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Making MiFID II Work

MiFID II Liquidity Landscape:

H1 2019

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By Rebecca Healey & Charlotte Decuyper, Market Structure & Strategy, EMEA,
and Gareth Exton & Joe Fields, Global Execution & Quantitative Services

One week on after the loss of equivalence to Switzerland July 1st and the introduction of Swiss Ordinance, it is clear that the immediate winner has been trading on the primary Swiss Exchange. There has been an increase in the number of both trades and the notional executed each day on the primary lit and its dark book SwissAtMid, excluding a dip on July 4th due to the US holiday. While European venues are currently prohibited from offering or facilitating trading in certain shares of Swiss companies and a number of stocks have been de-listed from European venues such as Aquis Exchange, CBOE Europe, ITG Posit, Liquidnet MTF, Turquoise and UBS MTF, alternative means to trade remain, either by:

- Trading direct on SIX Swiss Exchange (SIX) via remote membership – currently available to Liquidnet members via their broker relationship;
- Via a local Swiss Broker;
- Or Via an SI

Market participants have endeavoured to find a workable solution based on trading instruments in the most liquid relevant market under Best Execution. However, the current industry approach is not watertight and should a hard interpretation of the Share Trading Obligation (STO) be enforced,MiFID II investment firms would be prohibited from trading shares on SIX if those shares are also admitted to trading on EU trading venues.This would result in MiFID II investment firms being forced to re-direct order flow from SIX to European venues, even when SIX was the most liquid market. Trapped between Swiss Ordinance and the STOeither those firms directly regulated by FINMA (all members and all Swiss institutions) – trade on a non-Swiss venue, and incur the risk of fines and potential prison time from FINMA, or firms authorised by MiFID II are required to trade on a European venue where they would breach Swiss Ordinance rules. However, in a victory for pragmatism, European firms have applied a loose interpretation of the STO, and the impact has not yet been as severe as some predicted. Changes in liquidity formation have occurred but it is still unclear whether this is down to a shift in activity as a result of the loss of equivalence or a temporary blip and, more importantly, what this will mean in the event of a Hard Brexit in October 2019.

Results so far:

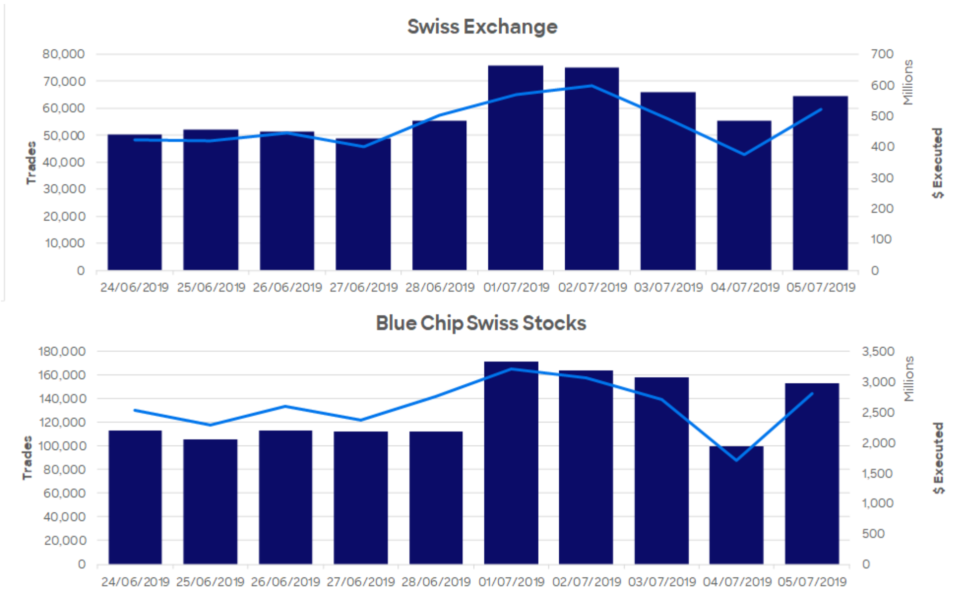
- Primary volumes have increased from around 50k trades per day to ~65k and VIrtex has increased from 110,000 to around 150,000 trades a day (See exhibit 1).
- There was a similar increase in the notional traded, rising from $437m a day in the last week of June to $550m on average in the first week post equivalence on SIX (see exhibit 1).
- The loss of periodics has seen a shift of small-sized orders such as POV and VWAP onto the primary lit books which is typically smaller clips of liquidity (see exhibit 1).
- Spreads on the primary market have widened slightly, this may be due to the increased activity and liquidity on just these two order books potentially making the market less competitive in less liquid names as there is less incentive for market makers to be competitive on pricing. This could potential impact the ability to unwind risk positions which could have a further detrimental impact on market maker appetite (see exhibit 3).
- In the dark market, Six SwissAtMid has seen an almost doubling of activity, although overall market share remains in single figures given that they are the only dark MTF still listing Swiss names (excluding dual listed names) (see exhibit 2).
- The number of executions on Swiss names trading on SIs also increased this week, however the $ notional has fallen, suggesting that smaller trade sizes are being printed on the SIs. Whether this is being done on the ELPs is open to interpretation at this stage (see exhibit 2).

