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Market Structure

Liquidity Landscape

MiFID II – The Beginning of the End?

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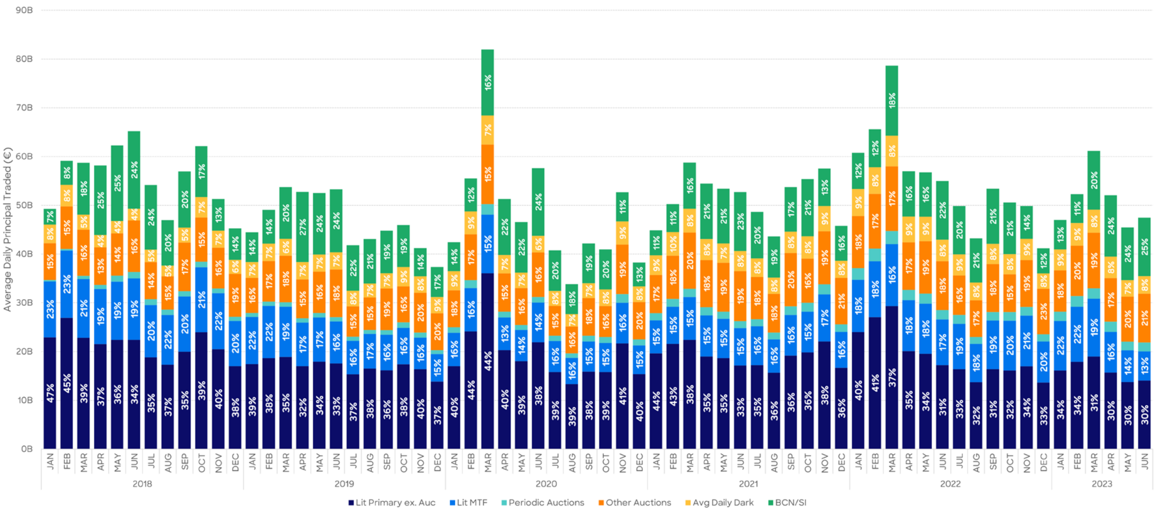
Across global markets, recent rises in interest rates mean fixed income, and even cash deposit accounts, can be competitive with equities for investor's asset allocations. Despite the technology-fuelled rallies, the prospect of higher inflation and an economic downturn has resulted in liquidity in continuous markets remaining light, continuing to challenge participants' ability to execute in volatile markets. With the Swedish Presidency concluding with the EU Council and Parliament agreement on the MiFID II,[1] the regulator's ability to address depressed secondary market activity continues to challenge. Lit volumes set record lows in April, May, and June, falling to 41% of overall activity in June, down from an average 50 – 60% throughout 2018 – 2021.

Exhibit 1

EMEA Flow Breakdown[2]



Source: Cboe and Bloomberg, January 2018 to June 2023

What this means for European Markets

Overall, European equity markets averaged €48.1B in daily value transacted in the first quarter, down 10% over the Q1 2023 average of €53.4B (*see Exhibit 1*). More importantly, lit primary activity (excluding the close) settled at the 30% mark for the first time in both May and June 2023, reinforcing the need to source liquidity outside of intraday continuous trading.

Despite the relative calm that returned to European equity markets in the second quarter after the turmoil of March's banking crises, the threat of recession remains. As central banks continue to respond to increasingly persistent price pressures, interest in ChatGPT and artificial intelligence (AI) drove significant capital flows into the technology and semiconductor sectors, providing some respite for investors. However, with the ongoing war in Ukraine and central banks issuing indications of further aggressive monetary tightening to come, trading is becoming increasingly reactionary to trends and geopolitical issues. This has reaccelerated the trend away from the continuous lit sessions, following a relative plateau in 2022.

[1] Capital markets union: Council and Parliament agree on proposal to strengthen market data transparency – https://europa.eu/!gKbrJ3
[2] All data in this report has been sourced from Liquidnet internal analysis and CBOE and Bloomberg market data.

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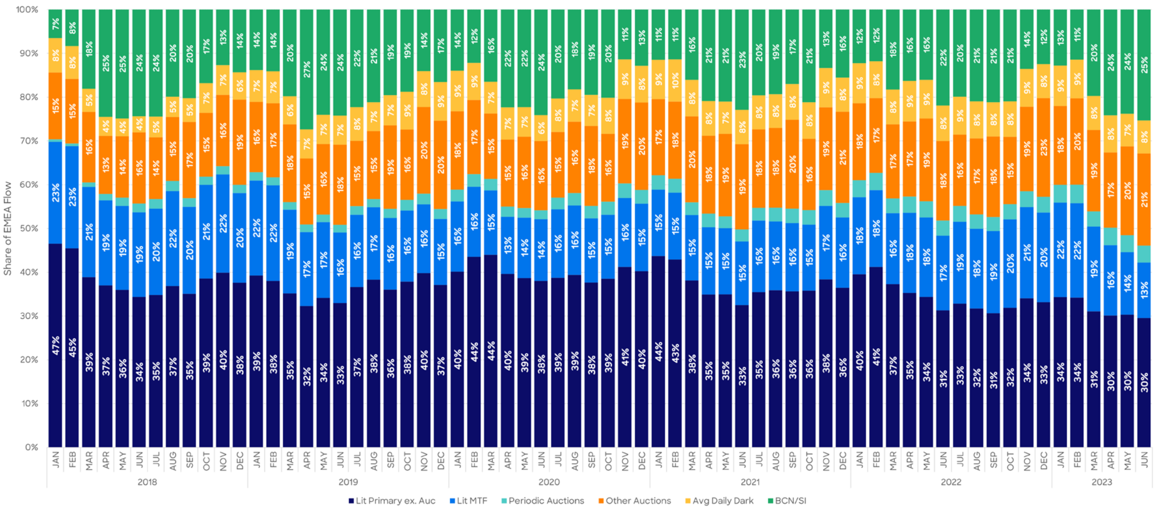
Exhibit 2

