Liquidnet

Market Structure

Liquidity Landscape

January 2022

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Post the widely anticipated MiFID II/R published by the EU Commission in November, and despite industry hopes, there is likely to be minimal convergence between EU and UK rulebooks to smooth the risk of liquidity fragmentation and mitigate unnecessary operational complexity. While on the surface little appears to have changed, gradual shifts are occurring which could lead to very different trading environments in which to operate. One year on post-Brexit, here's what we have learned:

1. Rise of Regional Parallel Divergence

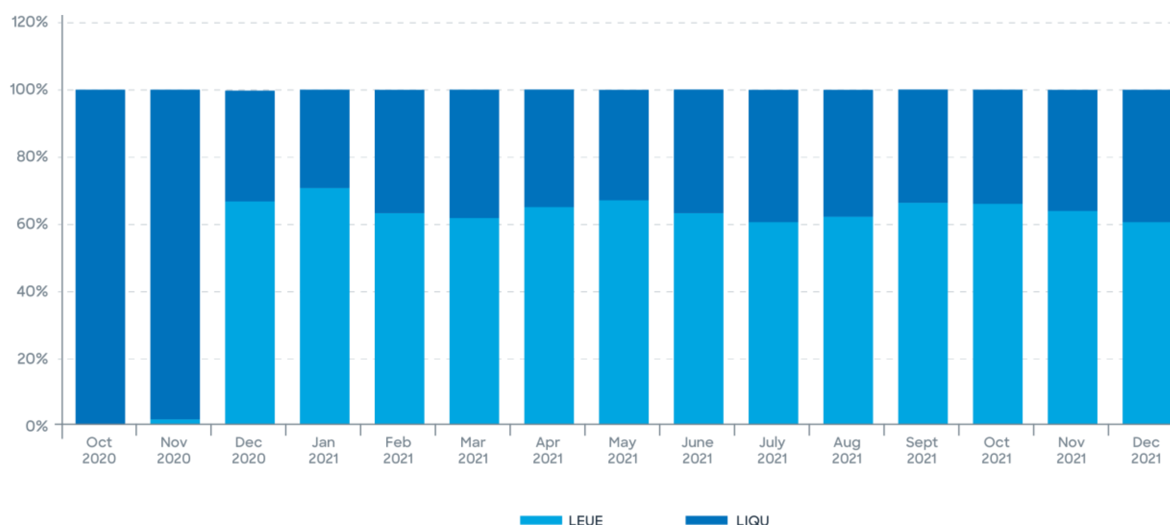
Current prospects to agree on a Memorandum of Understanding (MOU) between the EU and the UK on regulatory collaboration remain low. The political climate on the future relationship between the two jurisdictions only adds to the state of flux regarding future liquidity formation and what firms will need to do to adjust.

Most UK venues set up operations in the EU to ensure continuity of business with volumes in EEA names moving to these venues overnight as Brexit took place, Liquidnet was no exception with over half of EU trading now taking place in Europe (*see Exhibit 1*). However, the diverging regulatory approaches adopted by the European and UK regulators with regards to financial service will likely further polarize the debate. The European Commission published a range of proposals at the end of November 2021 aiming to push more volumes onto lit markets:

- Replacing the DVC with a single volume cap of 7%
- Increasing the minimum threshold for the Reference Price Waiver (RPW) to twice the standard market size (SMS), orders below that threshold are expected to be traded on lit markets
- Increasing Pre-trade firm quotations for SI to a minimum of twice the SMS
- SI can no longer match small trades at midpoint. Matching orders at midpoint within the current bid and offer prices below LIS but above twice the SMS is still allowed as long as tick sizes are complied with. However, matching at mid above LIS can continue unrestricted.