Next: Brexit

Equivalence remains a highly sensitive subject and political posturing is set to continue given that by granting equivalence to Switzerland, Europe may be forced to adopt a similar approach with the UK. There are two concerns here; firstly, the lack of competition in Switzerland offers end investors less choice and this could potentially drive up trading costs over time given that spreads have already widened and liquidity in small and mid-cap names is already challenging; secondly, under a hard Brexit scenario, the ability for the UK and European firms to rely on equivalence also seems unlikely. There are a larger number of dual listed UK and EU stocks and for many the main centre of liquidity is in the UK. However, should the EU force EU firms to trade EU stocks on European venues, the outcome would likely damage European fund performance rather than UK counterparts. Previous analysis by Liquidnet illustrates that just 1% of activity is European to European, under a quarter is European to UK and International trading, with over three quarters of activity occurring without interaction with an EU member[1]. Added to which the European liquidity calculations include EU asset managers who operate funds under a management company which could be delegated back to UK trading desks and as such, would fall under a UK STO, not an EU STO. While the loss of equivalence for Switzerland has resulted in a concentration of liquidity and widening spreads, it is not a given that the same will apply for the UK. A concentration of International, UK and Swiss activity might negatively impact European asset managers more than their UK and international counterparts, as they will potentially have to trade in less liquid markets, making entering or exiting a more expensive strategy. One to watch as Brexit negotiations continue.

SWISS EQUIVALENCE

Exhibit 1:

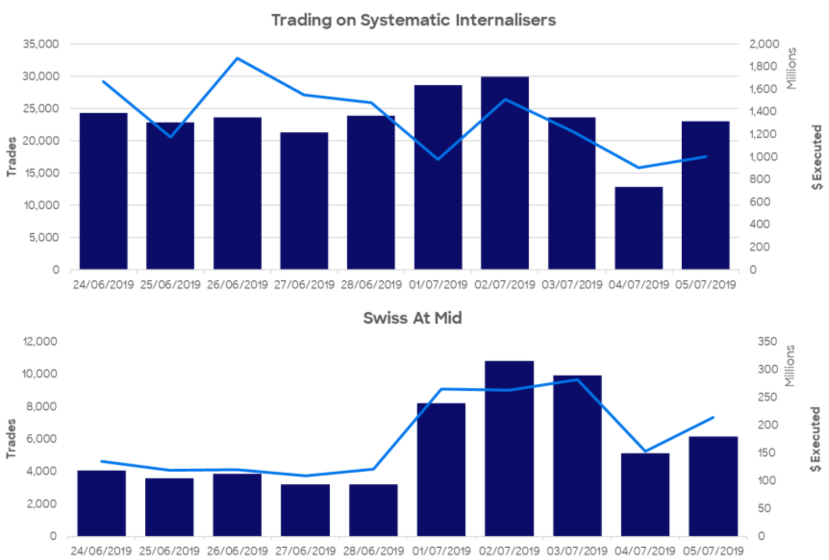


Source: Bloomberg

- On the Swiss Exchange and also on the Blue Chip Swiss stocks we have seen an increase in the number of both trades and the notional executed each day. The dip on Thursday was most likely due to the fact it was Independence day in the US.

- The increase in trading unsurprisingly continued while the number of trades on SIs was the same as the week previous, although the average $ notional filled has fallen significantly.