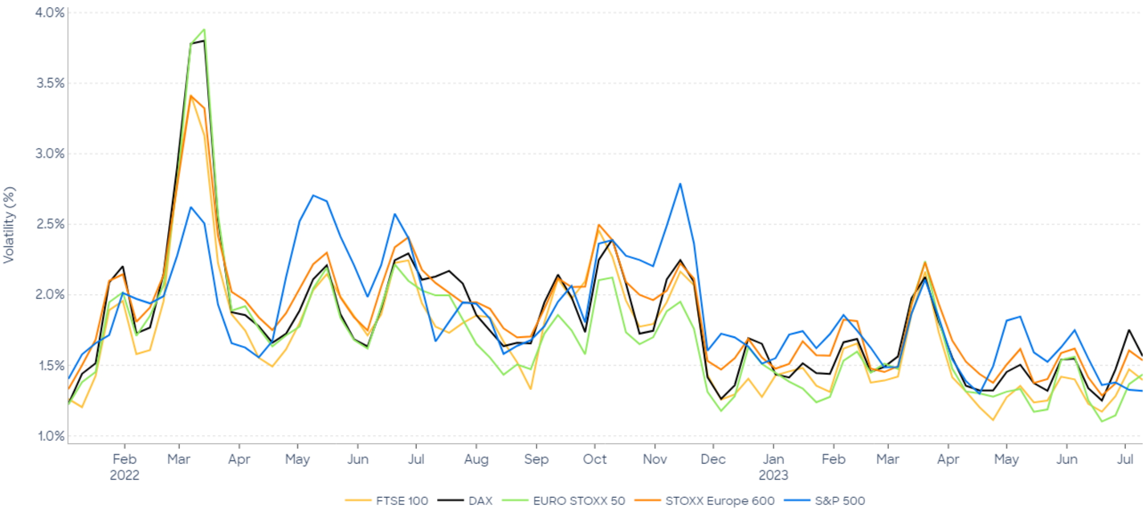
Trend away from the primary accelerates



Source: Cboe and Bloomberg, January 2018 to June 2023

Exhibit 3

Volatility Subsides

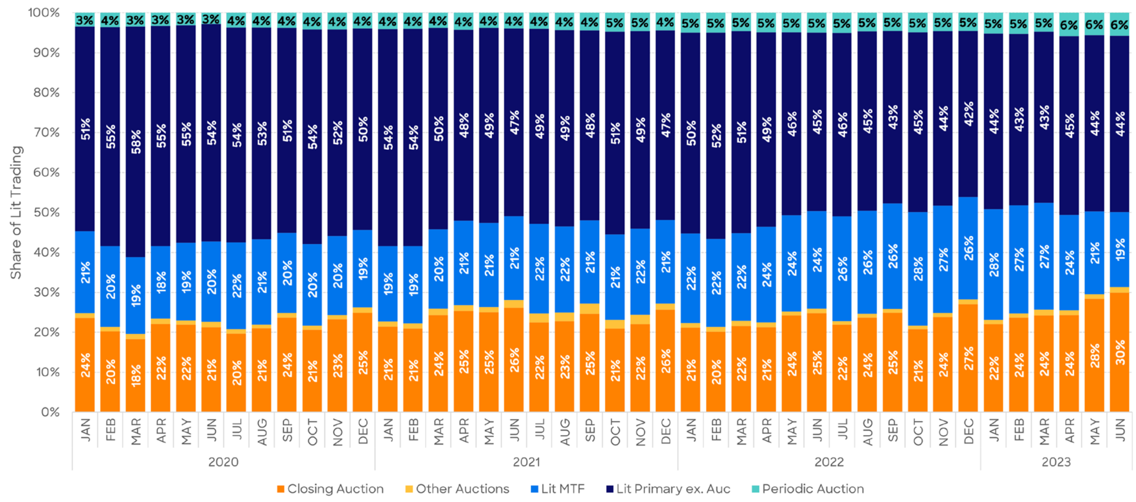


Source: Bloomberg, January 2021 to June 2023

As quickly as heightened volatility emerged during the first quarter's banking crisis, it subsided. Beginning in April, volatility retreated back down, settling at nearly half of the peak seen in March 2023 and down toward the levels of 2021 and winter 2023. Lower volatility generally translates into a lower cost of trading, and market participants may stand to benefit if this lower volatility regime continues through the summer and into the back half of the year.

