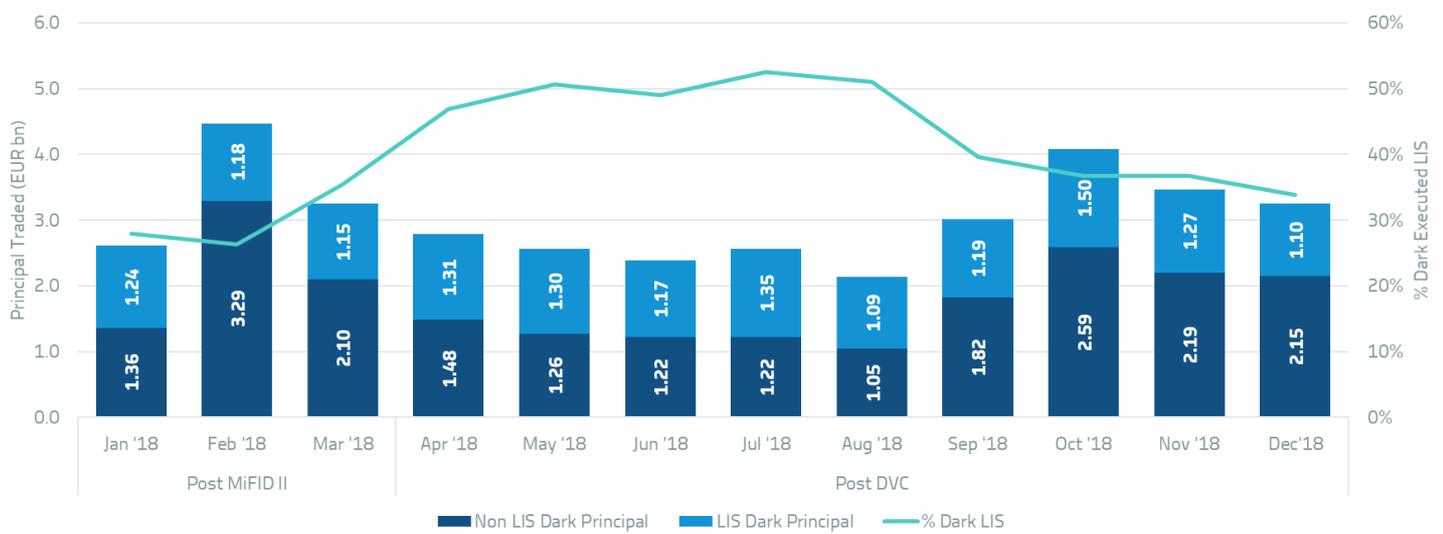
Source: Bloomberg

- Periodic auctions have plateaued in recent months, settling within a range of 1bn to 1.2bn EUR per day.
- There are now six periodic auction providers, with Aquis and UBS the newest entrants.
- Despite increased competition, CBOE remains the biggest participant in this market with ~80% of the market, followed by Aquis capturing 7%, and Goldmans Sigma Y ~6%. Aquis who launched its periodic auction platform in May registered an important growth in the last 6 months.
- The average execution size has increased to above 10k EUR.