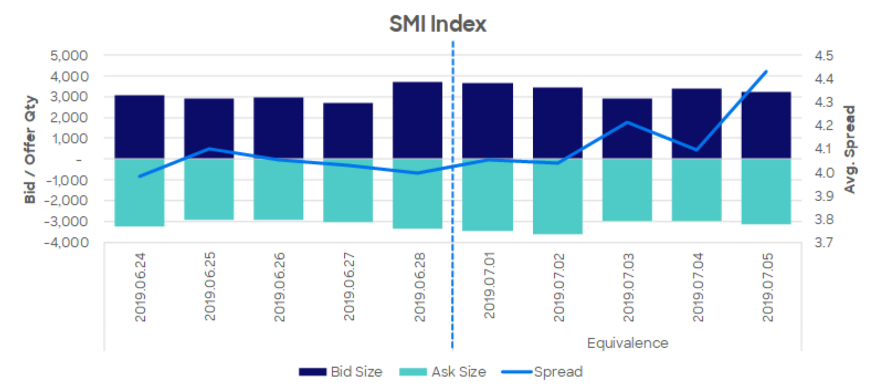
Exhibit 2

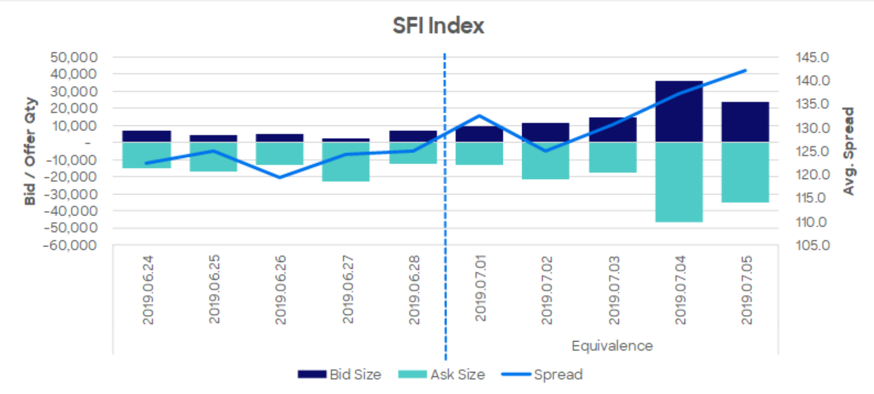


Source: Bloomberg

[1] https://www.liquidnet.com/expert-insights/liquidity-landscape-q1-2019

Exhibit 3:





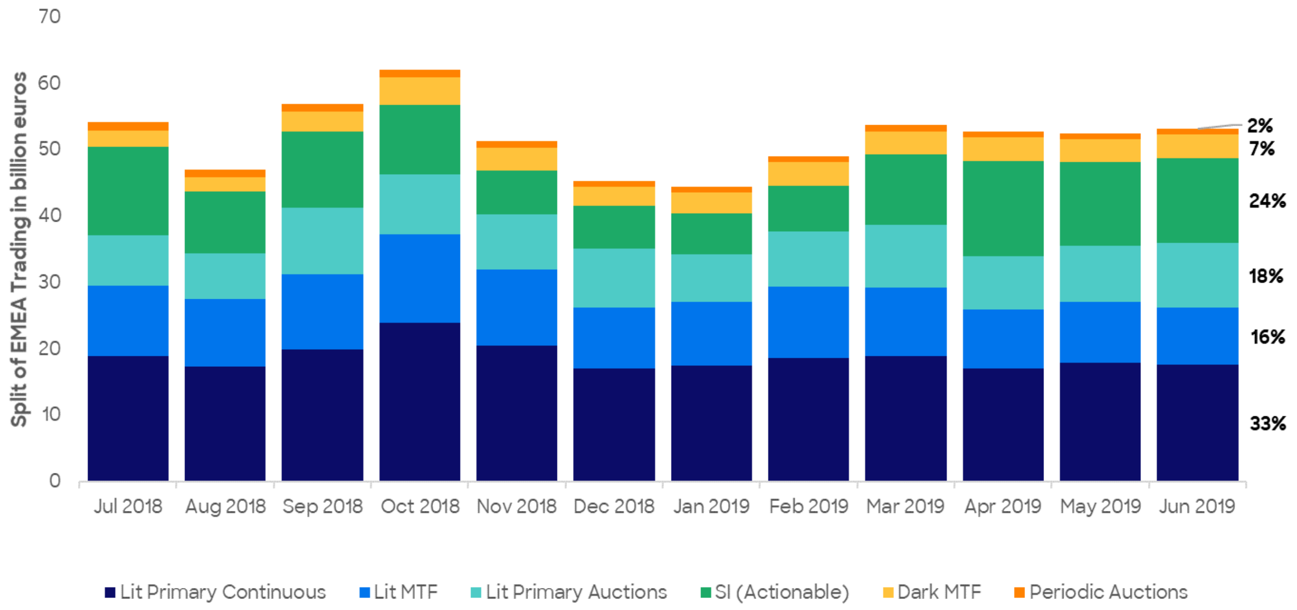
Source: Reuters

- Looking at the two indexes we can see that the SMI has remained quite level in terms of liquidity on the book while the spread has widened slightly. The spread has widened more significantly on the SFI index along with increased order sizes on the bid and offer.
- The increase in spreads is most likely due to a single top of book for passive market share with little incentive for market makers to aggressively price. The 2% passive market share on the rules for the Swiss LPS[2] pushes market makers to ensure they are trading enough to drive them up the queue. The loss of activity on opposing MTFs and without tight requirements, bid/offer spreads could continue to widen. What we don't know at this stage is whether the loss of the ability to arbitrage on different venues has led to some market makers choosing to step away entirely. This will only emerge over time.