Exhibit 4

Auction Activity Grows Further

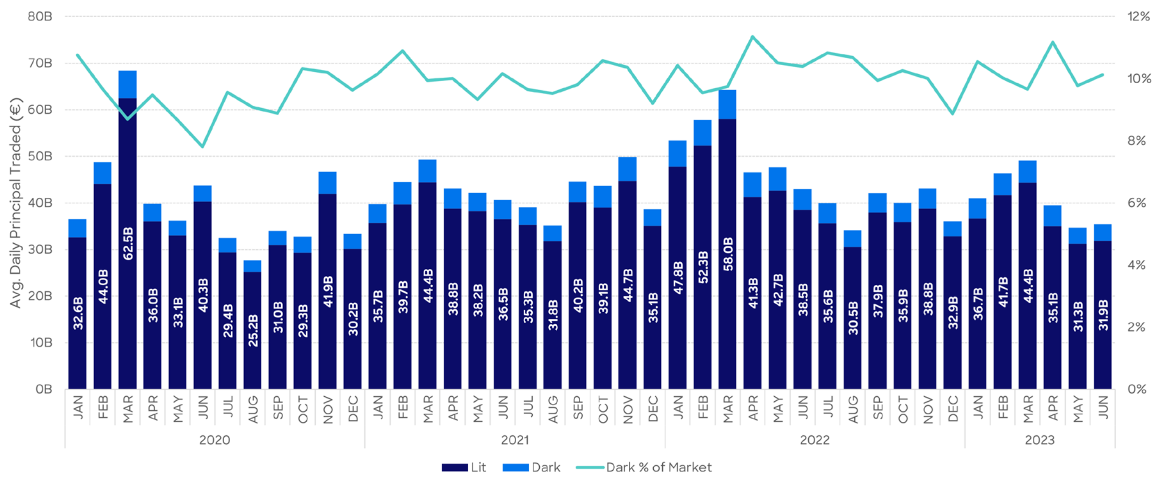


Source: Cboe and Bloomberg, January 2020 to June 2023

Closing auction activity rose to new heights during the quarter, reaching 28% of overall lit activity in May and 30% in June. This shift in volume to the close is at the expense of activity in the continuous session. Periodic auctions continue to grow in popularity, having achieved a consistent 6% lit market share during each month of the quarter. As closing auction volumes keep growing, it will be interesting to see if this incentivizes further acceleration in auction activity, as, if they underweight the auction, market participants risk missing out on such an important segment of price discovery.

Exhibit 5

The Dark Market

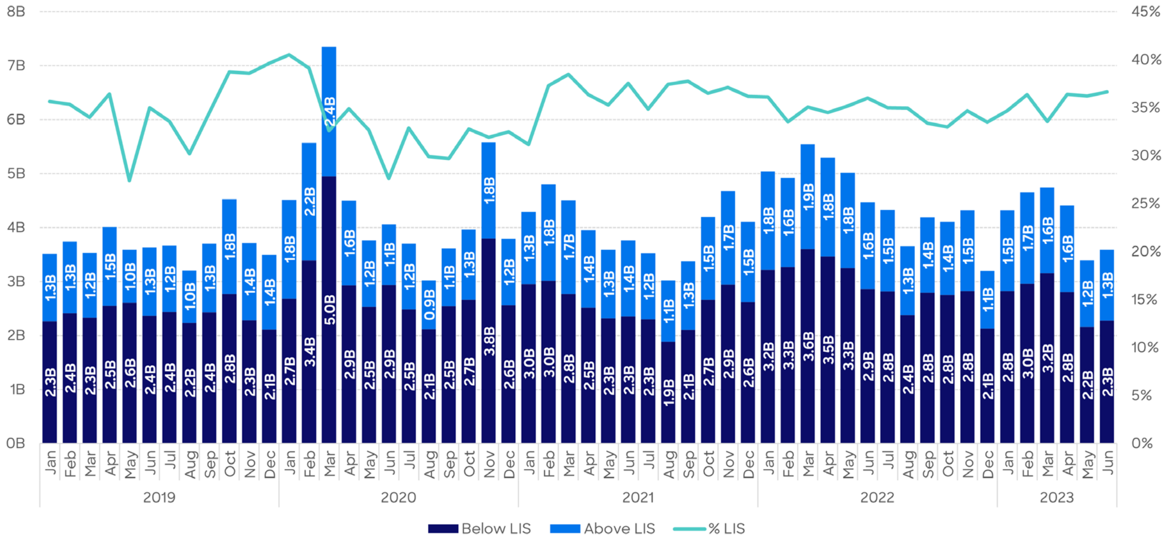


Source: Cboe and Bloomberg, January 2020 to June 2023

Despite historic regulatory concerns over the potential growth in the dark market, volumes over the past three years have remained between 9 - 11% of overall market activity. Dark activity in the second quarter remained in the upper half of the historic range, peaking at 11% in April before settling lower near 10% in May and June. However, the ability to execute in thin liquidity means certainty of execution, rather than price improvement in the dark, will ensure the percentage of dark volumes will remain static.