Source: Bloomberg

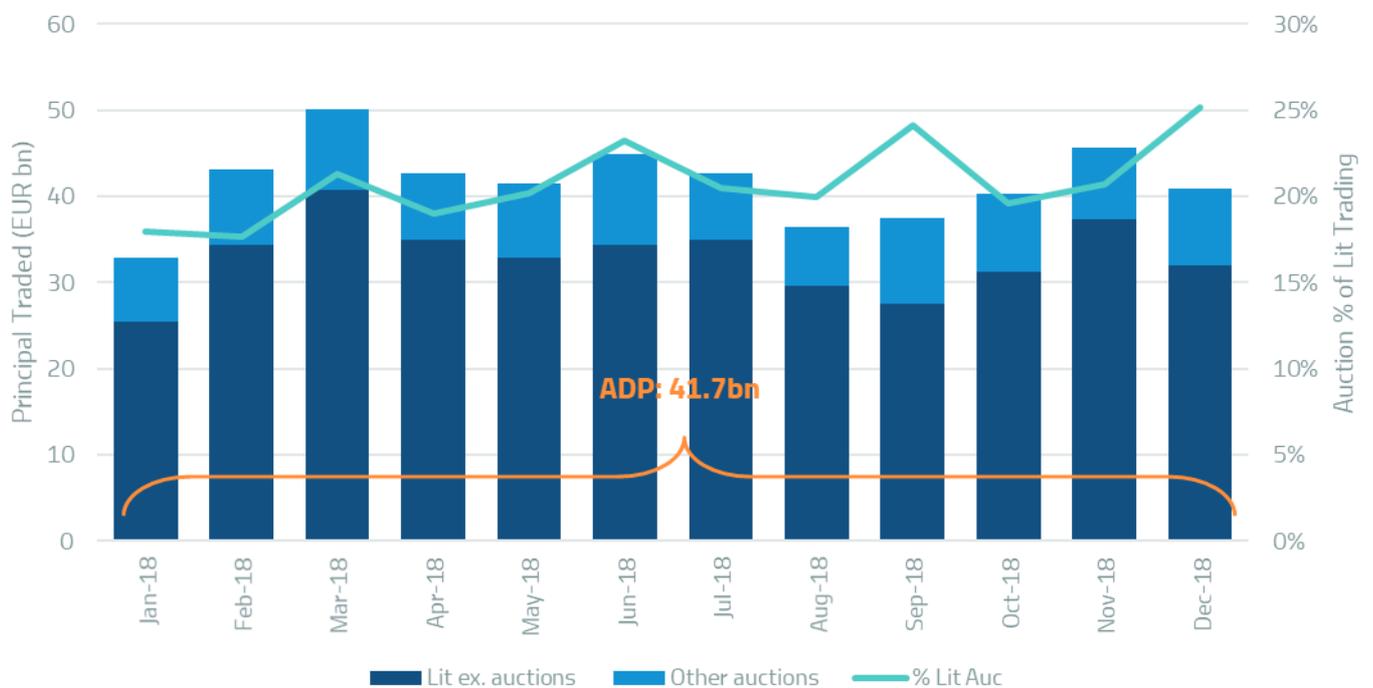
LARGE-IN-SCALE



Source: Bloomberg

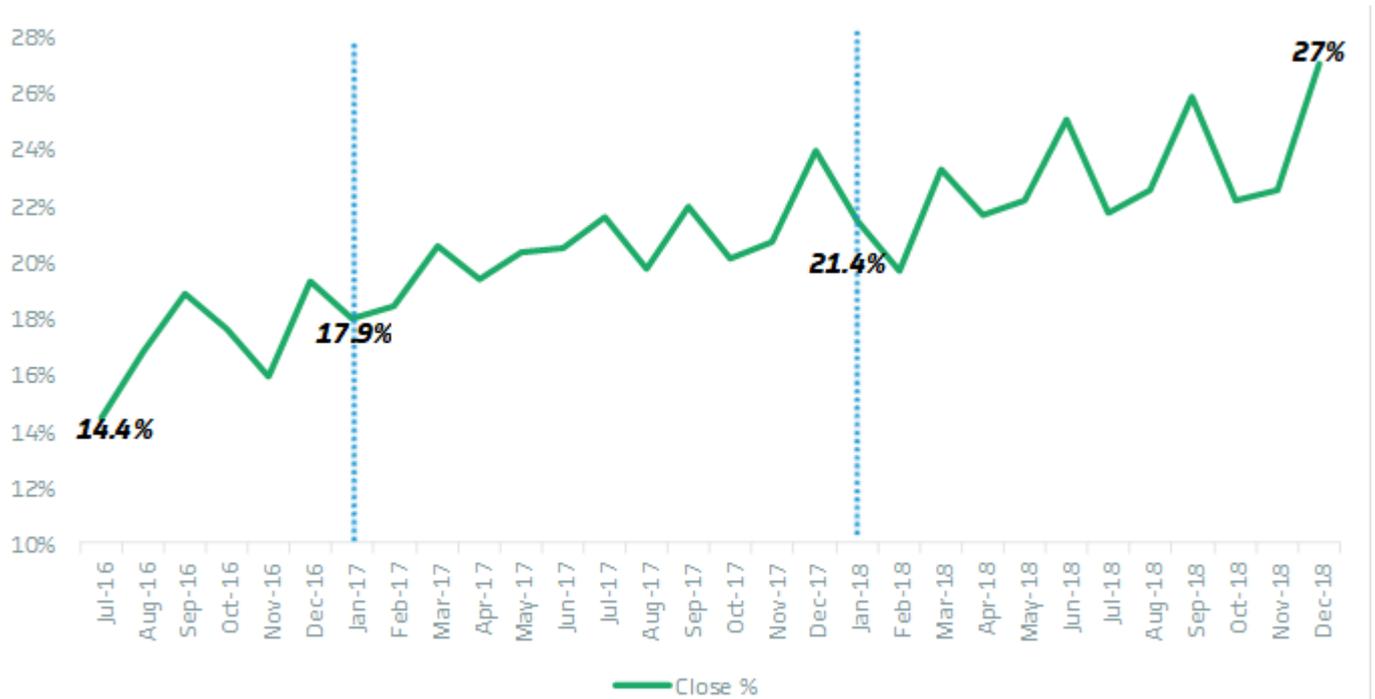
- Dark activity has continued to increase since the first DVC suspensions were lifted in September. As a result, the proportion being traded LIS fell to ~36%.
- LIS in notional terms is fairly consistent between 1.1bn and 1.5bn EUR per day since the start of the year and this has continued despite DVC suspensions being lifted.

LIT VENUES



Source: Bloomberg

CLOSING AUCTIONS



Source: BigXYT

ABOUT THE AUTHORS

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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.

GARETH EXTON, HEAD OF EXECUTION CONSULTING LIQUIDNET EMEA



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 different 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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