[2] https://www.six-exchange-regulation.com/dam/downloads/regulation/rule-book/directives/09-LTC_en.pdf

LIQUIDITY OVERVIEW

Exhibit 4:

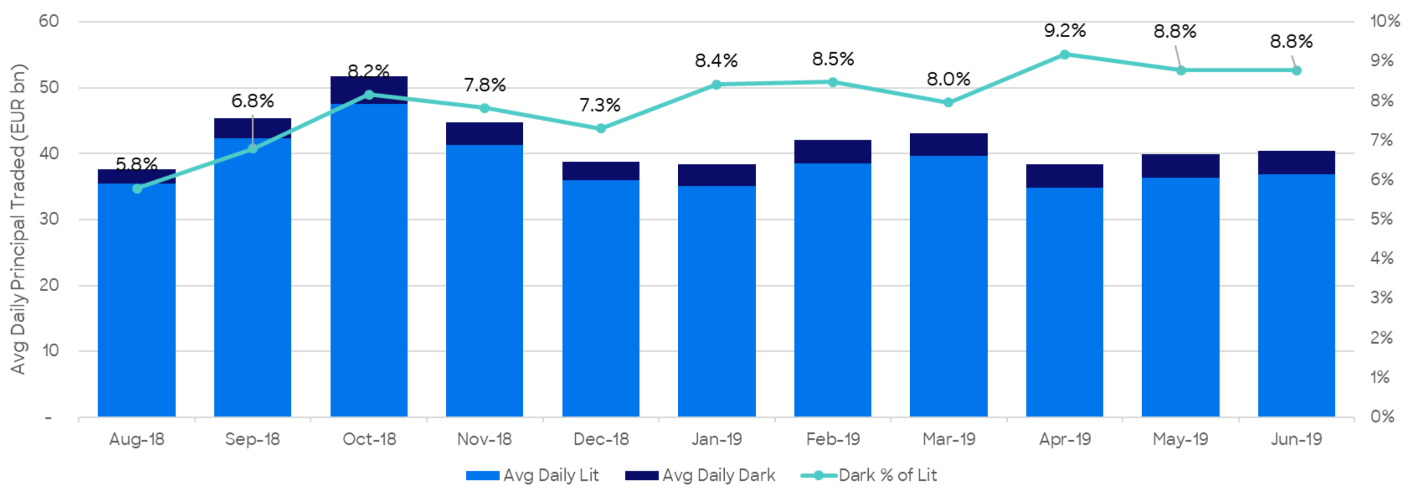


Source: Bloomberg

- Lit volumes account for 67% of the market, while the dark market stagnates around 7%. Periodic auctions maintain their 2% market share; after a steep increase in the first half of 2018, periodic auctions have settled into a regular size of below ~1.00bn EUR per day.
- SI activity grew substantially in the last quarter representing on average 25% of total volumes. SI reporting continues to be challenging with off-book activity often printed as SI activity although it is not technically liquidity you could have interacted with.