Exhibit 6

The Large-in-Scale Market

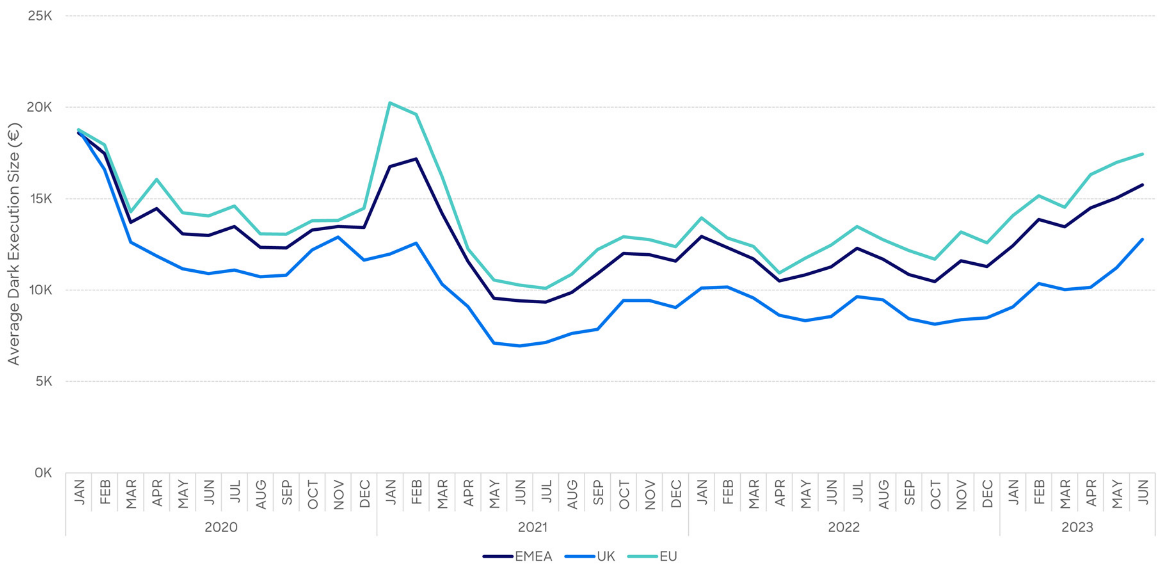


Source: Cboe and Bloomberg, January 2019 to June 2023

Mirroring the decline in overall market volumes, Dark activity declined in the second quarter to a monthly average daily principal of $3.83B, down from $4.6B in the first quarter. However, the Large-in-Scale segment of the dark market saw its share **increase** throughout the quarter, peaking in June at 39% of the dark market. As liquidity shifts away from the continuous sessions, transacting in block and in size can help mitigate market impact and avoid potential volatility in the lit sessions. If current trends continue and volumes keep shifting to the auction and away from the continuous sessions, the benefits of transacting in the large-in-scale market could increase further. Moreover, proactive manufacture of liquidity will grow in importance, alongside the technology and tools that help traders not just access, but generate, liquidity in an increasingly challenging market.

Exhibit 7

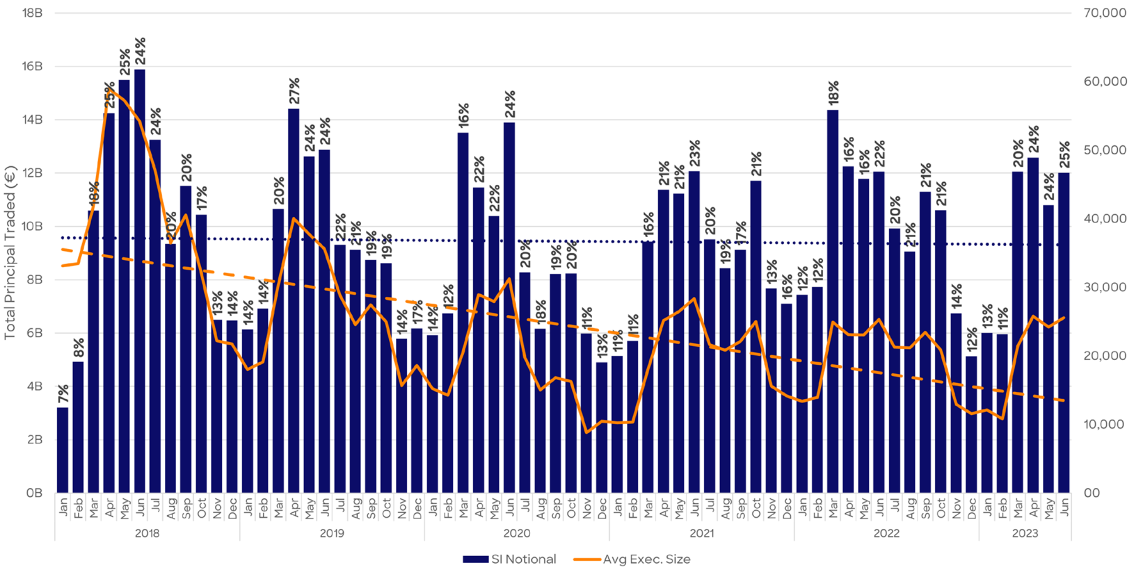
Dark Execution Size



Source: Cboe and Bloomberg, January 2020 to June 2023

In line with the relative growth of the Large-in-Scale market, there was a noted increase in average dark execution size. The growth in execution size was clear and consistent across EMEA, the UK, and the EU. In May, the spread between the UK and other EMEA markets started to tighten, slightly closing the gap which had opened post-Brexit.