Exhibit 1: Location of EU flow

Split of Liquidnet By MTF

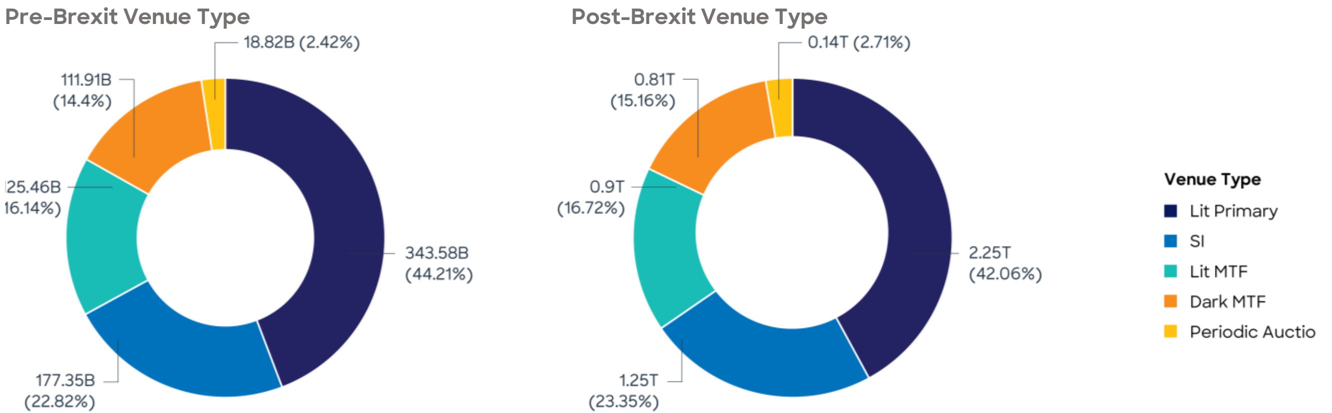


Source: Liquidnet Internal Data Oct 2020-Dec 2021

Understanding Routing Practices

In contrast, the UK has removed the DVC and accepted the dark as a valuable trading mechanism as long as dark volumes remain within a range of 11% and 17%. Similarly, the UK is keen to adopt a more risk-based approach to the advantage of SIs, however the market share of SI appears to have remained stable pre versus post Brexit (*see Exhibit 2*).

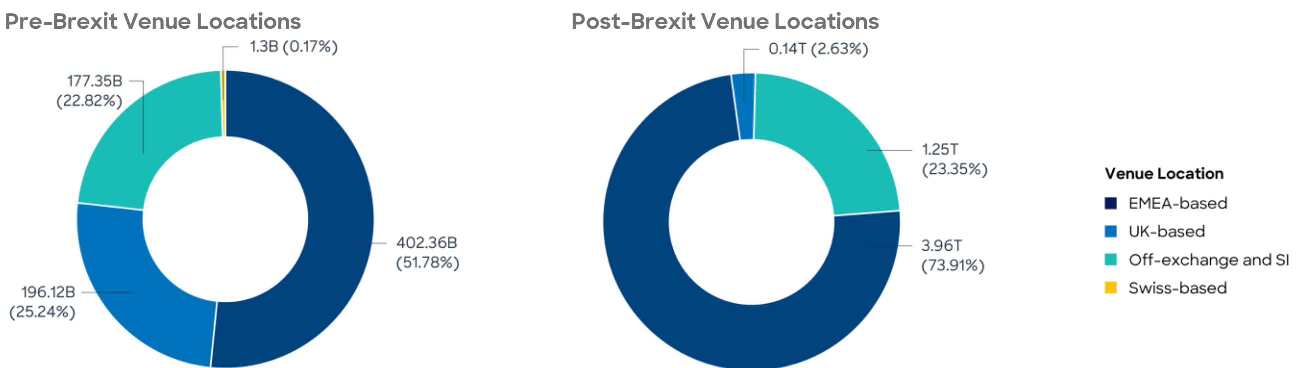
Exhibit 2: Pre- vs. post-Brexit liquidity landscape for STO stocks addressable liquidity only, January 2022



Source: Bloomberg data. STO stocks 1 December 2020-31 December 2021

What is apparent is the need to understand how routing practices are working. Strong concerns remain with EU regulators over the potential lack of oversight of UK trading venues should they start to attract more international and European flow. This concern has not materialised in practice with 74% of volumes in STO stocks still taking place on EEA venues and only 2.63% on UK venues (*see Exhibits 3 and 4*). Another concern on the European side is the lack of oversight over UK clearing houses. Although the European Commission is planning to extend equivalence of UK clearing houses until 2025 to avoid a cliff-edge effect in 2022, the legislator is also looking to publish a consultation to make the EU more attractive to clearing and reduce the over-reliance on the UK infrastructure.