OVERALL MARKET VOLUMES

Exhibit 5

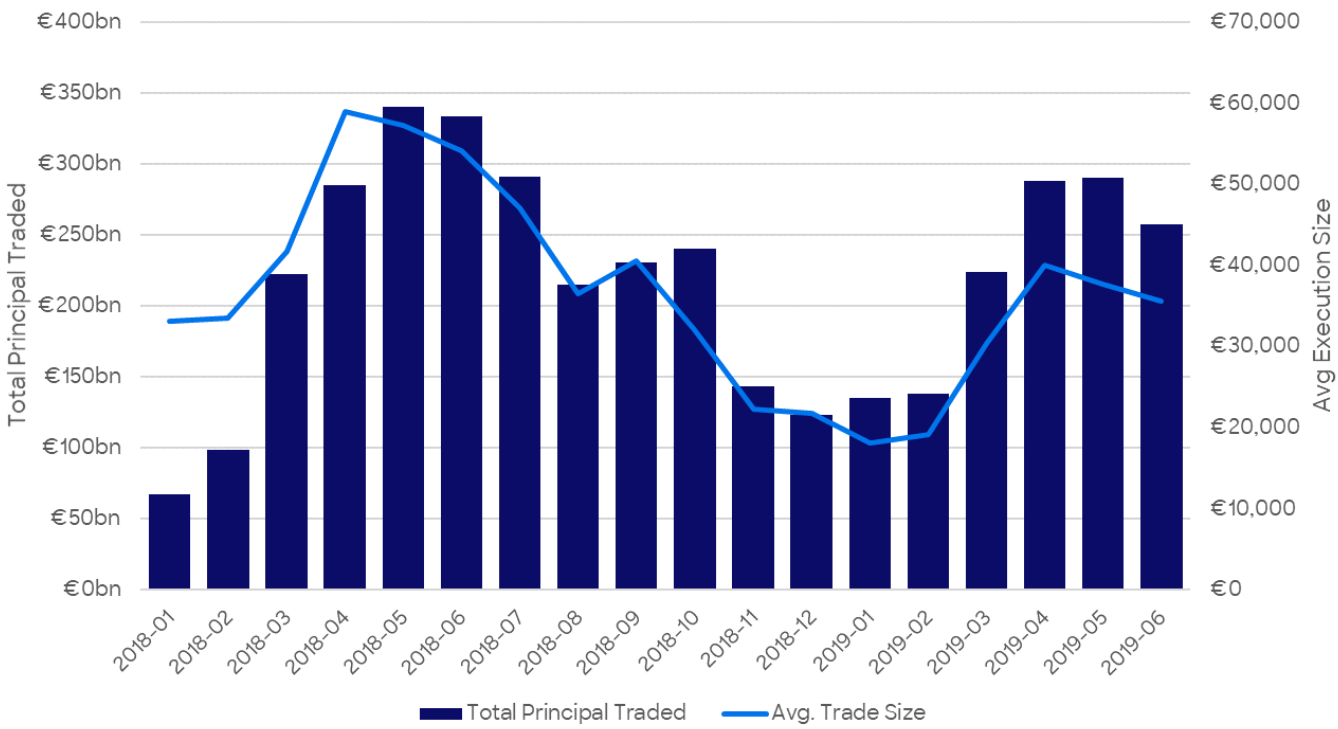


Source: CBOE

- Overall market volumes remain below 40bn EUR in the second quarter as activity has slowed down since January.
- Dark market as a percentage of the Lit remains above 8%. However, it is worth noting that this includes LIS activity accounting for ~33% of dark volumes.

SYSTEMATIC INTERNALISERS

Exhibit 6:

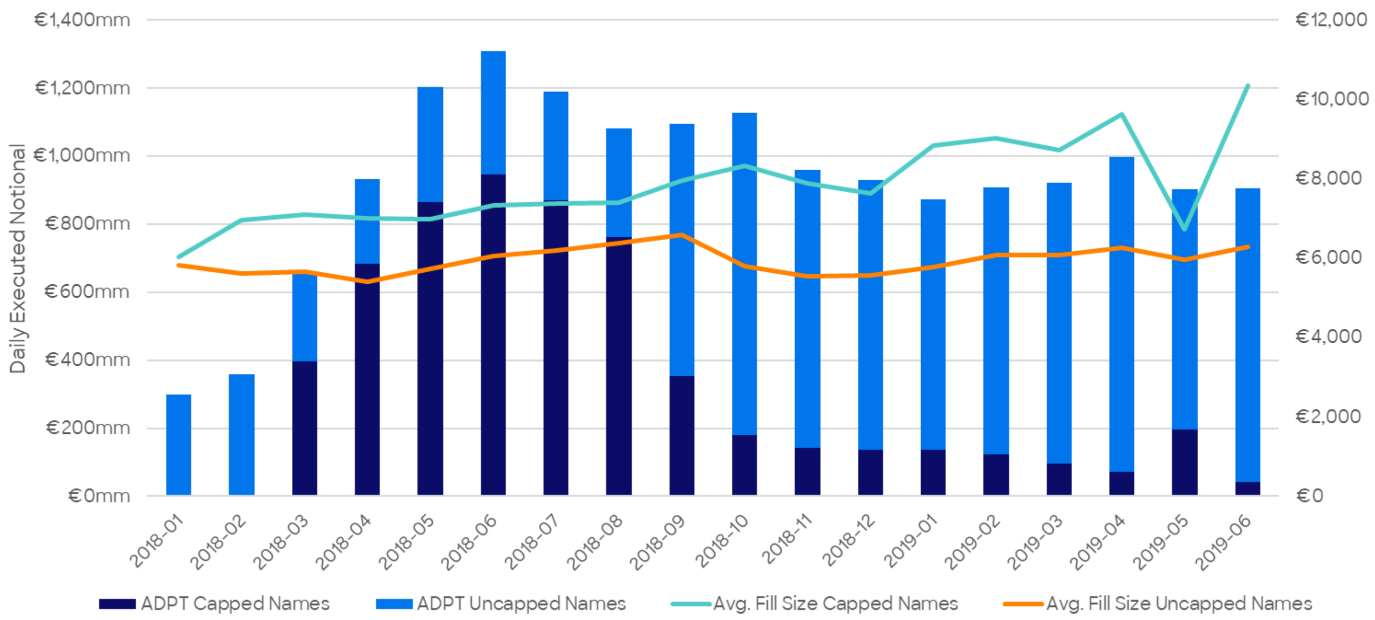


Source: Bloomberg

- SI activity dropped significantly in the first quarter of 2019 averaging 165.6bn EUR but picked up again the second quarter to 278.7bn EUR.
- Coinciding with the drop in activity in the first quarter there has been a continued fall in the average execution size to ~22.4k EUR, which rose again to ~37.7k EUR as activity in these venues increased in the second quarter.

PERIODIC AUCTIONS

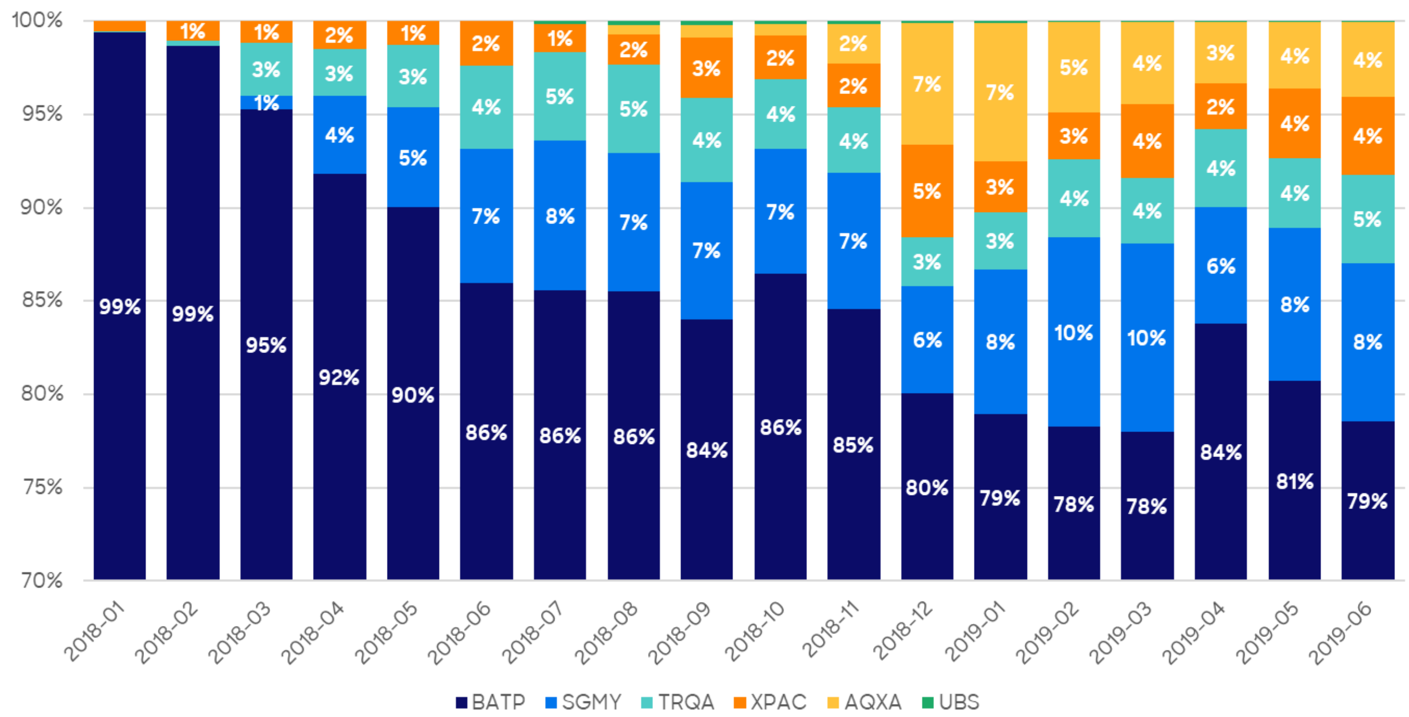
Exhibit 7:



Source: Bloomberg

- Periodic auctions have plateaued in recent months under 1bn EUR per day, down from the highs of 1.3bn EUR in June 2018.
- It is worth noting that the majority of the activity executed on these venues is now in uncapped names. It will be interesting to watch if, in September, when the DVCs may be triggered again for some stocks, the market share for periodic auctions picks up again as a result of firms adjusting their behaviours.
- The average execution size remains stable for uncapped names around 6.1k EUR while it has picked up for capped names in June 2019 to 10.3k EUR.
- Despite increased competition, CBOE remains the biggest participant in this market with~79% of the market, followed by Goldmans Sigma Y ~8% and Turquoise capturing 5% (see exhibit 8).

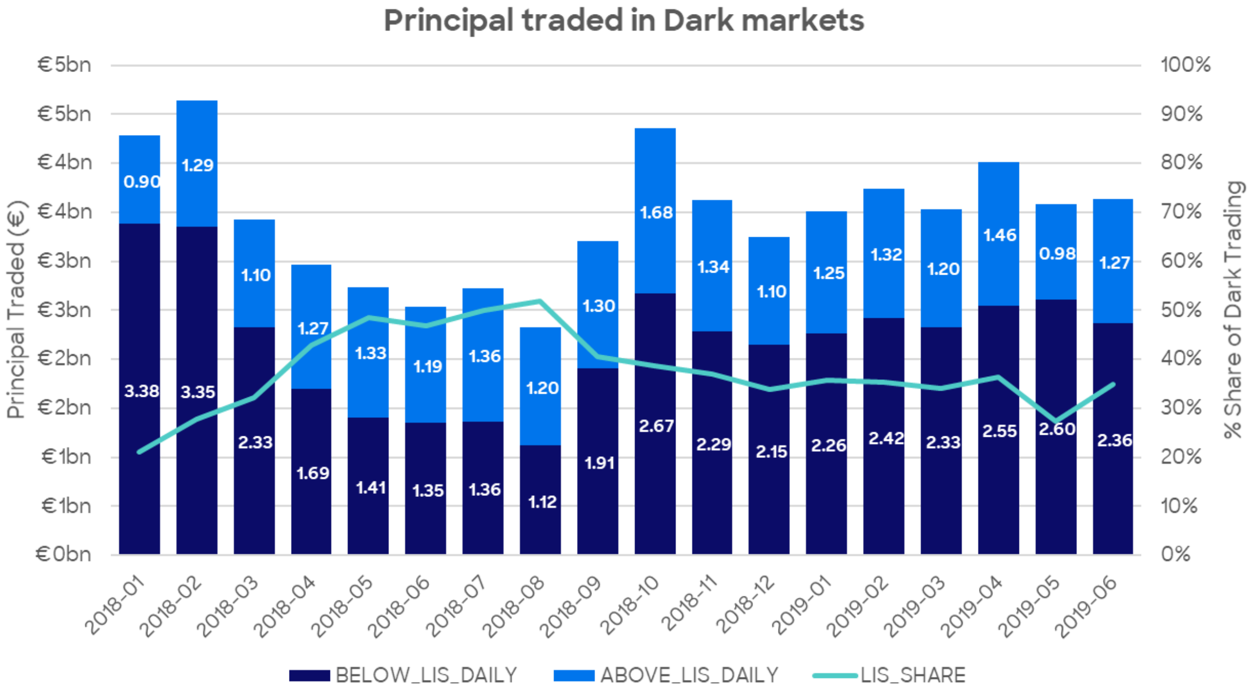
Exhibit 8



Source: Bloomberg

LARGE-IN-SCALE

Exhibit 9:

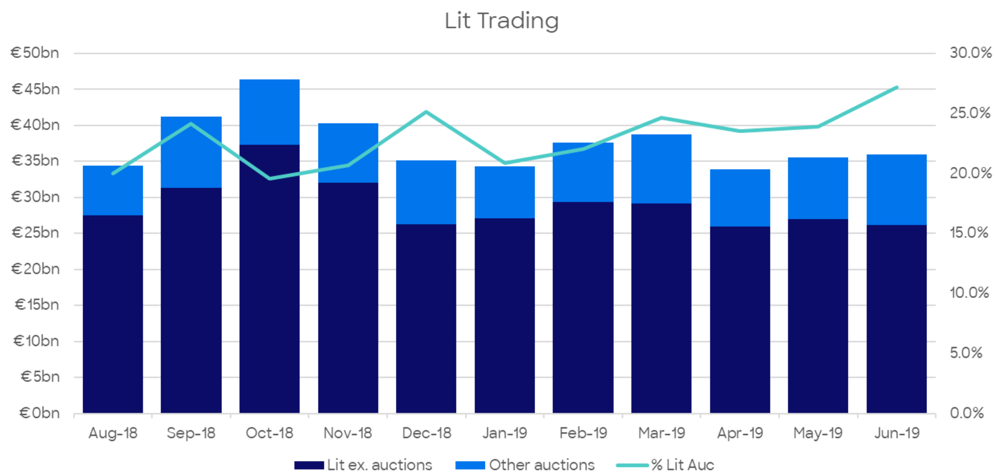


Source: Bloomberg

- Dark activity has stabilised after the first revocation of the DVC suspensions representing ~7% of total volumes.
- LIS trading still accounts for ~33% of the dark market. LIS in notional terms is fairly consistent between 1.00bn and 1.50bn EUR per day since the start of the year and this has continued despite DVC suspensions being lifted.

LIT VENUES

Exhibit 10:



Source: CBOE

- Lit auctions continue to grow now consistently representing an average 25% of lit market volumes
- Q2 2019 has also seen the ADPT fall in lit trading

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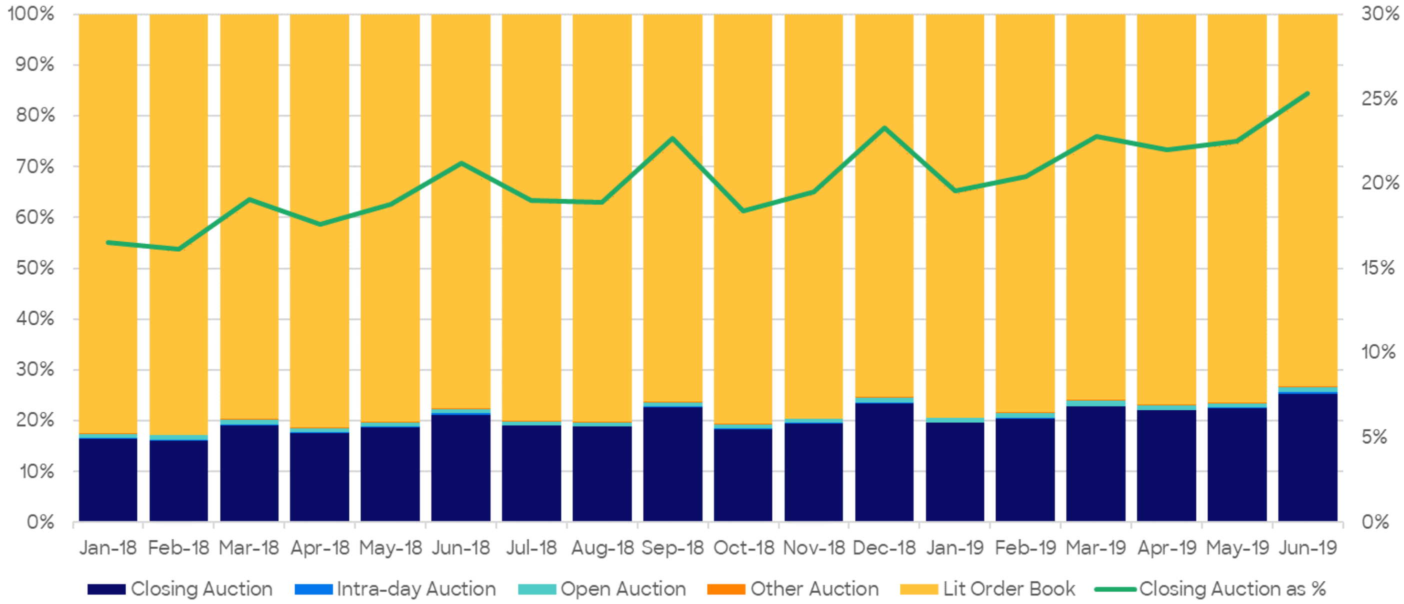
CLOSING AUCTIONS



Source: Big XYT

- Closing auctions have grown in the last 15 months reaching 25% of lit market volumes in June 2019
- While the success of these auctions is the direct result of the growth of index investing and ETFs, participants also feel they get a fairer deal than on continuous lit order books

ABOUT THE AUTHORS

REBECCA HEALEY, HEAD OF MARKET STRUCTURE AND STRATEGY, LIQUIDNET EMEA

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.

JOE FIELDS, EXECUTION CONSULTING LIQUIDNET EMEA

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.**