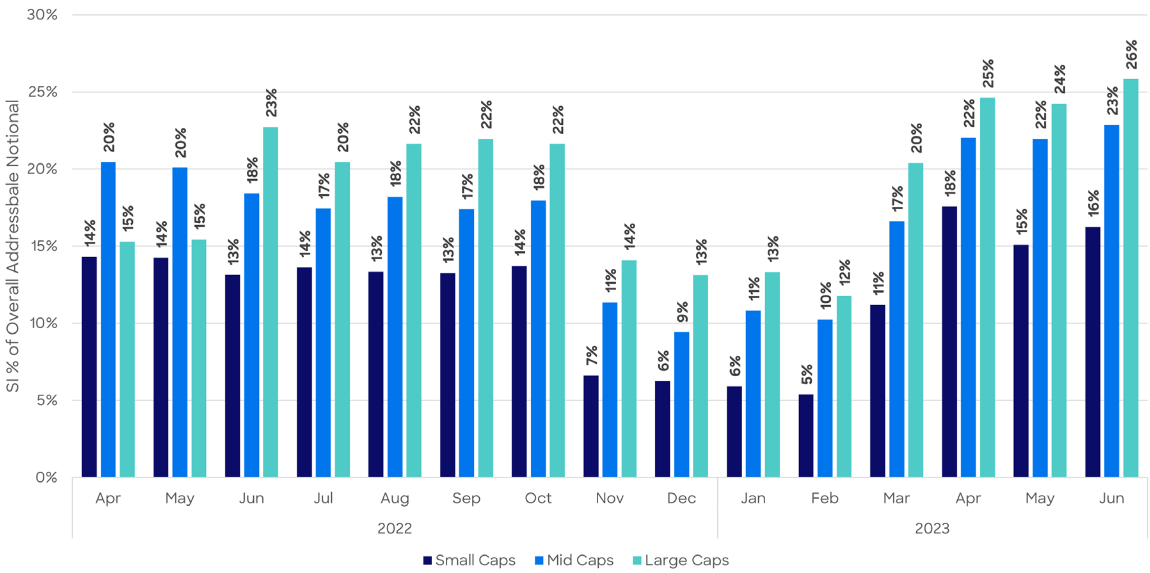
Exhibit 8
Systematic Internalisers



Source: Cboe and Bloomberg, January 2018 to June 2023

SI volumes expanded during the quarter in line with their expected seasonality, rising to an average of 24.6% of overall activity, higher than the norm of the past few years. SI percentage of overall market activity reached 25% in June, the highest level since early 2019. In terms of total principal, SI activity in the second quarter remained in line with previous second quarters, indicating it is capturing market share at the expense of other segments like the lit continuous sessions

Exhibit 9
Systematic Internalisers and SMEs



Source: Cboe and Bloomberg, April 2022 to June 2023

Interestingly SI activity is still dominated by large caps stocks: SMEs SI activity is significantly and consistently lower than that in both Mid and Large Cap names. In June, SIs represented 16% of total Small Cap activity as opposed to 23% among Mid-Caps and 26% among Large Cap. This underscores the challenges traders face when sourcing liquidity in already difficult to trade SME names.

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New Policy Objectives

Widely anticipated, the UK Treasury have now announced plans to rebundle research payments. In an attempt to shore up UK Capital Markets, rebundling research is seen as one step in proposals to "increase returns for pensioners, improve outcomes for investors and unlock capital for (our) growth businesses"[3] according to the UK Chancellor, Jeremy Hunt. The plans also include investing 5% of DC funds to unlisted equities by 2030 could unlock up to £50B of investment to provide access to capital for the high growth companies necessary for the transition to a future greener economy.

While many have dismissed rebundling research payments as not feasible—whether that's due to clients not being willing to pay for research in a competitive environment, or underlying changes in research consumption post unbunding, Covid, and the surge in ESG investing—the UK proposals echo challenges also being raised in Europe. Spain has now taken over the Presidency of the European Council[4] where advancing the green transition through supporting local industry is a key objective of the new presidency, meaning greater focus on Capital Markets Union.

As with UK companies, the greatest challenge in accessing European public markets is finding meaningful liquidity. Europe is grappling with how to engage retail as well as institutional investors to support those organisations which will achieve the Green Deal's aim of a future sustainable economy. Similar to Lord Hill's Listings Act, The European New Listings Act[5] will also be a key cornerstone of the Spanish Presidency's objectives, and also focuses on the ability for investment firms to re-bundle research and execution if necessary or use issuer-sponsored research and to inform clients of this to increase investment in SMEs. Issuer-sponsored research should be produced in line with a code of conduct which ESMA is tasked with creating under RTS—again also proposed under Rachel Hunt's Investment Research review in the UK.[6]

However, the European Listings Act goes further with proposed amendments to restricting liquidity to the main listing venue have been made which are likely to have unintended consequences. While concentrating SME liquidity is laudable, restricting the optionality of SME trading to primary markets potentially makes trading small and micro-cap equities more expensive.

Traditionally trading SMEs relied on uncovering available liquidity off-exchange; the means of facilitating this liquidity now needs to be upgraded. Recent trading activity has demonstrated the importance of being able to put trades together efficiently in fast moving markets when large sections of the market are increasingly dependent on automated workflows, rather than voice trading. Liquidnet analysis of its pool activity found it saved its customers 29.2 bps in EMEA in spread savings and a further 30.5 bps in market impact savings from transacting in block, representing an aggregate notional client savings of $9.6M.[7]

While the Swedish Presidency's proposal only **requires that the issuer has not objected to trading of its shares on the other SME secondary markets** (see recital 6a), the Parliament version introduces wording which **forces another venue to notify and explicitly obtain consent from the issuer to trade its shares on another venue**. The risk here being that issuers may not want their shares to trade on another venue if it creates new requirements for them as issuers. The concern is that if the precedent becomes established, the right of alternative venues to admit stocks (or brokers to trade them off-venue) could be further eroded.