Exhibits 3 and 4: Pre- vs. post-Brexit liquidity landscape for STO stocks addressable liquidity only: Liquidity Landscape H1 2021 vs. January 2022



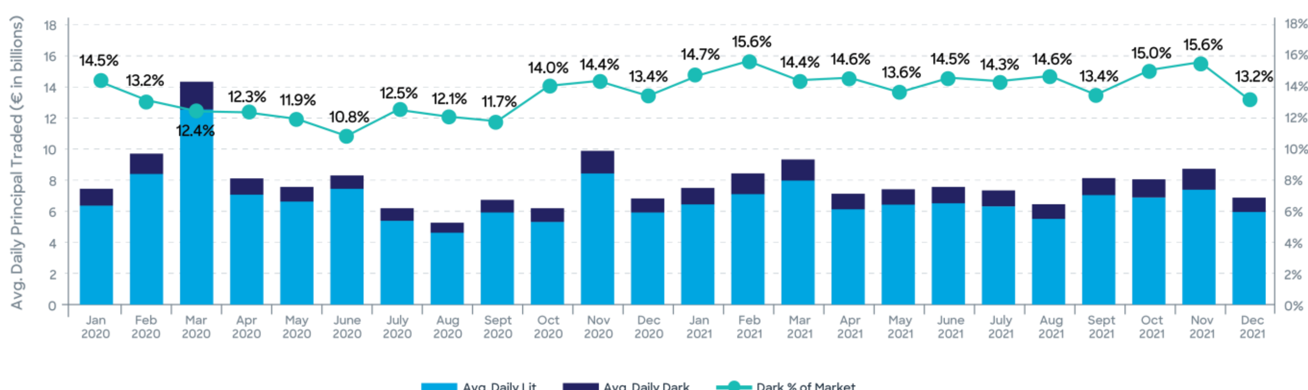
Source: Bloomberg data. STO stocks 1 December 2020-31 December 2021

Should more volumes in EEA shares trade on UK venues in the future, Europe will likely react unfavourably to that shift with delegation arrangements remaining in question. The ability for EU asset managers to delegate services such as portfolio and risk management to third parties based in non-EU countries is further restricted under new EC proposals under the AIFMD review, which introduces more red tape in terms of reporting and a minimum presence in the local management company to avoid the risk of letterbox set-ups in the EU. A more radical approach cannot be excluded if equity volumes were to move outside of the European Union. The EU has now granted Australia, Hong Kong and the US, Share Trading Obligation (STO) equivalence allowing European firms subject to MiFID II to execute directly on these venues. Similarly, Derivatives Trading Obligation (DTO) equivalence was granted to US venues. Meanwhile, UK venues remain outside of equivalence decisions.

2. Evolution of the UK market structure

The UK adoption of a more flexible approach towards dark trading came to a great relief for UK based market participants. However, concerns are now emerging regarding the share of dark trading that rose to 15.6% in November before going down to 13.2% in December (*see Exhibit 5*). The question is at what level does use of the RPW waiver start negatively impacting price formation with the publication of stale quotes? Interestingly the FCA is considering the use of non-UK prices for waivers.