While asset managers in certain jurisdictions are in favour of issuer consent before admission to trading on any venue; this has been limited to fund units and shares which are usually traded in the primary markets, and where members want control over secondary market distribution channels. There is no appetite to restrict liquidity provision in either MTFs or SIs given the current challenges in trading SME equity. Secondly, if the issuer is only able to trade on a single venue, this may lead to home selection bias (for example opting to trade on Deutsche Börse, when in fact there may be more volume on SME Nordics)—making it negative for both the investor and the investee company dependent on the public markets to meet their funding needs. The inevitable consequence from more expensive and illiquid trading would be a withdrawal from public markets and the opportunities for growth that those public markets represent. A further possible consequence could be a transfer of any institutional trading that remains in those instruments from EU venues to non-EU venues.

In the UK, the Hill Review[8] also intends to reform the UK's listing regime to be more attractive to innovative firms, especially in the software, financial technology, and biotechnology sectors. It seeks to counteract the slow movement of listings away from London, most recently made notable by decisions by ARM and CRH to seek listings in New York. Among the recommendations in the report are potential changes to listing rules to allow for dual-class share structures, more inclusive involvement of retail investors, adjustments to prospectus rules, and greater attention paid to the UK's attractiveness as a place of business.

[3] https://www.gov.uk/government/speeches/chancellor-jeremy-hunts-mansion-house-speech
[4] https://spanish-presidency.consilium.europa.eu/en/programme/the-spanish-presidency-programme/
[5] https://www.europarl.europa.eu/RegData/etudes/BRIE/2023/747111/EPRS_BRI(2023)747111_EN.pdf
[6] https://www.gov.uk/government/publications/investment-research-review
[7] Liquidnet analysis of its Small and Micro Cap pool executions in EMEA January through May 2023
[8] https://www.gov.uk/government/publications/uk-listings-review

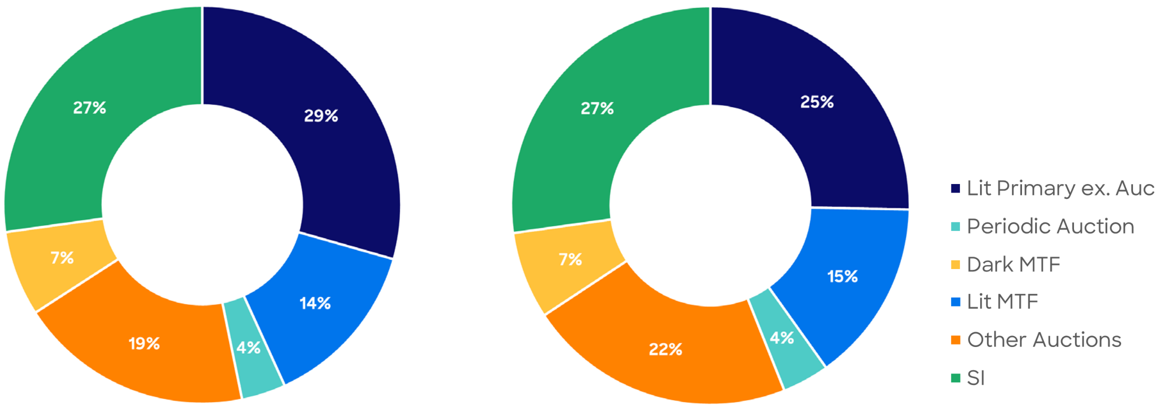
Policy makers seem wedded to the idea that more research will equate to more trading. However, the analysis for small-, mid-, and large-cap stocks illustrates that while off-book volumes remain relatively stable as a proportion of lit primary trading, approximatively 30%, SI activity tends to increase as we go up the market cap spectrum. This highlights that it is more profitable for a bank to cover large-caps over small-caps as it will be rewarded with volume (*see Exhibits 9 and 10*).

Exhibit 10

SME Liquidity Challenged by Lack of Breadth

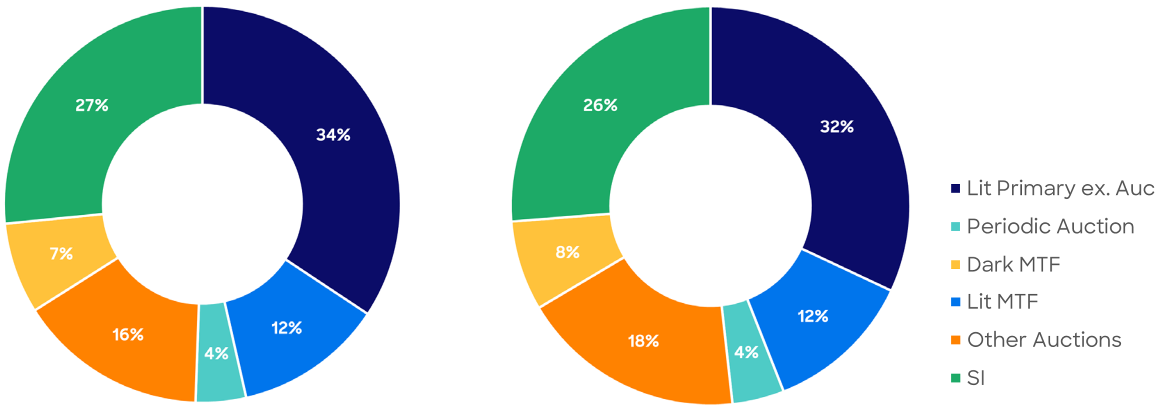
Large Cap

Germany | France



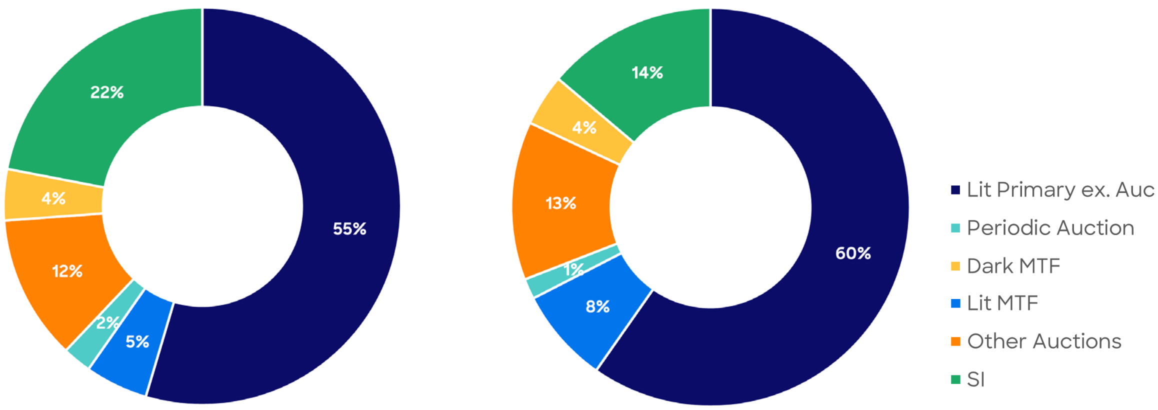
Mid Cap

Germany | France



Small Cap

Germany | France



Source: Bloomberg, April 2023 to June 2023

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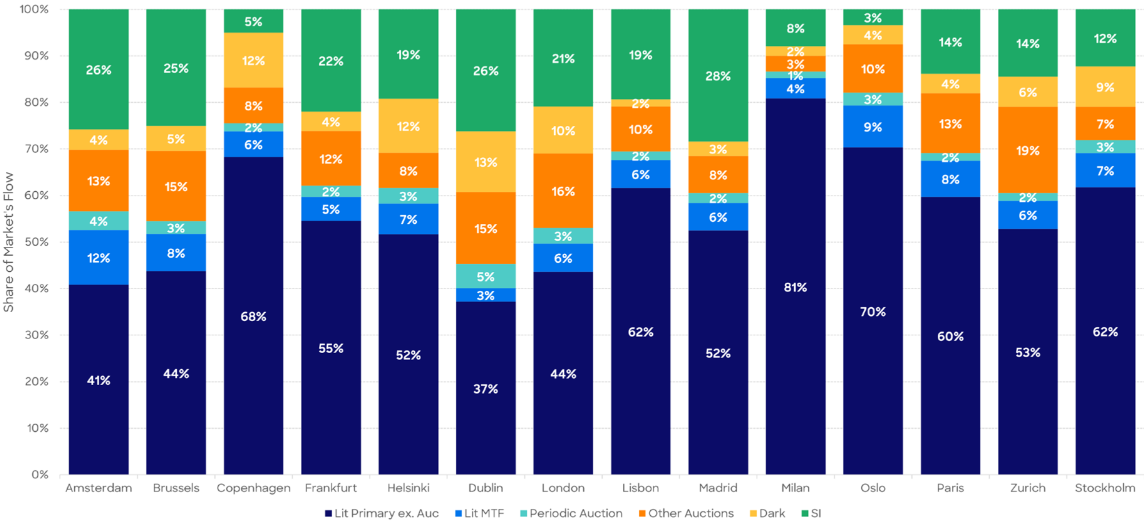
For an investment in a stock with an order size that is 250% of the average daily volume (ADV), executing a small-cap on the lit market is often an onerous if not an impossible task, taking months sometimes to find a counterpart to trade with, and even then, the price can quickly be negatively impacted given the sensitivity of any information leakage. As noted by a medium-sized UK Asset Manager:

"Daily liquidity just isn't suitable; you need a notice period of a year to give time to the fund manager to reallocate with SMEs. Look at the sharp correction post-Lockdown 1– even if you had wanted to sell, you couldn't, there was no one on the other side. Then, as a fund manager you are faced with a wall of reporting, and so when it comes to looking again at investing in a small cap you are going to think again because no one wants to go through the nightmare of reporting every time something goes wrong."