Exhibit 5: Dark trading as a proportion of on-venue trading in the UK

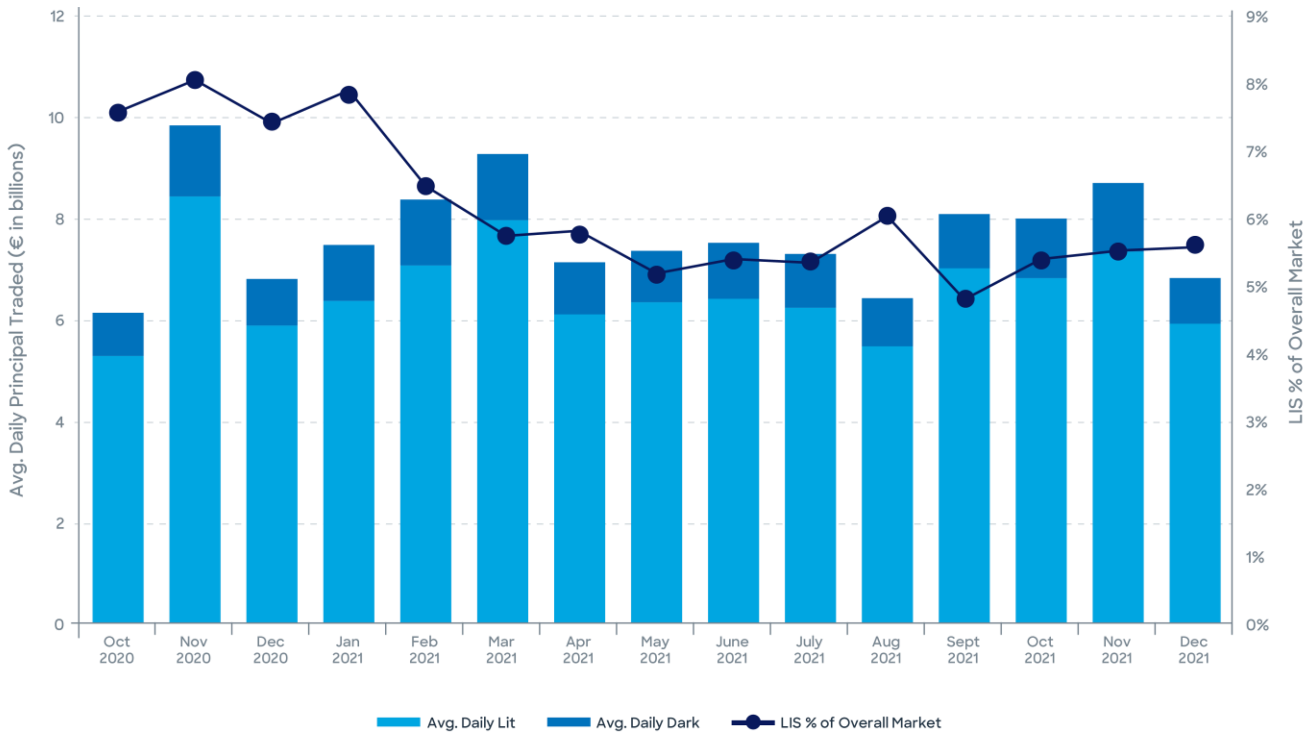


Source: Bloomberg UK based on exchange executions Jan 2020-Dec 2021

The proportion of LIS remains constant over the year of 2021 although it decreased significantly from the levels seen in 2020 (*see Exhibit 6*). This trend was also noticed in Europe throughout 2021 (see *Exhibit 7*). LIS remains an important strategy for asset managers to mitigate their impact and ensure the best outcome for their end investors, but as markets become more fragmented, and smaller size order flow is forced onto lit venues, participants will have to start rethinking trading strategies as a result.

Exhibit 6: LIS as a percentage of on-venue trading in the UK

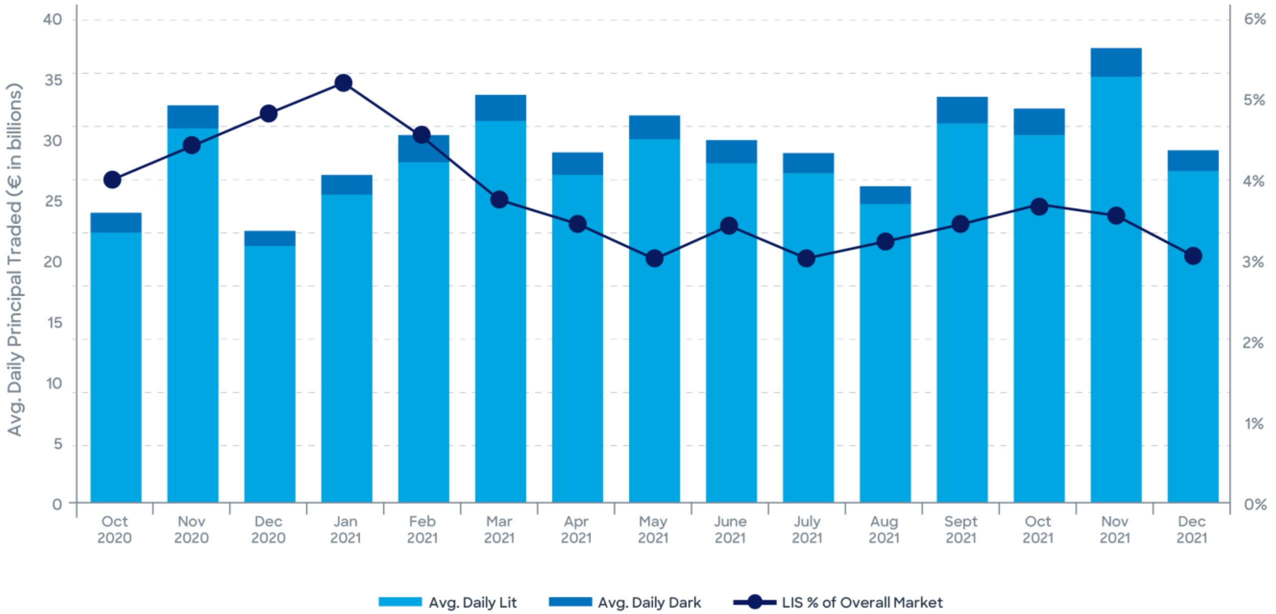
LIS as % of Overall Market



Source: Bloomberg UK based on exchange executions Jan 2020-Dec 2021

Exhibit 7: LIS as a percentage of on-venue trading in the EU

LIS as % of Overall Market



Source: Bloomberg EU based on exchange executions Jan 2020-Dec 2021

3. The Return to the Office, Operational Resilience, and the future of Trading Technology

As more individuals are returning to the office, the emergence of more hybrid working models following the pandemic are likely to re-shape existing financial hubs as more companies start to question their office footprint but also how they source—and pay for talent globally. One side impact of this is in the US where more companies are moving their headquarters to states offering better tax incentives away from the main hub of NYC. With the US and the UK now both considered third countries, delegation of portfolio management to an asset manager in the US or the UK will face the same regulatory scrutiny, with companies likely to favour the best option from a cost/benefit perspective.

With new future trading challenges to address, such as Crypto trading and ESG, **operational resilience** is also set to dominate the post-Covid debate in 2022. The EU launched a consultation in 2021 focused on the role of technology in finance and the growing reliance on third-party providers, sometimes based outside of the EU, for services including cloud computing, over which European regulators have little oversight. The UK is also strengthening its operational resilience oversight, with the Bank of England[1] publishing an announcement stating that firms must have identified and mapped “their important business services; set impact tolerances for these; and initiated a programme of scenario testing” by 31 March 2022. They noted a significant increase in outsourcing, in particular to cloud providers, which requires appropriate oversight and risk management to be in place.

Given the continued focus by Heads of Trading on how to better integrate data and technology into execution processes, another area of note is ESMA’s latest consultation paper on Trading Venue parameters[2] which could have interesting ramifications for **how technology is used to connect liquidity**. Any system which brings together buying and selling interests, even “bilateral interaction” such as RFQ-ESMA considers multilateral in nature and should therefore be registered as a trading venue, regardless of whether it is “using in-house facilities or by employing third-party systems.” Although ESMA notes that communication platforms which provide pricing data or other tools to make trading decisions is not sufficient to require the platform to be authorized as a trading venue, any communication platform that provides the ability to communicate “where the intention to enter into a transaction can be confirmed between the users of such platform” will qualify it as a multilateral system. This includes EMS, unless the EMS in question merely supports the execution of orders on a trading venue and does not allow the interaction of multiple third party buying and selling interests. If the EMS “sends orders for execution directly to specific counterparties instead of trading venues,” it may “be considered multilateral in nature and hence in scope of trading venue authorization.” Single Dealer Platforms come into scope “where the system operator brings together third-party interests, even with a single counterparty, and does not deal on own account, should be regarded as a multilateral system, and seek authorization as a trading venue.” Pre-Arranged Trades (PAT) also come into scope—PAT “is only possible in a multilateral system without authorization as a trading venue when a) all transactions arranged through the investment firm’s system or facility have to be formalised on a trading venue; and b) the transaction

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1 https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2022/january/uk-deposit-takers-2022-priorities.pdf?la=en&hash=C4AF2E8171C532EF391CF8378BEB4E94B7738BE5

2 https://www.esma.europa.eu/sites/default/files/library/esma70-156-4978_consultation_paper_on_the_opinion_on_trading_venue_perimeter.pdf

benefits from a pre-trade transparency waiver on the trading venue where it will be formalised." Europe's approach to shoring up trading venues is even more interesting when you take into consideration the SEC's latest proposals to Form-ATS to make trading venues operate as ATSs[3]—all of which is likely to have further ramifications on how technology will be used in the future and where liquidity will form.

With the FCA set to launch another consultation paper on Equity Transparency in June, the industry looks set for continued change as to which jurisdiction will benefit in the future—regulatory convergence or divergence looks to remain a hot topic in 2022 and possibly not just between the UK and Europe.

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3 https://www.sec.gov/news/statement/gensler-ats-20220126

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