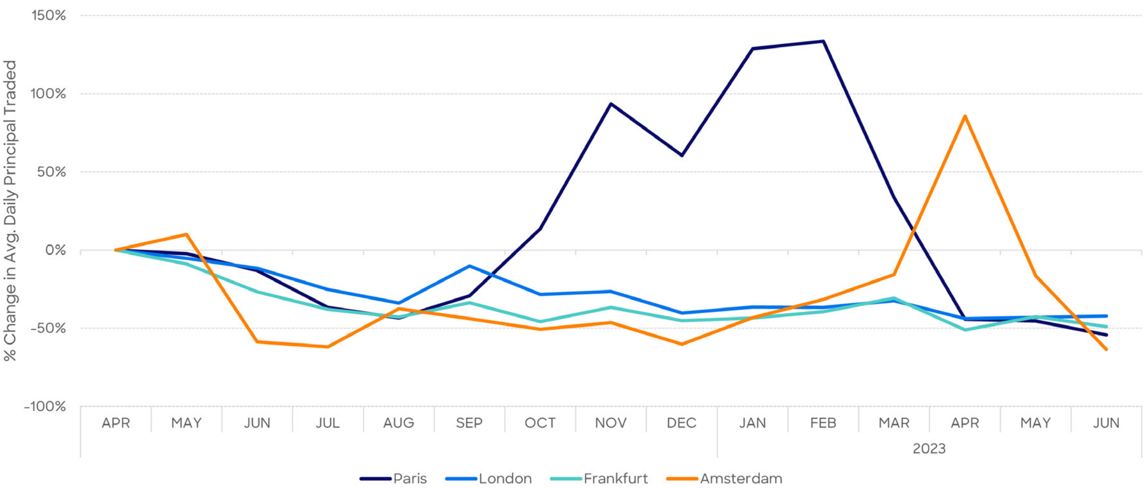
For SME stocks to trade, alternative trading strategies need to be established to **create** liquidity. The data that can be incorporated into the execution process may include unstructured content such as machine-read corporate communications and social media as well as broader structured data—short interest, directors' dealings, volatility, credit indicators, and market events. There is no concept of a global exchange and downloading regulatory filings is a nigh on impossible. Full visibility of trading activity—lit and dark—is required as well as the peripheral factors around that liquidity to build a more holistic picture of how liquidity can be generated, which in turn would provide more confidence to trade—and therefore invest—in small- and mid-cap stocks.

Exhibit 11
Geographic Trends among SMEs



Source: Bloomberg, April 2023 to June 2023

Exhibit 12
Trends in SME Activity in Major Market Centres



Source: Bloomberg, April 2023 to June 2023

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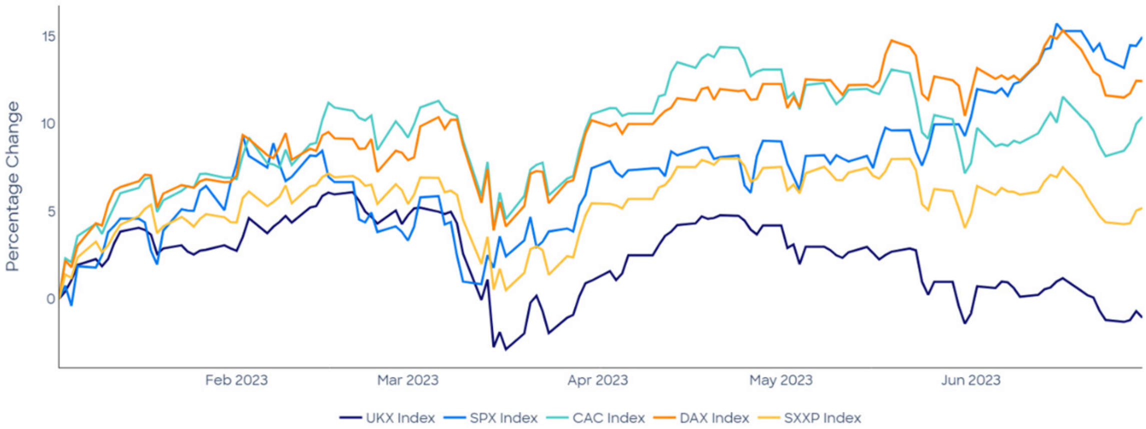
Despite some month-over-month volatility in Paris and Amsterdam, SME market activity has declined over the past year, settling in the second quarter at between 45% and 55% below the levels of April 2022. There is significant regional variation in the distribution of SME flow, with the primary exchange dominant in Italy, Norway, and Portugal, but more limited in Dublin, London, and Paris. As compared with the overall market, SMEs see a far greater proportion of flow on the lit primary—44% SME lit primary vs. 23% overall lit primary in London, 60% vs. 26% in Paris, and 55% vs. 30% in Frankfurt.

Exhibit 13

Divergent Returns and Diverging Approaches



Source: Bloomberg, January 2023 to June 2023

Starting at the beginning of the quarter, deviations began to emerge in index performance across the major European markets following a more tightly correlated Q1. By the end of the quarter, the FTSE100 was the noted laggard, with the DAX is the lead. Moving into summer, it remains to be seen how the evolving macroeconomic climate and continued liquidity challenges may drive markets going forward.

Given the policy maker's objective of SME growth to pivot both the EU and the UK economies to greater sustainability, we can anticipate far more regulatory oversight in the months ahead. With further regulatory announcements on the Consolidated Tape both in Europe and the UK, as well as policy guidance on the Trading Venue Perimeter[9] and the definition of a "multilateral system" coming into force on 9 October 2023—MiFID II may finally be over but regulatory overload is definitely not.

[9] Policy Statement (PS23/11)